RATING REPORT

Khushhali Microfinance Bank Limited

REPORT DATE:
April 28, 2023

RATING ANALYSTS:

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RATING DETAILS

Rating Category	Latest Rating		Previous Rating	
	Long-term	Short-term	Long-term	Short-term
Entity	A-	A-2	A	A-2
Outlook/ Rating Watch	Rating Watch – Negative		Rating Watch – Developing	
Rating Date	*April 28th, '23*		*December 16th, '22*	

COMPANY INFORMATION

Incorporated in 2000	**External auditors:** EY Ford Rhodes
Public Limited Company	**Chairman of the Board:** Mr. Robert Binyon
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. Aameer Mustaaly Karachiwala
United Bank Limited – 29.7%	
Rural Impulse Fund II S.A. SICAV-FIS – 24.5%	
MultiConcept Fund Management S.A (responsibility Global Micro and SME Finance Fund). – 19.9%	
ShoreCap II Limited – 14.3%	
ASN-NOVIB MicrokredietPool – 9.9%	

APPLICABLE METHODOLOGY(IES)

VIS Entity Rating Criteria: Micro Finance Banks (June 2019)
https://docs.vis.com.pk/docs/Micro%20Finance%20201906.pdf

Khushhali Microfinance Bank Limited

OVERVIEW OF THE INSTITUTION

Khushhali Microfinance Bank Limited (previously Khushhali Bank Limited) was incorporated in 2000 with proclamation of Khushhali Bank Ordinance by Government of Pakistan. Subsequently, it was transformed into a public limited company in 2008. Objective of the bank is to provide financial services to Micro, Small and Medium Enterprises and low-income households across Pakistan.

Profile of President/CEO

With over 30 years of experience, Mr. Aameer Karachiwalla is a Chartered Accountant from the Institute of Chartered Accountants of England & Wales. Mr. Karachiwalla currently appointed as President/Chief Executive Officer in replacement of Mr. M. Ghalib Nishtar. Previously he serves as CFO of UBL. He joined UBL in 1998 and has previously held the positions of Chief Operating Officer, Chief of Staff and Group Executive Retail Banking at UBL.

Financial Snapshot

Total assets:

end-FY22: Rs. 132.2b;
end-FY21: Rs. 116.5b;
end-FY20: Rs. 107.1b;
end-FY19: Rs. 81.5b.

Total Equity:

end-FY22: Rs. 8.1b;

RATING RATIONALE

Rating Rationale

Khushhali Microfinance Bank Limited (KMBL) is one leading providers of microcredit services in the microfinance (MF) sector of Pakistan, having a market share of 18% (FY21: 19%) in loan portfolio during the outgoing year; however, in line with adoption of portfolio consolidation strategy post capital adequacy breach (CAR), the Bank has forgone its market leader position during the ongoing year. Moreover, the ratings incorporate strong sponsor profile and implicit support of shareholders. The ratings take into account the lingering impact of Covid-19 along with the impact of the recent floods wherein portfolio credit quality has been impacted and the financial risk profile of the Bank has weakened. Around 12% of the total portfolio continues to be categorized under deferred and restructured loan portfolio at end of the outgoing year; the recoveries from wherein may take time and are uncertain. The weakening of asset quality indicators has led to a negative bottom line, which has in turn placed the CAR at below minimum regulatory requirement. Further, KMBL's liquidity position was also marked by a downturn on account of multiple factors including liquidation of investments, reduction in balances held with financial institutions, cashflow constraint faced due to low recovery ratio in light of sizable internal restructuring carried out and high incidence of non-performing loans (npls) during the period under review. The revision in ratings takes into account non-participation of three-fifths of the existing shareholders being closed-end funds in injecting additional equity. While management has presented their plan to raise equity from remaining sponsors along with expected sale of exiting international shareholders stake, the timely and successful implementation of the same will remain important. Going forward, strengthening of capital adequacy and liquidity of the Bank is important for sustenance of ratings.

