The Pakistan Credit Rating Agency Limited

Rating Report

Telenor Microfinance Bank Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
30-Oct-2019	A+	A1	Stable	Maintain	-
30-Apr-2019	A+	A1	Stable	Maintain	YES
07-Nov-2018	A+	A1	Stable	Maintain	YES
27-Apr-2018	A+	A1	Stable	Maintain	-
23-Nov-2017	A+	A1	Stable	Maintain	-
28-Apr-2017	A+	A1	Stable	Maintain	-
28-Apr-2016	A+	A1	Rating Watch	Maintain	-
08-Feb-2016	A+	A1	Stable	RW-Developing	-
27-Feb-2015	A+	A1	Stable	Maintain	-
27-Feb-2014	A+	A1	Stable	Upgrade	-

Rating Rationale and Key Rating Drivers

The ratings take comfort from association of Telenor MFB ("the bank") with strong sponsors – Telenor Group (~66%) and the recently inducted Chinese Fintech equity partner - Ant Financial, through its investment arm, AliPay (Hong Kong) Holding Limited (~34%). The group's shareholding is expected to go up by the end of CY19, following injection of the next equity tranche. The bank's business profile emanates from its formidable customer base and sustained relative position. Securing a ~17% share in the MFB's gross loan portfolio (GLP) and ~18% in its gross deposits as at End-1HCY19, the bank continues to hold a prominent position in the MFBs market. With the advent of a new investor on board, the bank's strategic direction has shifted towards expanding Pakistan's digital ecosystem through tapping the Mobile-Wallet market potential. Significant developments in this regards are underway. Ambition of a sustainable consumer platform rests upon increasing acquisition, retention and transactional activity in branchless banking (BB) wallets. The substantial increase in expenditures (monitored on a periodic frequency) can be mapped onto the growth initiative of the bank. Rising marketing expenses as part of Bank's strategy to increase digital footprint has resulted in increased administrative costs and affected the profitability ratios for the period under review. In 1HCY19, the bank's bottomline closed in red on account of budgeted BB losses and elevated provision expense on the conventional front. This has majorly stemmed from deterioration in asset health, as NPLs recorded in 1HCY19 rose to ~6.5% of GLP. Resultantly, the bank recorded a significant loss of PKR ~3,917mln during 1HCY19 as compared to a net loss of PKR ~329mln in 1HCY18. Comfort is, however, drawn from the injected and expected equity induction by Ant Financial.

The ratings are dependent upon successful materialization of the devised business plan and achieving break-even in BB in the envisaged timeline, without affecting the overall health of the bank. Any deviation from the desired targets would be considered negative. Meanwhile, revival of conventional indicators - particularly credit quality and growth is imperative.

Disclosure

Name of Rated Entity	Telenor Microfinance Bank Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | MFI (Jun-19)
Related Research	Sector Study | Microfinance(Sep-19)
Rating Analysts	Muhammad Usman | muhammad.usman@pacra.com | +92-42-35869504

Profile

Structure Telenor Microfinance Bank Limited (hereinafter referred to as "Telenor" or "the bank") was incorporated with the SECP in 2005, under the Companies Ordinance, 1984 (now Companies Act, 2017). The Head office of the bank is located in the Central Commercial Area, Karachi.

Background The bank was previously a wholly owned subsidiary of Telenor Pakistan B.V (Telenor Group). In Nov'18, Ant Financial - an affiliate fintech company of the Chinese Alibaba Group, acquired ~34% shares in the bank through its investment arm - Alipay (Hong Kong) Holding Limited.

Operations The bank operates through a nationwide network of 104 branches in the low-income areas within Pakistan, offering a diversified range of lending products. It has been offering branchless banking (BB) services also since 2009 to its clients through its BB Brand "EasyPaisa".

Ownership

Ownership Structure After the aforementioned acquisition of shares by Ant Financial, the shareholding of Telenor Pakistan B.V diluted to ~66% in the bank, while Ant Financial holds ~34% stake as of today.

