The Pakistan Credit Rating Agency Limited

Rating Report

HBL Microfinance Bank (The First MicroFinanceBank Limited)

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
28-Dec-2022	A+	A1	Stable	Maintain	-
28-Dec-2021	A+	A1	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings assigned to the HBL Microfinance Bank underpin the Bank's affiliation with Aga Khan Development Network and Habib Bank Limited (HBL) – one of the largest banks in the country. The bank has been able to devise a sound strategy and established a strong footprint over the years. The bank is categorized among top-notch microfinance banks currently. The bank secures a 22.1% market share amongst the microfinance banks as of end-Sep`22 in terms of GLP. The recent growth recorded in the GLP is a result of enhanced outreach secured by the Bank. The same growth pattern is projected in the future as well; wherein the need to curb infection remains vital. The Bank is the largest provider of Housing Finance in the Microfinance Banking Sector and one of the largest contributors from the microfinance industry in the Government Mark-up Subsidy Scheme (GMSS); as of September 30, 2022, its outstanding portfolio amounted to PKR 6.6bln. During 9MCY22, the bank recorded a sizable improvement in markup income, due to an enhanced portfolio. The sustainability and improvement in fee and commission income have been supplementing the profitability. The bank's higher provisioning expense in 9MCY22 is attributable to the increased specific provisioning. However, the net profitability sustained its growth trend. The investment book is vested in government securities which adds to the liquidity side. Funding is majorly fueled through deposits where high contribution arises from the demand deposits. An increase in the equity base provides a cushion in the risk absorption capacity of the bank. Capital Adequacy Ratio (CAR) was recorded at 16.1% as of end-Sep’22. Further, the strengthening of CAR remains vital. The Bank has already initiated the process of issuance of further capital amounting to PKR 1bln by way of the right issue. The additional capital injection will further strengthen the rapid growth potential of the Bank, going forward. The strengthening of the equity base over the last few years is positive. The industry's parameters are deteriorating on account of pressured macroeconomic indicators, attributable to the aftermath of the COVID-19 and recent flood situation. The relative impact and aftermath on the risk profiles of industry players have been unfolding in the ongoing months. The upcoming two quarters will remain important for the industry players as to the behavior of flood-impacted portfolios as well as relevant guidance from the regulators.

The ratings are dependent upon the Bank’s ability to aptly combat the emerging risks under the current scenario to keep its business and financial risk profile intact. Given the strong business acumen of the sponsors, a distinct focus is vested to continue leading the market with good asset quality. Meanwhile, the Bank’s propensity to protect its performance indicators is imperative..

Disclosure

Name of Rated Entity	HBL Microfinance Bank (The First MicroFinanceBank Limited)
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Microfinance Institution Rating(Jun-22),Methodology | Correlation Between Long-term & Short-term Rating Scales(Jun-22),Methodology | Rating Modifiers(Jun-22)
Related Research	Sector Study | Microfinance(Sep-22)
Rating Analysts	Sehar Fatima | sehar.fatima@pacra.com | +92-42-35869504

Profile

Structure The HBL Microfinance Bank Ltd, "the Bank", was incorporated in 2002 as a nationwide microfinance bank; licensed by the State Bank of Pakistan.

Background The Bank was established through a structured transformation of the credit and savings section of the Aga Khan Rural Support Program (AKRSP), an integrated development program to pioneer the microfinance sector in the country since 1982 in Gilgit-Baltistan and Chitral. The Bank is a fast-growing microfinance bank currently operating with a nationwide network of 214 (end-Dec21: 213) branches with its head office located in Islamabad.

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) Agri-Loan (ii) Livestock (iii) Micro-enterprise (iv) Housing and (v) Others.

Ownership

Ownership Structure The Bank is majorly owned by Habib Bank Limited (HBL) (76.42%), followed by Aga Khan Agency for Microfinance (AKAM) (14.16%), Aga Khan Rural Support Programme (AKRSP) (5.23%), and Japan International Cooperation Agency (JICA) (4.19%).

Stability Shareholding of HBL has enhanced in recent years and its shareholding has grown to 76.42% recently. The ownership structure is expected to stay stable in the foreseeable future.

Business Acumen The business acumen of the Bank is considered strong due to its affiliation with HBL and AKAM.

Financial Strength HBL is renowned and one of the biggest Banks in Pakistan. The Aga Khan Development Network (AKDN) is a group of development agencies with mandates that include the environment, health, education, architecture, culture, microfinance, rural development, disaster reduction, the promotion of private-sector enterprise, and the revitalization of historic cities.

Governance

Board Structure The Board comprises eight directors; which include, four representatives of Habib Bank Limited, two representatives of Aga Khan Agency for Microfinance, one representative of Aga Khan Rural Support Programme, and one representative from Japan International Cooperation Agency. The Board is chaired by Mr. Rayomond Kotwal – currently the Chief Financial Officer of HBL. He has over three decades of experience and has worked in senior finance roles with United Bank Limited, NIB Bank Limited, Citibank NA, Citi Cards Canada Inc., and ICI Pakistan Limited.

