RATING REPORT

Silk Bank Limited (Silk)

REPORT DATE:
July 1, 2019

RATING ANALYSTS:
Talha Iqbal
talha.iqbal@vis.com.pk

Muhammad Ibad Desmukh
ibad.deshmukh@vis.com.pk

RATING DETAILS				
	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	A-	A-2	A-	A-2
Rating Action	Maintain		Maintain	
Outlook	Stable		Positive	
Outlook Date	*27th June 2019*		*29th June 2018*	

COMPANY INFORMATION	
Incorporated in 1994	**External auditors:** Grant Thornton Anjum Rahman Co. Chartered Accountants
Public Limited Company	**Acting Chairman of the Board:** Khalid Aziz Mirza
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Azmat Shahzad Ahmed Tarin
Arif Habib Corporation Limited – 28.23% Shaukat Tarin – 11.56% International Finance Corporation – 7.74% Zulqarnain Nawaz Chattha – 7.47% General Public Local – 45%	

APPLICABLE METHODOLOGY
VIS Commercial Banks Rating https://www.vis.com.pk/kc-meth.aspx

Silk Bank Limited (Silk)

OVERVIEW OF THE INSTITUTION	RATING RATIONALE

OVERVIEW OF THE INSTITUTION

Silk Bank Limited (Silk) was incorporated as a public listed company in 1994. Ownership of the bank is shared by Arif Habib Corporation, Mr. Shaukat Tarin, Gourmet Group and International Finance Corporation.

Profile of Chairman

Khalid Aziz Mirza served for 13 years in various positions in Investment Corporation of Pakistan (ICP), and Credit & Finance Corporation London, Subsequently, for about two decades, he remained on the professional investment staff of the International Finance Corporation (IFC) (Member, World Bank Group).

Profile of CEO

Azmat Shahzad Ahmed Tarin's experience spans over three decades. Mr. Tarin has been serving the bank in his current position since 2008.

RATING RATIONALE

Silk Bank Limited (Silk) is a commercial bank that is categorized as a small to mid-sized bank with market share of 1.0% (2017: 0.9%) in deposits as at end-2018. The bank operates through 123 branches (2017: 123) including 30 (2017: 30) Islamic branches located across the country.

In the ongoing year, the bank plans to add 35 new branches. In order to provide a platform to cater to unbanked population, the bank plans to launch digital banking to increase its outreach. By introducing the "smart branch" concept, Silk will also increase its distribution footprint and increase number of branches at strategic locations across the country.

Key Rating Drivers:

Corporate financing depicted increase despite curtailment plans while consumer portfolio continued growth momentum. Despite accretion of fresh NPLs, overall asset quality indicators improved on account of faster growth in advances while provisioning coverage also increased. Asset quality pressures may result from a) sizeable concentration of advances to closely-linked groups/companies and b) sole proprietors/partnerships operating business of general trading. Accordingly, close monitoring of exposures is warranted. Management draws comfort from strong sponsor profile of such clients which is expected to support timely repayments.

Gross advances of Silk increased by 14.9% to reach Rs. 103.6b (2017: Rs. 90.1b) at end-2018. Overall market share of the bank in advances was reported at 1.3% (2017: 1.4%) in 2018. Increase in advances was primarily manifested in corporate (including Islamic financing) and consumer portfolio. A sizeable portion of advances within Islamic financing was extended to individuals operating as sole proprietorships. Corporate loan book (including Islamic financing) continues to represent major portion of Silk's financing portfolio.

Despite fresh accretion of non-performing loans (NPLs) (increasing by 13.9% in 2018), asset quality indicators of Silk improved due to faster growth in advances. Resultantly, gross infection in the portfolio decreased slightly to 6.4% (2017: 6.5%; 2016: 8.4%) while total provisioning coverage was higher at 78.1% (2017: 73.2%). However, asset quality pressures may emanate from concentration of large-ticket exposure against closely-linked groups/companies. Moreover, the bank has extended sizeable financing to sole proprietorships/partnership concerns. Accordingly, close monitoring of exposures is warranted to ensure that asset quality indicators remain within benchmarks for the assigned ratings. Management draws comfort from strong sponsor profile of such clients which is expected to support timely repayments.