Stability Ownership structure witnessed a change during 2HCY18 following acquisition of shares by Ant-Financial. Shareholding of Ant Financial is expected to increase by late CY19, following injection of the next equity tranche.

Business Acumen Telenor ASA, the parent company of the Telenor Group is a subsidiary of the Government of Norway. It is one of the world's major mobile operators, headquartered in Oslo, Norway, with operations spread across 13 countries. Inclusion of Ant Financial is considered positive for the bank, as the group is one of the leading fintech conglomerates across the globe. The bank is well poised to avail benefit from the strategic vision and direction of Ant Financial.

Financial Strength Financial muscle of the sponsors is considered even more robust following induction of Ant Financial, as an equity partner.

Governance

Board Structure The overall control vests in an eight member board of directors (BOD). Three directors, including the chairman - Mr. Irfan Wahab Khan, are representatives of the Telenor Group. Due to emergence of Ant Financial as an equity partner, the Board composition has recently been revised. Ant Financial is represented by three directors leading to equal representation from both ownership groups. Two independent directors complete the composition of the board.

Members' Profile The board members carry extensive experience in the telecom industry and financial services. Inclusion of Ant Financial fintech tycoons have added strength to the overall board members' profile.

Board Effectiveness Attendance of Board members recorded in the meetings during the period was good.

Financial Transparency KPMG Taseer Hadi & Co. Chartered Accountants are the External Auditors of the bank. They expressed an unqualified opinion on the financial statements for the year ended Dec'18 and an unqualified review report for the half year ended June'19.

Management

Organizational Structure The bank's operations are grouped under eleven departments with each department head reporting directly to the CEO, while the head of internal audit, reports to the audit committee.

Management Team The bank has undergone several key management changes during the period. Precisely, in February 2019, Mr, Muhammad Aslam Hayat, the Chief Compliance Officer of the bank, took up the role of the CEO (Acting). The new CEO, Mr. Mudassar Aqil (formerly the CEO of FINCA MFB), took charge from 28th October 2019. He carries with him over two decades of experience in the banking industry. In the same month, Mr. Farhanullah Khan joined the bank as the CFO, in place of the outgoing CFO, Mr Murtaza Ali. He too, has a wealth of experience in the financial sector, spanning over two decades.

Effectiveness Telenor has designated various management committees to manage and oversee operational efficacy. An executive committee is in place which comprises the CFO, CHRO (Chief Human Resource Officer), CRO (Chief Risk Officer) and the COO that report directly to the CEO. Asset liability committee is also in place.

MIS Detailed MIS reports are generated to support the senior management in timely and effective decision making. With the paramount focus diverted on the BB front, special MIS reports to monitor the KPIs related to BB progress are generated and presented to the Board on a monthly and quarterly basis.

Risk Management Framework Telenor has an established Risk Division Unit in place to oversee associated risks. The bank has developed and deployed a credit policy manual, which comprises guidelines for risk management framework.

Technology Infrastructure In light of the forecasted increase in traffic on Easypaisa platforms, the bank's technological infrastructure is considered robust.

Business Risk

Industry Dynamics Pakistan Microfinance Industry comprises 41 microfinance providers including 11 Microfinance Banks (MFBs), 15 Microfinance Institutions (MFIs), 6 Rural Support Programmes (RSPs) and 9 other projects. MFBs dominate the Industry with a share in lending portfolio of ~70%. The total Gross Loan Portfolio of MFBs amounted to PKR~206,003mln as at End-1HCY19, recording a meagre growth of ~9% during the period.

Relative Position As at End-1HCY19, the bank held ~17% (End-CY18: ~17%) of the total gross loan portfolio of the microfinance industry, and a ~24% share (End-CY18: ~22%), in terms of active borrowers. The bank's share of the total deposits in the industry stood at ~18% (End-CY18: ~18%).

