The Pakistan Credit Rating Agency Limited

Rating Report

Khushhali Microfinance Bank Limited | PPTFC | PKR 1.5bln | Jun-22

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
19-Jul-2023	B-	-	Negative	Downgrade	Yes
30-Jan-2023	BB	-	Developing	Downgrade	Yes
14-Dec-2022	A-	-	Negative	Maintain	Yes
07-Sep-2022	A-	-	Stable	Initial	-
24-May-2022	A-	-	Stable	Preliminary	-

Rating Rationale and Key Rating Drivers

The lingering impact of Covid-19 along with the impact of the floods in Jul'22, the portfolio credit quality has been impacted severely and the financial risk profile of the Bank has weakened. The recoveries may take time and are uncertain. The weakening of the financial profile has led to a negative bottom line, along with weak asset quality indicators that have placed the CAR below the minimum regulatory requirement and are accordingly recognized in the ratings. The Bank issued the PPTFC-Tier I, amounting to PKR 1,500mln to strengthen the capital adequacy in Aug'22. In view of the declining CAR, the lock-in clause is being invoked on Tier-I instrument of the Bank, preventing any debt repayments for the period the said clause remains in place. The unpaid markup payments were due in a) Dec'22 and b) Jun'23 with next payment falling in Dec'23. The Bank's management plan to recapitalize the bank, however, is constrained by the availability of required confirmed approvals of the same. In the absence of equity support or payments guarantee from existing sponsors, the TFCs are mandatorily required to be converted into common equity as per the loss absorbency clause of the investor's agreement.
On the financial profile side, as of Mar'23, the net investment of the Bank stood at PKR 11.5bln and net advances clocked at PKR 86.2bln (Dec'22: PKR 14.2bln & PKR 86.1bln). The deposit base declined to PKR 96.5bln (Dec'22: PKR 111.8bln) as the Bank reduced the top 20 concentration to 17% (Dec'22: 26%). Repo borrowings escalated to PKR 9.1bln (Dec'22: PKR 2.2bln). During 1QCY23, gross income earned by the Bank stood at PKR 2.2bln (1QCY22: PKR 2.1bln). The quarter ended with a bottom-line loss of PKR 749mln (1QCY22: PKR -707mln & CY22: loss of PKR 3.1bln). As of Jun'23, the CAR of the Bank was below the regulatory limit.
Considering the given scenario, PACRA is revising the rating of the Tier-I instrument from "BB" (double B) to "B-" (Single B Minus) which denotes capacity for continued payment is contingent upon a sustained, favorable business and economic environment.

The strengthening of the capital adequacy as well as the liquidity of the bank is important for the sustenance and review of ratings. Management's commitment to recouping the asset health and consolidating the Bank's position within the stipulated time is an acute necessity.

Disclosure

Name of Rated Entity	Khushhali Microfinance Bank Limited | PPTFC | PKR 1.5bln | Jun-22
Type of Relationship	Solicited
Purpose of the Rating	Debt Instrument Rating
Applicable Criteria	Methodology | Microfinance Institution Rating(Jun-22),Methodology | Debt Instrument Rating(Jun-22),Methodology | Rating Modifiers(Jun-22)
Related Research	Sector Study | Microfinance(Sep-22)
Rating Analysts	Muhammad Azmat Shaheen | azmat.shaheen@pacra.com | +92-42-35869504

Issuer Profile

Profile Khushhali Microfinance Bank Limited ("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%), ASNNOVIB (10%) and Bank AL-Habib (2%). UBL is a "AAA" rated bank with an asset base of PKR 2.98tln and equity base of PKR 214.8bln as of Mar'23.

Governance The Board is chaired by Mr. Robert Binyon. UK National, Mr. Binyon graduated in Modern History from Christ Church Oxford and has a long experience of the banking industry around the globe, starting in 1972 with Morgan Grenfell, the London Merchant Bank. He held a variety of positions in the London Office and had two periods based in Geneva to run the Morgan Grenfell Bank in Switzerland.

Management With over 30 years of experience, the CEO - Mr. Aameer Karachiwalla is a Fellow of the Institute of Chartered Accountants of Pakistan and a long-serving Director and Chairman of the Board of Directors of Khushhali Microfinance Bank Limited. He is also the Chairman of The Board of UBL Insurers Ltd and Director at 1Link. Saleem Akhtar Bhatti is a finance expert with more than 25 years of industry experience. Mr. Aftab Alam is a retail banking professional and Chief Business Officer. He has over 20 years of progressive experience with Pakistan's leading microfinance bank and non-bank MF institutions.