Consumer financing continued to depict double digit growth across all three products (personal installment loan, ready line and credit cards) with overall portfolio growth recorded at 24% in 2018. In contrast to other peer banks, lending in the consumer portfolio is entirely in the unsecured segment where the Bank is amongst the leading players. Gross infection in the consumer portfolio increased to 3.7% (2017: 2.3%) at end-Dec'2018 but remains well below industry norms. In order to manage portfolio quality, increase in rates on consumer portfolio has not been commensurate with uptick in benchmark rates. Maintaining sound asset quality indicators in the consumer portfolio in the backdrop of weakening macro-economic dynamics will be an important rating consideration given the sizeable contribution of the segment to Bank's overall profitability. While consumer assets are expected to continue to grow in 2019, the bank plans to reduce overall advances by shedding corporate exposure against large customers while focusing on increasing non-fund based business.

Deposit base witnessed growth in 2018. However, deposit mix has room for improvement. High deposit concentration levels and low liquidity buffer translate into weak liquidity profile vis-à-vis rating benchmarks. Liquidity coverage ratio remains below regulatory requirements.

Deposit base of the bank grew by 20% to Rs. 132.7b in 2018 and remained at around the same level over 1Q19. While overall CASA ratio has increased to 56.3% (2018: 56.2%; 2017: 53.8%), growth in average current accounts in absolute and percentage terms was lower vis-à-vis preceding year. Also, a sizeable proportion of growth in deposits was through non-core deposits while CASA remains on the lower side vis-à-vis peer group median. Going forward, Silk plans to reduce its cost of deposits by shedding high cost deposits and replacing them with low cost deposits. Depositor concentration is sizeable and has increased on a timeline basis (top 50 depositors represent 48.5% of aggregate deposits). Planned reduction in loan book will help shedding high cost deposit. Thus reducing depositor concentration and high cost deposit. Depositor profile is planned to be enhanced with focus on core deposit growth, through opening of banking booths, digital banking, employee banking initiatives and launch of new products.

Given the bank's high ADR (80% at end-1Q19), Silk's liquid assets coverage of deposits and borrowings (adjusted for repo) is considered low at 25.2% (2018: 30.0%; 2017: 26.9%) at end-1Q19 while liquidity coverage ratio remains below regulatory requirement of 100%. Reduction in corporate portfolio and deploying the same in liquid avenues as planned by management will result in increase in liquidity buffer carried on the balance sheet and allow the bank to comply with regulatory requirements. Going forward, reducing depositor concentration levels and increasing liquidity buffer are considered important from a ratings perspective.

Operating profitability depicted growth on account of improvement in topline and controlled growth in expenses. Growth in operating profitability is projected to continue in 2019 given volumetric growth in earning assets and expected improvement in spreads. Overall profitability will be a function of provisioning charges on advances portfolio and materialization of planned sale in other real estate owned.

Operating profitability of the bank depicted notable increase in 2018. This can be attributed to increase in quantum of advances portfolio, higher fee based income and controlled administrative expenses. Markup income increased on account of volumetric growth in advances and increase in yield on advances due to higher policy rate. However, spreads for 2018 remained at a similar level vis-à-vis the preceding year as increase in cost of funds on account of rising interest rates offset the increase in yield on advances. Operating profit further improved in 1Q19 vis-à-vis same period last year with enhancement in spreads. Administrative expenses also witnessed an increase albeit at a slower pace vis-à-vis recurring income. Hence, efficiency ratio depicted improvement to 79.9% (2017: 87.5%). However, bottom-line was impacted by net provision and write offs amounting to Rs. 1.3b (2017: Rs. 0.5b).

Going forward, management is targeting reduction in financing portfolio and increasing quantum of investments, while also pursuing selective growth in high yielding consumer and SME segments. Due to a lag in re-pricing of advances vis-à-vis deposits, with deposits being re-priced earlier, spreads of the bank will witness improvement 2019, provided that the deposit mix remains consistent or witnesses increase in low cost deposits. Quantum and timing of improvement in spreads will depend on extent of further increase in interest rates. Growth in overall profitability will depend on quantum of impairment charges while imposition of super tax will reduce growth in profit after tax. Controlled increase in administrative expenses and fresh NPLs are also key factors. Materialization of planned sale in other real estate owned (OREO) if realized will also positively impact profitability.