Key Rating Drivers

Growth in micro-credit portfolio witnessed during first half of the year with disbursements scaled down in second half owing to distressed asset quality indicators coupled with pressure of maintaining minimum regulatory CAR: The gross micro-credit portfolio augmented to Rs. 86.5b (FY22: Rs.70.8b) by end-FY22 in line with lending activities reverting back to normal during the first half of the outgoing year after a period of adoption of consolidation strategy during FY21 to curtail worsening of portfolio health amid pandemic related repercussions. The loan disbursements were recorded higher primarily owing to higher average ticket size recorded in line with increased lending in ME & SME segments coupled with progression of clients to successive loan cycles wherein automatic increase in renewal loan is inbuilt. However, post June'22, owing to distressed asset quality indicators coupled with pressure of maintaining minimum regulatory CAR, the disbursement activities were scaled down; hence Bank missed its disbursement target of Rs. 72.8b for FY22. The gross loan portfolio (GLP) growth slowed down to 7.1% during second half of FY22 as opposed to 16.8% recorded during 1HFY22. In addition, as a result of complete halt on new unsecured bullet lending, plan to reduce group loans along with management's decision of re-implementing portfolio consolidation strategy, total number of active borrowers decreased by end-FY22. Subsequently, in line with asset quality and capital erosion challenges faced, KMBL no longer remains the market leader in terms of micro-credit lending in the ongoing year.

Microcredit Portfolio Risk Segregations: The concentration of group loans in total GLP was recorded significantly lower while share of ME & SME, individual and housing loans increased as an outcome of management decision of discontinuing of group lending due to low performance; post discontinuation decision, no further disbursement will be made under group lending. In terms of

end-FY21: Rs. 11.2b;
end-FY20: Rs. 10.8b;
end-FY19: Rs. 9.4b.

Profit (Loss) After Tax:

FY22: Rs. (3.0)b;
FY21: Rs. 572m;
FY20: Rs. 1.7b;
FY19: Rs. 1.8b.

sector-wise concentration no major changes were evidenced; albeit decline, agri portfolio continued to represent the largest chunk of GLP. In terms of sectoral composition, highest repayment risk is associated with general purpose loans, that are basically consumptive loans with no cash flow generation to support repayment; the proportion of same has increased during the period under review. However, the credit risk is largely mitigated as the aforementioned loans are backed against gold and have reported 0% loss rate. In terms of geographical distribution, the portfolio is predominantly concentrated in Punjab with the same constituting almost three fourths of the total GLP at end-FY22. In addition, in terms of type of payment, the share of EMI increased to 30% (FY21: 26%), whereas the proportion of principal on maturity (Bullet PMS) and pure bullet loans decreased by end-FY22. The higher proportion of EMI is a factor of increased focus towards ME & SME and Housing loans entailing monthly installments. Further, the proportion of secured portfolio increased sizably during the outgoing year. KMBL was able to achieve its target of enhancing proportion of secured portfolio to 50% to manage credit exposure by end-FY22.

Deferred, Restructured, Rollover (DRR) Portfolio: By end-FY22, the deferred portfolio pertaining to regulatory relief under Covid-19 decreased sizably to Rs. 670.0m (FY21: Rs. 6.7b) as the scheme matured by end-1QFY21. Under the SBP relief package, the regular/performing borrowers were allowed to reschedule/defer their loans in accordance with the SBP guidelines. However, the same is not a true reflective of high-risk portfolio as significant restructuring has been carried under bank's internal rescheduling scheme post SBP's deadline. The portfolio rolled over under bank's internal scheme was still recorded significant at Rs. 10.6b (FY21: Rs. 12.9b) by end-FY22. In general, in the last two years an inverse relationship has been evidenced between the portfolio deferred under SBP's relief and the bank's internal rescheduling with the decrease in the former off-set by the latter indicating double-restructuring. The exponentially higher figure of the double rolled-over portfolio reflects the actual asset quality of the Bank. However, in aggregate during the outgoing year the entire rolled over portfolio reduced to Rs. 11.2b (FY21: Rs. 19.6b); the same is reflective in higher non-performing loans booked at end-FY22. As per the management, given both portfolios are restructured and are in-turn high-risk, the entire portfolio is analyzed by the single lens. As per the management, the total rollover portfolio reduced to Rs. 10.2b at end-Mar'23. Out of the aforementioned, Rs. 7.0b is due to mature during the ongoing year with average recovery rate estimated at 65%; the remaining 35% amounting to Rs. 2.45b is projected to be classified as npl. VIS believes that the actual npl percentage is likely to exceed the one provided by the management on account of current recovery percentage being low at 48.7% coupled with the existing delinquent portfolio carrying a higher credit risk in line with having been provided relief twice. The elevated credit risk on this double restructured portfolio is also a function of stressed credit repayment capacities of the borrowers amid worsening macroeconomic indicators. The transition of DRR Portfolio at end-FY22 is presented in the table below:

	Amounts in billion
Rollover & restructured Portfolio (DRP) at 31st March, 2021	Rs. 35.1b
Amounts recovered till end-FY22	Rs. 17.1
Percentage Recovered	48.7%
Written-off by end-FY22	Rs. 6.8b
To be Recovered (both DRP & Internally Restructured)	Rs. 11.2b
Classified under NPL at end-FY22	Rs 1.6b

Portfolio impacted during Floods-22: In contrast to regulatory relief provided to micro-credit borrowers during Covid-19, the flood affected clients were not provided any blanket cover by the central bank. On the other hand, different portfolio segregations and clients were evaluated on case-to-case basis. As per the information shared, out of the Rs. 7.0b DRP due in the ongoing year, Rs. 1.0b has been impacted by recent floods. The portfolio falls under the Markup Waiver Scheme (MWS) of Kisan Package Scheme introduced by SBP in which the markup accrued till end-Sep'22 is split in

half and is to be equally absorbed by the Bank and SBP. In line with the waiver provided by the central bank, the management is hopeful to recover the entire amount. Moreover, rescheduling/restructuring of the principal amount pertaining to same loans for up to one year in calamity-notified areas is also approved. In addition to MWS, SBP also announced "GOP Markup Subsidy Scheme" for revival of agriculture/livestock sectors against loans of up to Rs. 500,000 to subsistence farmers at markup rate of 0% per annum along with "Interest Free Loans and Risk Sharing Scheme" for landless farmers up to Rs. 200,000.

Strategy Going Forward: The business approach entails implementation of portfolio consolidation and cost rationalization strategy with reduction of GLP to around Rs. 80.0b, reduction in exposure to high-risk and loss-making segments and continuation of new business by replenishing the gaps through lending in more stable and secure segments. In regard to this, no new-to-bank disbursement is being made under unsecured portfolio with exception of women borrowers, availability of credit guarantee schemes (USAID & Kissan Package) and EMI repayment mode. The management plans to increase disbursements under semi-secured lending products including salary/pension schemes. With these practices the unsecured bullet would be shifted to secured bullet. KMBL plans to scale down the challenging unsecured-bullet portfolio amounting to Rs. 32.0b at end-FY22, constituting around 38% of GLP, to Rs. 26.0b by end-FY23. Out of this portfolio, Rs. 25.0b is due to mature in the ongoing year including Rs. 7.0b of the DRR portfolio. Subsequently, the Bank plans to improve secured and semi-secured portfolio share to 65% by end of the ongoing year. In addition, the management plans to improve concentration of EMI portfolio to 40% by end-FY23. The proposed increased disbursement under Housing finance will aide in enhancing proportion of EMI portfolio.

Collection and Recovery Unit (CRU): CRU remains the key focus which is being prioritized and empowered with requisite resources. The collection and recovery target has been revised through a consultative process among, Collection, Business, Risk and Finance; the revised resolution rate target is projected to improve the loss rate from 6% to 4% in the ongoing year. During FY22, 600 retail/business staff (LOs) in branches have been downsized. They were either transferred to the CRU or resigned, and their positions were not replaced. Further, 100 more LOs were re-designated as Collection Officers (CO) and assigned to CRU in Feb'23. The management plans to transfer 80 more LOs to CRU as Cos during the ongoing year. Further, current cash recovery (CCR) has been added as a KPI in the incentive scorecard of LOs during the rating review period. Now, 60%-80% weightage is given to collection, npl, charge off and portfolio conversion. In addition, CCR is added as the qualifying criteria and discounting factor for individual and team incentives.