Revenue During 1HCY19, the bank earned interest/markup of PKR~5,347mln (1HCY18: PKR 3,964mln), a growth of ~35% YoY. The overall operating income depicted growth, but on the contrary, earnings from branchless banking decreased to PKR~3,645mln (1HCY18: PKR~3,848mln).

Profitability As defined in the bank's strategic plan, major expenditure is being incurred in the BB domain for marketing activities in order to attract and retain digital wallet customers. Total spending in the BB front, during 1HCY19, amounted to PKR~5,812mln (1HCY18: PKR~4,527mln). Resultantly, loss before tax from BB operations was recorded at PKR~2,167mln during 1HCY19. On the core banking front, performance indicators also deteriorated in 1HCY19 on the backdrop of delinquency in asset quality. Combined bottomline loss from both core and BB operations was recorded at PKR~3,917mln (1HCY18: PKR~329mln).

Sustainability A strong competitive position persists for the bank. The strategic alliance with Ant Financial is expected to bring synergies, as a result of a collaboration with a leading global fintech company.

Financial Risk

Credit Risk Even though the Bank's loan book represents a fairly diversified product segmentation, as at End-1HCY19, the bank's infection ratio rose to ~6% (End-CY18: ~4%). The bank has written off advances of PKR~918mln during 1HCY19 (CY18: PKR~385mln). Management has cautiously recorded general provision in branches with high delinquency ratio and is of the view that the provisions recorded are adequate.

Market Risk The bank's earning assets comprising deposit accounts, call money lending and investments in market treasury bills made up ~29% of its total assets as at End-1HCY19 (End-CY18:~29%). Investments such as Market Treasury Bills along with nil borrowings, limit market risk and is likely to provide a hedge against interest rate volatility, along with liquidity support to the bank.

Funding The Bank's external funding solely consists of deposits, clocking in at PKR~45,204mln as at End-1HCY19 (End-CY18: PKR~42,275mln), depicting a growth of 7% during the period under review. Deposits pertaining to BB increased to PKR~8,154mln as at End-1HCY19 (End-CY18: PKR~7,426) with growth of 10% during the period, excluding the impact of deposits relating to BISP's payments. Funding mix is shifting from core to branchless deposits, which are a considered a no cost, sticky product.

Liquidity Liquidity profile deteriorated during the period under review as evident by the bank's liquid assets to deposits and borrowings ratio falling to ~37% as at End-1HCY19 (End-CY18: ~50%). The increase in branchless deposits and a fall in investment in government securities has had a two fold effect on the ratio.

Capital Adequacy As at End-1HCY19, the bank's CAR clocked in at ~26% (End-CY18:~35%). Equity injection by Ant Financial in the prior year, amounting to PKR~9,716mln, gave a boost to the bank's Capital Adequacy. This has been somewhat cancelled out by the recent losses incurred by the bank. The next equity tranche in late CY19 is expected to further strengthen the CAR.

Telenor Microfinance Bank Limited

PKR mln

BALANCE SHEET	30-Jun-19	31-Dec-18	31-Dec-17	31-Dec-16
Earning Assets				
Advances	31,889	32,786	24,746	15,851
Investments (Government Securities)	6,613	9,008	6,767	11,568
Deposits with Banks	5,084	3,813	4,139	2,551
Lending to Financial Institutions	7,100	5,473	3,368	323
	50,686	**51,080**	**39,020**	**30,293**
Non Earning Assets				
Non-Earning Cash	5,133	4,262	3,514	3,125
Net Non-Performing Finances	179	159	16	(15)
Fixed Assets & Others	9,031	6,965	4,578	2,901
	14,343	**11,386**	**8,108**	**6,011**
TOTAL ASSETS	**65,029**	**62,466**	**47,128**	**36,304**
Interest Bearning Liabilities				
Deposits	**45,204**	**42,275**	**36,665**	**27,830**
Branch Banking	29,783	34,156	27,225	23,851
Branchless Banking	15,421	8,119	9,440	3,979
Borrowings	-	-	-	-
	45,204	42,275	36,665	27,830
Non Interest Bearing Liabilities	10,072	6,523	5,457	3,888
TOTAL LIABILITIES	**55,277**	**48,798**	**42,122**	**31,718**
EQUITY (including revaluation surplus)	9,696	13,613	4,981	4,576
Deferred Grants	56	56	25	10
Total Liabilities & Equity	**65,029**	**62,466**	**47,128**	**36,304**