Members' Profile All of the Board members are experienced professionals who carry diversified expertise as well as a strong technical skillset. The majority of the members have banking experience which is an added advantage. All of the members are heading different high-profile organizations.

Board Effectiveness The Board has five committees in place: (i) HR Committee (ii) Risk Committee (iii) Audit Committee (iv) IT Committee & (v) Financial Inclusion Committee. During the year, seven meetings were held and attended by seven of the eight members of the board.

Transparency KPMG Taseer Hadi & Co. are the external auditors of the bank. They expressed an unqualified opinion on the financial statements for the year ending December 31, 2021. The internal audit department directly reports to the audit committee creating an aspect of independence.

Management

Organizational Structure The Bank has a horizontally spread organizational structure comprising eleven departments; whereas, ten departments directly report to the CEO. Also, the reporting lines and job descriptions at each level are well-defined.

Management Team The management positions are filled by qualified professionals to strengthen departmental results. Mr. M. Amir Khan joined the Bank as CEO in Jun'12. He brings with him over 30 years of extensive experience in consumer and commercial banking. Mr. Adil Ali Abbasi is the CFO of the Bank.

Effectiveness The Bank has designated various management committees to manage and oversee operational efficacy.

MIS The Bank has a strong MIS infrastructure which includes system-generated reports and detailed live dashboards for efficient and effective decision-making.

Risk Management Framework The Bank has in place a separate Risk Management department to oversee various risks including credit, operational, and market risks. The Risk Management Committee meets on monthly basis to ensure that the risk profile of the Bank remains within BoD's approved limit.

Technology Infrastructure Last year, the Bank upgraded its IT infrastructure, for its core banking and other critical systems, housed in a state-of-the art Tier-3 level data center housed in its Head Office. During the year Bank is in the process of upgrade of its Core Banking System (CBS) to the latest version of Flexcube by Oracle. The CBS is being enhanced with various features and functionalities to keep it abreast with the evolving business and stringent regulatory requirements

Business Risk

Industry Dynamics Pakistan's Microfinance Industry comprises 50 microfinance providers including 30 microfinance institutions (MFIs). During 9MCY22, active borrowers of the industry enhanced to 8.8mln borrowers reflecting growth of 3.5% from last quarter. Similarly, the GLP surpassed PKR 470bln, an increase of ~5% compared to last quarter. Further segregation reveals that MFB's portfolio closed at PKR 360bln while NBMFC's portfolio stood at PKR 110bln. In the case of MFBs, PAR > 30 days increased to 5.95% (CY21: 5.1%) primarily attributable to the impact of the recent floods in the country.

Relative Position The bank secures a 16.40% market share amongst the microfinance banks as of end-Sep'22 in terms of GLP.

Revenue The markup income clocked in at PKR 15.2bln during CY21 (CY20: PKR 11.4bln), depicting sizable growth of 34% YoY, primarily attributable to the enhanced portfolio (microcredit loans). Net markup income grew by 34.7% (end-Dec'21: PKR 8.9bln, Dec'20: PKR 6.6bln). During 9MCY22, Mark-up earned enhanced to PKR 17.1bln (9MCY21: PKR 10.5bln) attributable to enhanced micro-credit loan and high key policy rate. Also, the net Mark up income improved to PKR 7.4bln (9MCY21: PKR 6bln).

Profitability During CY21, the Bank's non-markup expenses increased by 24% to PKR 6.3bln (CY20: PKR 5.1bln). Despite the provisioning expense of PKR 1.8bln in CY21 (CY20: PKR 1.6bln), the Bank's net profitability reflected a robust increase to stand at PKR 1.5bln (CY20: PKR 575mln). During 9MCY22, the non-mark-up income of the bank witnessed an increase to PKR 1.5bln (9MCY21: PKR 916mln) primarily attributable to enhanced fee and commission income. The provisioning expense inched up further to PKR 1.8bln (9MCY21: PKR 1.6bln). Hence, the net profitability clocked at PKR 801mln (9MCY21: PKR 589mln).

Sustainability HBL MfB has upgraded the Loan Origination System (LoS) to Customer Management Solution – an end-to-end digital model used to automate the processes and reduce the turnaround time, has been implemented in 170+ locations at end-Sep'22. Customer Management Solution will be further implemented in 186 locations of the Bank, adding convenience for the customer and robust delivery of service. Branchless Banking (FirstPay) has seen tremendous growth and more than 1.27m+ wallets have been opened since its launch at end-Sep'22.

Financial Risk

Credit Risk The advances (net) clocked in at PKR 77.0bln as of end-Sep22 (end-Dec21: PKR 56.8bln). Non-Performing loans increased to stand at PKR 2.6bln (end-Dec'21: PKR 2.3bln). The PAR-30 ratio stood at 3.4% (end-Dec'21: 3.9%). The coverage ratio reflected a decline to 93% as of end-Sep'22 (end-Dec21: 102%).