Deteriorating asset quality indicators: Essentially, the entire micro-credit portfolio rolled over under SBP's relaxation of deferring repayment by one year at end-1QFY21 should have matured by end-1QFY23; the two-year period includes one-year relief followed by maximum one-year tenor in case of bullet loans. However, given sizable proportion of the same portfolio was rescheduled under Bank's internal restructuring scheme the complete infection statistics of the portfolio are yet to be ascertained. Therefore, despite increase in npls of the Bank to Rs. 3.5b as opposed to Rs. 2.0b in FY21, the same still is not the true reflective of KMBL's asset quality. Therefore, the reported figures of gross and net infection increasing are still largely down played at end-FY22. Moreover, with relaxation in the provisioning requirements allowed by SBP involving additional 30 days allowance for recording of OAEM for the DRR portfolio coupled with extension of loss recognition for Housing and ME portfolio to 2 years (FY20: 180 days) and 18 months (FY20: 180 days) respectively has also assisted MFBs in spreading their loss over a longer time period. Moreover, with internal restructuring, the impact of loan losses for KMBL has been staggered even more than peer MFBs. There has been a change in the reported last year's npl figure as KMBL includes suspended income in the npl computation given under category of classification as opposed to all other market players which only include principal amount, therefore, in order to have the same practice across the board, only principal amounts have been taken for FY21 and onwards.

Further, the advances charged off against provisions and bad debts directly written off stood higher at end-FY22. With sizable quantum of write-offs added, the incremental infection also showed

worsening and was recorded higher at end-FY22. On the other hand, the provisioning coverage (only specific provision) improved in line with increase provisioning requirements stemming from progression of NPLs to subsequent loss categories. The general provisioning is now maintained at 1.0% (FY21: 1.9%) of the total micro-credit portfolio against the SBP's prudential requirement (PR) of 1% as a subjective cover for the expected loan losses; however, some proportion of the same was depleted and converted to specific provisioning during the outgoing year.

Decline in investment portfolio; credit risk and interest risk are negligible: Investment portfolio of the Bank decreased as an outcome of liquidation of investment in T-bills and TDRs as the aggregate portfolio of the aforementioned declined to nil as opposed to T-bills and TDRs reported at Rs. 3.5b and Rs. 3.0b respectively at end-FY21. The overall decline in the investment portfolio resulted from channeling of additional funds towards micro-credit lending along with lending to financial institutions. On the other hand, the investment in PIBs was reported higher at end-FY22. Out of the total PIB portfolio, only Rs. 300.0m is vested in fixed tenure securities while the remaining constitute of floaters therefore the interest rate risk faced by the Bank is negligible. Going forward, the management plans to invest in short-term securities in the ongoing increasing benchmark rate scenario to mitigate market risk. Credit risk emanating from investment portfolio remained negligible as almost the entire investment portfolio is vested in sovereign securities.

Asset liability mismatch exists: At end-FY22, there was asset liability mismatch in one-year and two-to-three-year bracket mainly due to significant amount of deposits falling due in the said brackets. KMBL currently faces liquidity stress; the same is considered critical from the ratings perspective. As per the management, to mitigate the aforementioned risk the Bank is in negotiations with the sponsoring commercial bank to extend standby credit lines worth Rs. 8-10b.

Weakening profitability indicators; declining markup spread and high provisioning expense are the main contributing factors: KMBL's profitability position has weakened during the outgoing year in line with decline in markup spreads coupled with significant provisioning expense booked on account of sizable npls emanating from rolled-over portfolio. The contraction of spreads was majorly a function of reduced yield of micro-credit portfolio in line with suspended income on npls along with higher cost of funding originating from policy rates hikes evidenced during the outgoing year. Moreover, despite slight growth in recurring non-markup income, primarily loan processing fee in line with increased lending of high-ticket loans pertaining to ME & SME and Housing category along with higher recoveries, Operational self-sufficiency (OSS) ratio showed a downward trend and was recorded lower on account of sizable provision expense booked, reduction in spreads and increase in non-markup expenses. Subsequently with OSS recorded lower than 100% indicating expenses not being covered by income, KMBL reported negative bottom line during FY22 resulting in capital erosion and regulatory CAR breach.