Business Risk The microfinance Bank's asset quality witnessed significant impairment due to multiple factors, chief amongst them was the impact of Covid-19 and high inflationary environment amidst a slowdown in the economy and high interest rates. Recent massive floods took a deep toll as well. Consequently, profitability of entire microfinance sector was adversely affected resulting in capital erosion. All put together, contributed to significant operating losses for many players in the sector and to the extent of breaching CAR prescribed by the regulator. During 3MCY23, the GLP surpassed PKR 377 billion during 3MCY23, an increase of 4.3% compared to CY22. The growth in active borrowers and GLP continues to be driven by the MFB peer group as they managed to add over 162,495 clients and PKR 15.5 billion in GLP. The Bank catered to the borrowers of the microfinance industry as at End-Mar'23, grabbing an 24% market share in terms of Gross Loan Portfolio. On the other hand, the bank secured a share of 20% of total deposits in the industry, as at end-Mar'23. During 3MCY23, mark-up income earned by the Bank increased to PKR 5.3bln (3MCY22: PKR 4.1bln). Markup expense for 3MCY23 increased by 41.7% to PKR 3.4bln (3MCY22: PKR 2.4bln). The Bank witnessed an upsurge of 8.5% in its non-markup income to PKR 433mln (3MCY22: PKR 399mln). The Bank's provisioning expense increased to PKR 1.4bln (3MCY22: PKR 785mln). Consequently, net loss increased to PKR 749mln during 3MCY23 (3MCY22: loss of PKR 310mln).

Financial Risk As of Mar'23 loan portfolio clocked at PKR 81.6bln (CY22: PKR 83.7bln), a decrease due to performance issues of Deferred & Reschedule Portfolios. The bank has increased general provision reserve to 1.04% (Dec'22: 0.7%) against the regulatory requirement of 1.0% on total loan portfolio at the end of Mar'23. The Bank reported Loss Before Tax (PBT) of PKR 1.1bln during 3MCY23 (3MCY22: loss of PKR 483mln) and Loss After Tax (PAT) of PKR 749mln (3MCY22: PKR loss of 310mln). The net markup income enhanced and closed at PKR 1.8bln (3MCY22: PKR 1.7bln). Markup revenue on loans were PKR 4.7bln during 1QCY23 (1QCY22: PKR 3.5bln), the growth of MPR helped offset the losses on rescheduled portfolio. The net profit margin fell due to major increase in markup/interest expense and elevated provisions against advances. During the year under review, Bank's total asset registered a decline to PKR 122.3bln (CY22: PKR 132.1bln). Net advances to total assets also increased to 70.6% from 65.4% (Dec'22). The equity of the Bank decreased by PKR 0.8bln and closed at PKR 7.3bln from PKR 8.1bln of last year.

Instrument Rating Considerations

About The Instrument KMBL issued Rated, Privately Placed Listed/DSLR, Unsecured, Subordinated, perpetual Tier I Term Finance Certificates (TFC) of up to PKR 1,500mln to contribute towards the bank's Tier I capital for complying with the Capital Adequacy for Microfinance Banks. The profit was payable semi-annually, with the rate of 6MK+4%. The instrument is subordinated to the payment of principal and profit to all other claims except common shares. 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 is 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 is 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 is subordinated as to payment of principal and profit to all other claims except common shares disbursement.

Credit Enhancement The transaction is unsecured.