Market Risk The investment book clocked in at PKR 22.5bln as of end-Sep'22 (end-Dec'21: PKR 13.7bln) majorly vested in government securities. Investment book to total assets inclined to 18% (end-Dec'21: 12.5%).

Funding The Bank's funding is majorly fueled through deposits (end-Sep'22: PKR 98.2bln, end-Dec'21: PKR 91.3bln), where the major contribution arises from demand deposits. The total borrowing recorded a slight uptick to stand at PKR 6.9bln (end-Dec'21: PKR 4.8bln). The Bank's advances-to-deposit ratio (ADR) increased to 78.4% (end-Dec'21: 62.2%) attributable to an increase in advances book.

Cashflows & Coverages The bank's liquid assets as a percentage of deposits declined to 38.4% (end-Dec21: 48.3%) primarily due to a sizable increase in the deposit base.

Capital Adequacy Capital Adequacy Ratio (CAR) stood at 16.1% as of end-Sep 22 (end-Dec'21: 17%), above the regulatory requirement. The equity base recorded a good increase to PKR 11.9bln (end-Dec'21: PKR 10bln).

PKR mln

HBL Microfinance Bank Unlisted Public Limited	Sep-22 9M	Dec-21 12M	Dec-20 12M	Dec-19 12M
A BALANCE SHEET				
1 Total Finances - net	76,891	56,913	42,207	30,508
2 Investments	22,515	13,730	14,542	4,513
3 Other Earning Assets	8,442	24,534	8,170	3,856
4 Non-Earning Assets	17,346	14,885	12,024	7,926
5 Non-Performing Finances-net	200	(40)	(579)	429
Total Assets	125,395	110,021	76,363	47,232
6 Deposits	98,269	91,363	61,726	38,404
7 Borrowings	6,964	4,883	4,021	-
8 Other Liabilities (Non-Interest Bear	8,252	3,692	3,927	2,781
Total Liabilities	113,485	99,937	69,675	41,185
Equity	11,910	10,083	6,688	6,047
B INCOME STATEMENT				
1 Mark Up Earned	17,144	15,276	11,404	8,522
2 Mark Up Expensed	(9,698)	(6,294)	(4,740)	(3,468)
3 Non Mark Up Income	1,480	1,430	876	768
Total Income	8,925	10,412	7,540	5,822
4 Non-Mark Up Expenses	(5,896)	(6,353)	(5,157)	(4,370)
5 Provisions/Write offs/Reversals	(1,804)	(1,884)	(1,567)	(853)
Pre-Tax Profit	1,225	2,175	815	599
6 Taxes	(424)	(619)	(241)	(168)
Profit After Tax	801	1,556	575	430
C RATIO ANALYSIS				
1 Performance				
Portfolio Yield	28.9%	28.4%	29.7%	30.1%
Operational Self Sufficiency (OSS)	107.0%	114.4%	106.6%	106.5%
Return on Equity	9.7%	18.6%	9.0%	7.5%
Cost per Borrower Ratio	N/A	1.1%	1.0%	1.0%
2 Capital Adequacy				
Net NPL/Equity	1.7%	-0.4%	-8.7%	7.1%
Equity / Total Assets (D+E+F)	9.5%	9.2%	8.8%	12.8%
Capital Adequacy Ratio	16.1%	17.0%	15.0%	15.8%
Capital Formation Rate [(Profit After Ta	10.6%	23.3%	9.5%	7.8%
3 Funding & Liquidity				
Liquid Assets as a % of Deposits & Shor	38.4%	48.3%	41.7%	28.1%
Funding Diversification (Deposits/(Dep	93.4%	94.9%	93.9%	100.0%
Net Advances to Deposits Ratio	78.4%	62.2%	67.4%	80.6%
4 Credit Risk				
Top 20 Advances / Advances	0.0%	0.0%	0.0%	0.0%
PAR 30 Ratio	3.4%	3.9%	2.8%	3.5%
Write Off Ratio	3.7%	2.5%	1.3%	1.8%
Risk Coverage Ratio (PAR 30)	92.6%	101.7%	148.0%	61.3%

Credit Rating

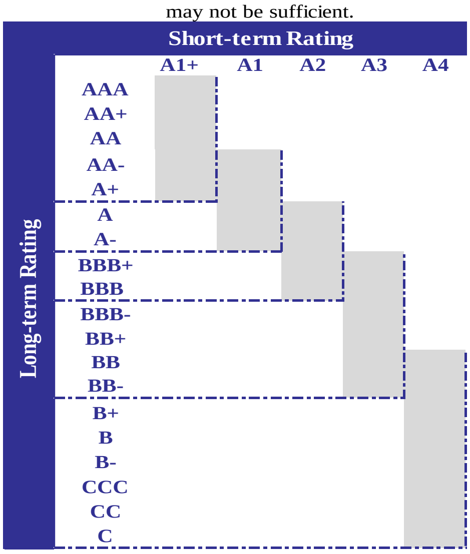
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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 | Clause 11-(A)(p).
(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