The uptick in markup income earned was predominantly on account of volumetric increase in GLP along with higher yield of government securities; however, the notable growth in micro-credit portfolio did not reflect fully in the markup income earned as markup on advances was recorded only slightly higher during FY22. The yield on net advances dropped noticeably to 22.5% (FY21: 26.3%) owing to suspension of income post classification of a performing loan along with markup waivers offered to borrowers as part of restructuring carried out to combat higher credit risk situation. It is pertinent to note that the reported markup on advances and yield are still not a true reflective of cash generation from the aforementioned micro-credit portfolio as a significant proportion of Bank's GLP amounting to Rs. 11.2b at end-FY22 is still placed under internal restructuring and the markup earned on the same has been booked as income; however, the markup amounting to Rs. 12.6b (FY21: Rs. 12.1b) placed under other assets is an income generated yet to be received. Given, the expected delinquency ratio of the double restructured/ rollover portfolio is high, the probability of recovery of income booked in advance is slightly on a lower side; therefore, the reported yield of advances portfolio is a magnified number. This accrual phenomenon resulting in suspended income upon classification is the major reason decline in yield on advances during FY22; the suspended markup on NPLs was booked at Rs. 1.4b (FY21: Rs. 967.8m) in the outgoing year. On the other hand, yield on

investments improved to 12.8% (FY21: 7.5%) in line with higher benchmark rates recorded during FY22. However, with sizable cut in yield on advances, overall yield on interest bearing assets decreased during FY22.

Total markup expense increased in line with higher deposits base along with increased cost of funding during the outgoing year on account of SBP's policy rate being at the very high end of the spectrum. Moreover, the cost of deposits also increased in line with average benchmark rates being higher than the preceding year coupled with increase in proportion of interest bearing high-cost deposits in the overall deposit mix. Subsequently, in line with combined impact of drop in yield of earning assets and higher cost of funding, the Bank's markup spread declined during FY22. Going forward, funding cost is likely to remain a challenge in the medium term with the same projected to increase to 14.0% for the ongoing year.

Despite increase in number of new loans disbursed microcredit application processing fee and commission increased only slightly given sizable waivers and rebates on processing fee were extended to borrowers during the outgoing year. On the other hand, other income also improved due to higher recoveries against written off advances during FY22. Total administrative expenses of the Bank increased mainly on account of increase in remuneration expense, vehicle running and utilities expenses; the same was a function of annual salary adjustments along with the inflationary commodity super cycle experienced. However, with sizable growth in the asset base overhead ratio remained constant during FY22. Loan loss provision was recorded significantly higher during the outgoing year in line with escalated credit risk owing to already hampered debt repayment capacity of borrowers post pandemic aggravated further by current dismal macroeconomic indicators. Subsequently, in line with decline with spreads, sizable provisioning expense booked and increase in operating expenses, KMBL reported loss before tax (LBT) of Rs. 4.2b during FY22 as to opposed profit before tax (PBT) of Rs. 869.6m in the preceding year.

Change in loan pricing strategy to combat declining spreads: KMBL pricing strategy has shifted from claiming the lowest price to adopting a competitive pricing model. In view of the changes in the policy rate and consequent increase in deposit rate, the Bank has increased asset pricing by 3-5% across the entire product suite since Nov'22 till date. In addition, the frequency of asset price reviews has completely changed with asset repricing now done exactly in tandem with deposit repricing with every new policy rate announcement to the avoid lag in pricing change from putting a drag on spreads. The management plans to increase the loan pricing by another 2-3% post April, 2023. On the flip side, although the increase in prices on the lending side will rectify net interest margin compression; however, the same can escalate credit risk as with higher markup payments the already stressed credit repayment capacity of micro-credit borrowers will be hampered further.

Network Cost Optimization: As per the network consolidation plan, 14 branches and 14 PBs will be closed in FY23. As per the management, 6 PBs and 11 branches have already been closed and merged with existing branches by end-1QFY23. KMBL has 12 MSE branches operational which cost annual rental of Rs. 27m; the Bank is reviewing the option of merger of MSE branches with retail branches in the same cities to save rental and other operating cost. The cost reduction estimated from the same is around Rs.19m per annum. Further, the management plans to curtail HO cost amounting to Rs. 160m by relocating the entire HO to a low-cost location – the premises has been finalized and relocation is expected by end-June'23. The cost saving of the relocation is estimated around Rs. 120m per annum.