PKR mln

Khushhali Microfinance Bank Ltd	Mar-23	Dec-22	Dec-21	Dec-20
Public Limited	3M	12M	12M	12M
A BALANCE SHEET				
1 Total Finances - net	81,710	83,811	69,648	60,213
2 Investments	11,363	11,137	10,940	17,680
3 Other Earning Assets	315	7,888	12,691	11,548
4 Non-Earning Assets	24,245	26,659	21,859	17,234
5 Non-Performing Finances-net	4,623	2,712	1,386	428
Total Assets	122,256	132,206	116,524	107,103
6 Deposits	96,479	111,792	93,162	88,650
7 Borrowings	13,580	6,675	7,608	2,828
8 Other Liabilities (Non-Interest Bearing)	4,895	5,630	4,569	4,831
Total Liabilities	114,954	124,097	105,339	96,309
Equity	7,303	8,109	11,185	10,794
B INCOME STATEMENT				
1 Mark Up Earned	5,252	20,100	18,653	18,670
2 Mark Up Expensed	(3,448)	(12,595)	(8,961)	(8,732)
3 Non Mark Up Income	567	2,195	1,995	1,543
Total Income	2,371	9,700	11,686	11,481
4 Non-Mark Up Expenses	(2,077)	(7,654)	(6,814)	(6,095)
5 Provisions/Write offs/Reversals	(1,346)	(6,231)	(4,003)	(2,994)
Pre-Tax Profit	(1,052)	(4,185)	870	2,392
6 Taxes	303	1,133	(298)	(652)
Profit After Tax	(749)	(3,052)	572	1,740
C RATIO ANALYSIS				
1 Performance				
Portfolio Yield	22.9%	24.2%	27.7%	31.3%
Minimum Lending Rate	30.8%	32.6%	29.4%	30.4%
Operational Self Sufficiency (OSS)	81.4%	83.4%	103.6%	113.0%
Return on Equity	-38.9%	-31.6%	5.2%	17.2%
Cost per Borrower Ratio	N/A	9,521.9	8,477.0	N/A
2 Capital Adequacy				
Net NPL/Equity	63.3%	33.4%	12.4%	4.0%
Equity / Total Assets (D+E+F)	6.0%	6.1%	9.6%	10.1%
Tier I Capital / Risk Weighted Assets	7.0%	8.6%	13.2%	14.4%
Capital Adequacy Ratio	9.3%	11.5%	18.3%	19.1%
Capital Formation Rate [(Profit After Tax - Cash Divide	-36.9%	-27.3%	5.3%	18.5%
3 Funding & Liquidity				
Liquid Assets as a % of Deposits & Short term Borrowi	15.7%	18.1%	16.7%	32.9%
Demand Deposit Coverage Ratio	239.4%	211.3%	151.5%	349.6%
Liquid Assets/Top 20 Depositors	84.1%	70.5%	97.7%	182.3%
Funding Diversification (Deposits/(Deposits+Borrowin	87.7%	94.4%	92.4%	96.9%
Net Advances to Deposits Ratio	89.5%	77.4%	76.2%	68.4%
4 Credit Risk				
PAR 30 Ratio	8.5%	5.6%	4.2%	3.0%
Write Off Ratio	0.0%	0.0%	0.0%	0.0%
True Infection Ratio	8.5%	5.6%	4.2%	3.0%
Risk Coverage Ratio (PAR 30)	38.8%	45.1%	54.0%	77.4%

Credit Rating

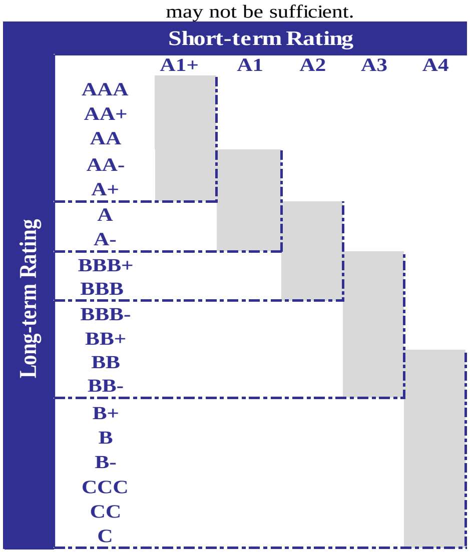
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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):

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

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
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Regulatory and Supplementary Disclosure

Nature of Instrument	Size of Issue (PKR)	Tenor	Security	Quantum of Security (PKR)	Nature of Assets	Trustee	Book Value of Assets (PKR)
PPTFC-Tier 1	1.5bln	Perpetual	Unsecured and subordinatedas to payment of principal and profit to all other indebtedeness of the bank, including deposits and will not be redeemable before maturity without prior approval of SBP	N/A	N/A	The Bank of Punjab (BOP)	N/A

Khushhali Microfinance Bank Limited| PPTFC| Tier 1| Redemption Schedule

Due Date Principal	Opening Principal	Principal Repayment	Due Date Markup/ Profit	Markup/Profit Rate		Markup/Profit Payment	Installment Payable	Principal Outstanding
	PKR			Base	Spread	PKR		

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.