Capitalization indicators have weakened on a timeline basis and are below regulatory requirements as well as VIS' benchmark for the assigned ratings.

Capital Adequacy Ratio (CAR) of the bank was 10.79% as at March 31, 2019, against minimum requirement of 11.9% on account of high capital consumption given the sizeable growth in advances portfolio. The bank has exemption from SBP, for meeting the Tier-1 and overall CAR requirements till

September 30, 2019. While declining on a timeline basis, Non-Earning Assets (NEAs) remain sizeable in relation to total assets and bank's own equity.
Timely achievement of planned reduction in risk weighted assets, disposals of non-banking assets, quantum of future profits and quality of exposures will be important determinants for achieving capitalization indicators in line with benchmarks for the assigned ratings.

Credit and market risk on investment portfolio is manageable.

Silk's investment portfolio decreased by 24.4% to Rs. 28.9b (2017: Rs. 38.3b) at end-2018. Credit Risk emanating from investment portfolio is considered minimal, as 97.8% of the investment portfolio was deployed in GoP securities at end-2018. Due to prevalence of increasing interest scenario, the management reduced the exposure in PIBs and deployed some of the additional liquidity in short tenor Sukuk/T-bills and listed equities. Market risk is manageable on account of less than 1% exposure in equities. Going forward, the management expects to maintain a similar portfolio mix until further clarity regarding interest rate movements is achieved.

Silk Bank Limited (Silk) Appendix I

FINANCIAL SUMMARY *(Rs. in Millions)*

BALANCE SHEET	31-Dec-18	31-Dec-17	31-Dec-16
Total Investments	28,925	38,267	37,488
Advances	98,354	85,851	64,803
Total Assets	173,677	166,855	135,034
Borrowings	18,052	35,582	30,195
Deposits & other accounts	132,664	110,278	86,787
Subordinated Loans	2,000	2,000	-
Tier-1 Equity	11,627	10,177	9,279
Net Worth	14,455	13,129	12,002
INCOME STATEMENT	**31-Dec-18**	**31-Dec-17**	**31-Dec-16**
Net Mark-up Income	6,605	5,486	4,349
Net Provisioning	1,269	554	-49
Non-Markup Income	3,415	2,943	2,213
Operating Expenses	6,781	6,434	5,326
Profit Before Tax	1,877	1,387	1,285
Profit After Tax	1,330	1,135	739
RATIO ANALYSIS	**31-Dec-18**	**31-Dec-17**	**31-Dec-16**
Market Share (Advances) (%)	1.3%	1.4%	1.2%
Market Share (Deposits) (%)	1.0%	0.9%	0.8%
Gross Infection (%)	6.4%	6.5%	8.4%
Total Provisioning Coverage (%)	78.1%	73.2%	77.5%
Net Infection (%)	2.2%	2.5%	2.7%
Net NPLs to Tier-1 Capital (%)	17.5%	19.8%	18.3%
Capital Adequacy Ratio (C.A.R (%))	10.92%	10.94%	10.67%
Efficiency (%)	79.9%	92.4%	94.8%
ROAA (%)	0.8%	0.8%	0.5%
ROAE (%)	9.6%	9.0%	6.0%
Liquid Assets to Deposits & Borrowings (%) *	30.0%	26.9%	23.0%
***Adjusted for Repo*			

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix II

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES	Appendix III
Name of Rated Entity	Silk Bank Limited (Silk)
Sector	Commercial Bank
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	see table below

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
27-Jun-19	A-	A-2	Stable	Maintained
29-Jun-18	A-	A-2	Positive	Maintained
30-Jun-17	A-	A-2	Stable	Reaffirmed
30-Jun-16	A-	A-2	Stable	Reaffirmed
30-Jun-15	A-	A-2	Stable	Reaffirmed
18-Dec-14	A-	A-2	Stable	Rating Watch Removed
30-Jun-14	A-	A-2	Rating Watch – Developing	Rating Watch – Developing
29-Jun-13	A-	A-2	Stable	Maintained
22-Oct-12	A-	A-3	Rating Watch – Developing	Maintained
18-Aug-11	A-	A-2	Rating Watch – Developing	Reaffirmed
25-Feb-11	A-	A-2	Rating Watch – Developing	Maintained

Instrument Structure	N/A
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.
Probability of Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.
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