P&L projections for the ongoing year: KMBL projects income on advances to improve on account of resource deployment in high yielding loan assets along with increase in pricing; however, the materialization of the same will be ascertained over time as the improvement stemming from aforementioned strategy will be offset by the cleansing of the rescheduled portfolio against which suspended markup of Rs 3.6b is expected to be booked in FY23. In addition, the management has made a change to loan processing fee during the ongoing year also which is expected to generate an

additional revenue of Rs. 400-450m, resulting in a projected increase of 25%. In addition, an increase of almost 100% is made to other fees including ATM card issuance and renewal fees. Similarly, the loan amount withdrawal charges for BVS verification have increased from Rs. 150 to 200 that will result in an incremental revenue generation of approximately Rs. 20m during FY23. Despite aforementioned price and fee increases, management has projected LBT of Rs. 4.0b for FY23; the same seems realistic in line with additional provisioning requirements of around Rs. 2.5b expected on internally restructured portfolio. Moreover, with 50% of the interest waiver on Kissan Package to be borne by MFBs, KMBL estimates that relief will have an impact on P&L of Rs. 471m for the ongoing year.

Liquidity Profile: KMBL's liquidity position was marked by a downturn on account of multiple factors including liquidation of investments, reduction in balances held with financial institutions and cashflow constraint faced due to low recovery ratio in light of sizable internal restructuring carried out and high incidence of npls during the period under review. The drop in liquidity indicators is further underpinned by the fact that despite all the above-mentioned liquidity stress indicators, the net advances to deposits ratio (ADR) also increased slightly to 77.0% (FY21: 76.1%) against the target of downward revision of 74% at end-FY22. Overall, the Bank's total liquid assets decreased owing to reduction in volume of investments vested in short-term government securities and TDRs. Subsequently, liquid assets in relation to total assets and liquid to total deposits and borrowings (adjusted for repo-borrowings) also stood lower by end-FY22.

Growth in deposit base: Deposit base increased to Rs. 111.8b (FY21: Rs. 93.2b), surpassing its target of Rs. 98.6b for end-FY22. The increase in the deposit base is largely in tandem with the industry growth given with discount rate being all-time high, the increase in mark-up bearing deposits has been sizable as investment has been largely replaced by savings. The management intends to reduce the deposit book to Rs. 105.6b by shedding high-cost deposits by end-FY23.The proportion of current and saving accounts (CASA) in overall deposit mix decreased to 39% (FY21: 42%) against target of 41% owing to major increase in quantum of fixed deposits in absolute terms during FY22. Therefore, the share of fixed deposits increased on a timeline basis by end of the outgoing year. Going forward, with the planned reduction in deposit size the management intends the targeted ADR to remain around 80% for FY23. With the projected ADR, the prevalent strain on liquidity profile of the Bank is expected to continue in the ongoing year as well. Given, retaining, and enhancing the quantum of current deposits has relatively become tough on account of benchmark rates being on the higher side creating significant opportunity cost against keeping capital in current accounts, KMBL expects CASA proportion to reduce to 37% by end-FY23. Owing to growth in deposit base, KMBL's reliance on borrowings decreased; the decline in borrowings was underpinned by no repo borrowings recorded at end-FY22. Going forward in the next three years, the Bank plans to continue growing its customer deposit base and phase out commercial borrowings on back of planned deposit growth.

Deposit Concentration Risk: Concentration risk on the liability side has increased as evidenced from contribution of top 50 depositors increasing to 30.9% (FY21: 22.3%) at end-FY22. Overall share of individual depositors has also decreased to 70% (FY20: 79%) by end-FY22; however, the same is still sizable; therefore, the granularity of the deposit base remained comfortable during the rating review period. For KMBL, deposits retention and new acquisition has been even more challenging due to weakening of capital adequacy and resulting credit rating downgrade; the same has adversely affected high net worth and institutional deposit relationships with around Rs. 12b of deposit erosion evidenced post Dec'22. Going forward, KMBL's deposit strategy will focus on retaining high net worth individuals' deposits by offering competitive rates while shifting focus from institutional to individual depositors. For implementation of the strategy, incentive structure has been revised to encourage incremental deposits and branch staff has been assigned targets for opening new to bank accounts. In addition, deposit weightage will be increased in scorecard at low npl branches. Although, the successful execution of the aforementioned can improve the granularity of the deposit mix; however, high cost of funding will remain a challenge.