INCOME STATEMENT	30-Jun-19	31-Dec-18	31-Dec-17	31-Dec-16
Interest / Mark up Earned	5,347	8,721	6,064	4,487
Interest / Mark up Expensed	(1,782)	(2,595)	(1,767)	(1,113)
Net Interest / Markup revenue	**3,566**	**6,126**	**4,297**	**3,373**
Direct Branchless Banking pre-tax profits	(2,167)	(1,907)	(421)	63
Other Operating Income	524	1,027	712	560
Total Revenue	**1,923**	**5,246**	**4,588**	**3,997**
Other Income	-	-	-	-
Non-Interest / Non-Mark up Expensed	(4,047)	(5,973)	(3,629)	(2,486)
Pre-provision operating profit	(2,124)	(727)	959	1,511
Provisions	(1,695)	(1,387)	(271)	(141)
Pre-tax profit	(3,819)	(2,114)	687	1,370
Taxes	(98)	(402)	(271)	(474)
Net Income	**(3,917)**	**(2,516)**	**417**	**896**

Ratio Analysis	30-Jun-19	31-Dec-18	31-Dec-17	31-Dec-16
Performance				
ROE	-99%	-27%	9%	22%
Cost-to-Total Net Revenue	210%	114%	79%	62%
Provision Expense / Pre Provision Profit	-80%	-191%	28%	9%
Capital Adequacy				
Equity/Total Assets	15%	22%	11%	13%
Capital Adequacy Ratio as per SBP	26%	35%	20%	31%
Loan Loss Coverage				
Non-Performing Advances /Gross Advances	6%	4%	1%	1%
Loan Loss Provisions / Non-Performing Advances	92%	89%	94%	116%
Funding & Liquidity				
Liquid Assets / Deposits and Borrowings	37%	50%	43%	63%
Advances / Deposits	71%	78%	68%	57%
CASA deposits / Total Customer Deposits	56%	49%	51%	53%
Intermediation Efficiency				
Asset Yield	24%	19%	17%	19%
Cost of Funds	8%	7%	5%	5%
Spread	16%	13%	12%	14%
Outreach				
Branches	104	104	85	74

Credit Rating Scale & Definitions

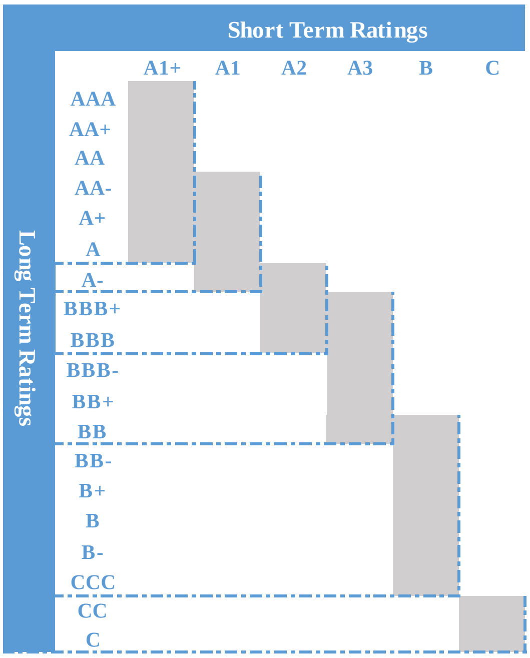
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

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 Ratings

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 conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



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, a) some material identifiable event and/or b) deviation from expected trend. 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 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) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) 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.

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