Equity erosion resulting in breach of regulatory CAR: The equity base of the bank has dwindled in line with reduction in appropriated profit on account of sizable loss reported during FY22. In line with subdued fundamentals, no dividend was paid out during the outgoing year against the projected dividend payment of Rs. 1.5/share for FY22. As a combined impact of reduction in core equity along with high incidence and reporting of npls, net npls as a percentage of the bank's Tier-I capital increased sizably at end-FY22. Stemming from equity erosion on account of deteriorating asset quality, KMBL reported a capital shortfall leading to CAR of the Bank recorded lower than the regulatory requirement at end-FY22.

Missed TFC Payments: The lock-in-clause has been invoked on the Tier-II instruments of the Bank by SBP thus preventing any debt repayments for the time period the said clause is in place. Missed payments for two instruments under rating review have taken place with TFC-1's first mark-up payment missed on 19thMarch, 2023. On the other hand, two markup payments of TFC-2 have been missed, dated 27the Dec, 2022 and 27th March, 2022. Given that it is high unlikely that the Bank will be able to replenish its equity shortfall during the ongoing year; therefore, further missed payment instances are expected. Subsequently, the risk of conversion of both instruments into common equity is on a higher side.

Equity replenishment plan: The performance of roll over/rescheduled portfolio continue to remain a key concern. KMBL continues its efforts for collection and recovery while risk assessment remains an ongoing process. The Bank in its earlier submission to the Board has highlighted that new capital need assessment was mainly coming from the projected losses of the aforementioned portfolio for which various ranges were projected by the risk team. In an attempt to revalidate the projected losses of reschedule/rollover portfolio, the Bank has recently taken assistance of UBL risk team who has performed two-week long assessment and submitted their risk assessment which has identified the loss range of principal loan amount in between Rs. 6.4-8.9b. As per the management, the primarily sponsor, UBL has agreed to pitch in funds as per their existing shareholding proportion but are not willing to increase their overall stake in the Bank. The contribution from UBL is expected to range between Rs. 1.9-2.7b. Moreover, one of the international sponsors, ASN Novib having an ownership of 10%, have also agreed to inject equity; however, the proportion and amount of the same has not yet been confirmed. Nevertheless, ASN NOVIB does not plan to contribute more than their current shareholding proportion. On the other hand, the remaining international sponsors having an aggregate stake of around 60% being closed end-funds have not shown any interest in injecting additional capital in the Bank. On the flip side, the management has approached a Dutch Entrepreneurial Development Bank to buy out the stake of three exiting international shareholders. In addition, the management is also hopeful that apart from buyout money the new prospective buyer is also willing to inject additional funds. Although the plan has been put into motion, the successful implementation of the same is yet to be seen.

Khushhali Microfinance Bank Limited — Annexure I

BALANCE SHEET	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022
Cash and Bank Balances with SBP and NBP	2,926.2	2,850.3	3,883.7	5,153.7
Balances with other Banks and/NBFIs/MFBs	4,181.1	10,752.2	10,177.3	3,903.0
Lending to Financial Institutions	450.0	796.0	100.0	4,893.1
Total Investments	10,111.7	17,679.9	14,089.8	11,287.1
Net Advances	53,541.2	60,640.8	70,884.2	86,100.0
Operating Fixed Assets	3,612.3	3,688.2	3,578.8	4,154.2
Other Assets	6,670.6	10,695.5	13,810.1	16,718.8
Total Assets	**81,493.1**	**107,102.9**	**116,523.9**	**132,209.9**
Total Deposits	63,882.3	88,649.8	93,162.4	111,791.7
Borrowings	1,326.0	427.7	4,608.4	2,175.0
Subordinated Debt	2,400.0	2,400.0	3,000.0	4,500.0
Other Liabilities	4,486.1	4,831.5	4,588.6	5,643.8
Tier-1 Equity	9,399.2	10,801.4	11,245.8	8,147.7
Net Worth	9,398.7	10,793.9	11,184.5	8,099.3
Paid-Up Capital	1,705.0	1,705.0	1,705.0	1,705.0
INCOME STATEMENT	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022
Net Mark-up Income	8,459.5	9,938.2	9,691.8	7,502.1
Net Provisioning / (Reversal)	2,259.4	2,992.4	3,960.5	6,162.7
Non-Markup Income	1,973.5	1,543.0	1,994.6	2,194.8
Operating Expenses	5,655.1	6,097.1	6,856.3	7,714.0
Profit Before Tax	2,518.5	2,391.8	869.6	(4,179.8)
Profit after tax	1,836.2	1,739.8	571.7	(3,048.2)
RATIO ANALYSIS	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022
Gross Infection (%)	4.7	3.1	2.9	4.0
Incremental Infection (%)	7.3	3.6	5.7	9.2
Provisioning Coverage (%)	29.9	34.3	28.1	45.9
Net Infection (%)	3.4	2.1	2.1	2.2
Net NPLs to Tier-1 Capital (%)	19.0	11.5	13.1	23.2
Capital Adequacy Ratio (%)	19.1	19.6	18.3	11.5
Markup on Earning Assets (%)	22.7	22.6	21.2	20.5
Cost of Funds (%)	10.8	11.2	9.5	11.6
Markup Spreads (%)	11.9	11.4	11.7	8.9
OSS (%)	115.8	112.9	104.0	84.2
ROAA (%)	2.4	1.8	0.5	-
ROAE (%)	20.9	17.2	5.2	-
Gearing (x)	N/A	N/A	N/A	N/A
Current Ratio (x)	N/A	N/A	N/A	N/A
Liquid Assets to deposits & borrowings (%)	27.1	36.0	29.8	22.1

ISSUE/ISSUER RATING SCALE & DEFINITIONS Annexure II

VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

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	Khushhali Microfinance Bank limited (KMBL)
Sector	Micro Finance Bank (MFB)
Type of Relationship	Solicited
Purpose of Rating	Entity Rating

Rating History

Rating Date	Medium to Long Term	Short Term	Outlook/ Rating Watch	Rating Action
RATING TYPE: ENTITY				
28/04/2023	A-	A-2	Rating Watch-Negative	Downgrade
16/12/2022	A	A-2	Rating Watch-Developing	Downgrade
04/29/2022	A+	A-1	Rating Watch-Developing	Reaffirmed
04/30/2021	A+	A-1	Rating Watch-Developing	Reaffirmed
04/29/2020	A+	A-1	Rating Watch-Developing	Maintained
04/30/2019	A+	A-1	Stable	Reaffirmed
04/26/2018	A+	A-1	Stable	Reaffirmed
04/28/2017	A+	A-1	Stable	Reaffirmed
04/29/2016	A+	A-1	Stable	Reaffirmed
RATING TYPE: PPTFC-I				
28/04/2023	B		Rating Watch-Negative	Downgrade
16/12/2022	BB-		Rating Watch-Developing	Downgrade
04/29/2022	A		Rating Watch-Developing	Reaffirmed
04/30/2021	A		Rating Watch-Developing	Reaffirmed
04/29/2020	A		Rating Watch-Developing	Maintained
04/30/2019	A		Stable	Reaffirmed
04/26/2018	A		Stable	Final
12/13/2017	A		Stable	Preliminary
RATING TYPE: PPTFC-II				
28/04/2023	B		Rating Watch-Negative	Downgrade
16/12/2022	BB-		Rating Watch-Developing	Downgrade
04/29/2022	A		Rating Watch-Developing	Reaffirmed
04/30/2021	A		Rating Watch-Developing	Reaffirmed
04/29/2020	A		Rating Watch-Developing	Final
12/11/2019	A		Stable	Preliminary

Instrument Structure	Unsecured subordinated TFC amounting to Rs. 1.0b, having tenor of eight years. Unsecured subordinated TFC amounting to Rs. 1.4b, having a tenor of eight years.
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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Due Diligence Meetings Conducted

	Name	Designation	Date
1	Mr. Saleem Akhtar Bhatti	Group Head Finance & CFO	April 06, 2023
2	Mr. Aftab Alam	Head of Distribution	April 06, 2023
3	Mr. Ali Imran Bokhari	Chief Risk Officer	April 06, 2023
4	Mr. Daniyal Haq Awan	Chief Internal Auditor	April 06, 2023
5	Mr. Atif Aziz Ahmed	Chief Information Officer	April 06, 2023