RATING REPORT

Khushhali Microfinance Bank Limited

REPORT DATE:
May 06, 2018

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-1	A+	A-1
Rating Outlook	Stable		Stable	
Rating Date	*April 30, 2019*		*April 26, 2018*	

COMPANY INFORMATION

Incorporated in 2000	**External auditors:** BDO Ebrahim & Co. Chartered Accountants
Limited Liability Company	**Chairman of the Board:** Mr. Aameer Mustaaly Karachiwala
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. M. Ghalib Nishtar
United Bank Limited – 29.7%	
Rural Impulse Fund II S.A. SICAV-FIS – 24.5%	
responsAbility Management Company S.A. – 19.9%	
ShoreCap II Limited – 14.3%	
ASN-NOVIB MicrokredietPool – 9.9%	

APPLICABLE METHODOLOGY(IES)

Methodology: Micro Finance Institutions (May 2016)
https://www.vis.com.pk/kc-meth.aspx

OVERVIEW OF THE INSTITUTION

Khushhali Microfinance Bank Limited (previously Khushhali Bank Limited) was incorporated in 2000 with proclamation of Khushhali Ordinance by Government of Pakistan. Subsequently, it was transformed into a public limited company in 2008. Objective of the bank is to provide microcredit services to underserved and poor segment of the society in a bid to promote social welfare.

Profile of Chairman: 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 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.

Profile of CEO:

Ghalib Nishtar has over 35years of management experience commencing with Bank of America in 1982 and concluding with the National Bank of Pakistan, as its Senior Executive Vice President.

Financial Snapshot:

Total assets: FY18: Rs. 70.5; FY17: Rs. 59.0

Total Equity: FY18: Rs. 8.2b; FY17:Rs. 6.4b

Profit After Tax: FY18: Rs. 2.5b; FY17: Rs. 1.8b

RATING RATIONALE

Khushhali Microfinance Bank Limited (KMBL) is the leading provider of microcredit services in the microfinance sector in Pakistan, having 23.1% market share in loan portfolio and 23.5% in retail deposits amongst microfinance banks with a net profit of around Rs. 2.5b. The assigned ratings take into account adequate capitalization, sound liquidity, and positive earnings trajectory despite slight weakness in asset quality in a challenging operating environment. The ratings are further supported by KMBL's expanding geographic presence, sustained growth in the microcredit portfolio, enhanced focus on digitalization of core functions, and strengthening control environment.

Key Rating Drivers

Business Volumes: During FY18, KMBL posted strong growth in its microcredit portfolio and retained its position as the leading microfinance provider in Pakistan. The bank enhanced its product suite by introducing three new products with higher upper limit in a bid to further improve market penetration and customer base. The sector-wise concentration remained largely stable and the agriculture/livestock loans formed 84.6% of the bank's overall portfolio. Going forward, KMBL plans to enhance share of enterprise lending with increased focus on individual and MSME products having higher loan size, though portfolio concentration is projected to remain largely skewed towards agriculture/livestock.

Portfolio Indicators: Asset quality came under some pressure during FY18 mainly on account of crop related issues with farmers and some slowing down of economy. The bank's non-performing loans, inclusive of principal and interest amount, increased to Rs. 628m by end-FY18 (FY17: Rs. 382m) as the water scarcity and unfavorable pricing of various crops, especially sugarcane, impacted the repayment capacity of farmers. Resultantly, the gross and net infection ratio of the bank increased slightly to 1.4% and 1.0%, respectively, by end-FY18 (FY17: 1.2% and 0.9%). However, the overall portfolio quality of Agri portfolio remained well within benchmarks and NPLs at Dec-18 remained 1.08%.The attrition rate among loan officers (LOs), though still on the higher side, improved during FY18 that has helped to keep portfolio quality in check.

Profitability: Profit before tax increased to Rs. 3.5b during FY18 (FY17: Rs. 2.5b), supported by sizeable growth in net and non-markup income despite increase in provision against non-performing loans and higher administrative expenses. However, Operational Self-Sufficiency improved slightly to 132.7% (FY17: 130.6%) on the back of healthy growth in core income. In line with the increasing interest rate environment, cost of deposit was recorded higher during FY18. Meanwhile, the yield on markup bearing assets was slightly lower YoY as KMBL sought to remain competitive on pricing to protect its market share. Consequently, the markup spread decreased to 11.70% (FY17: 12.9%) during FY18. Bottom line has exhibited healthy growth over the years that is projected to continue, going forward.

Liquidity: KMBL's lending activities are mainly funded by customer deposits. The bank registered a healthy growth in deposit base, mainly owing to sizeable increase in Khushhali Izafa and Khushhali Aamdani certificates of 36-month tenure. The concentration risk on the liability side improved with dilution of top-50 depositors to 21.9% (FY17: 30.8%) as a proportion of deposit base. Liquid assets in relation to deposits and borrowings though decreased to 34.0% (FY17: 41.2%), are considered adequate. The net advances to deposits ratio (ADR) stood higher at 77.7% and is projected to increase to 84.0% by end-FY19.

Capitalization: For the calculation of CAR, the capital was supported by retained earnings and issuance of sub-ordinated debt. With considerable increase in risk-weighted assets, CAR was maintained at 18.93% at end-FY18 (FY17: 18.39%). The bank plans to raise another Tier-II capital of Rs. 1.0b, which along with the prior year's profits, will suffice for the capital adequacy requirements.

Sponsors, Digitalization & Controls Framework: Shareholding of the bank remained the same with United Bank Limited (UBL) holding the highest ownership stake in KMBL. As per management, three shareholders namely Rural Impulse Fund II S.A. SICVA-FIS – Incofin Investment Management Comm.VA (24.5%), responsibility Management Company S. A. (19.9%) and ShareCap II Limited – Equator Capital Partners LLC (14.3%) have expressed intention to divest their respective shareholdings. The bank has appointed Standard Chartered Bank as an advisor in this context.

The big bang deployment of new core banking application – Temenos T-24 – was completed on March 19, 2019 along with the integration of allied applications. KMBL is working with the International Finance Corporation (IFC) to develop a collaborative digital roadmap, and digitalization of at least one agriculture product is targeted for FY19. The bank has also established a dedicated in-house Digital Financial Services (DFS) function. KMBL also executed several initiatives to strengthen its risk management and controls environment, including formation of compliance risk policy to monitor and mitigate risk, implementation of risk nucleus systems, automation of name screening and transaction monitoring, and a comprehensive penetration risk testing by a third-party.

Khushhali Microfinance Bank Limited Annexure III

FINANCIAL SUMMARY			*(amounts in PKR millions)*
BALANCE SHEET	**Dec 31, 2016**	**Dec 31, 2017**	**Dec 31, 2018**
Total Investments	2,967.9	16,297.6	8,915.7
Net Advanced	22,939.5	32,216.0	43,374.3
Cash Balances	2,688.4	4,063.4	9,291.1
Total Assets	33,773.5	58,961.2	70,472.0
Total Deposits	21,179.4	45,746.9	56,018.0
Borrowings	6,199.9	4,782.7	3,964.9
Tier-1 Equity	4,937.2	6,354.3	8,198.5
Net Worth	4,937.1	6,355.8	8,199.5
INCOME STATEMENT	**Dec 31, 2016**	**Dec 31, 2017**	**Dec 31, 2018**
Net Mark-up Income	4,119.1	5,744.9	7,335.9
Net Provisioning / (Reversal)	684.8	712.7	738.7
Non-Markup Income	1,118.7	1,339.9	1,638.6
Operating Expenses	2,755.9	3,857.0	4,706.6
Profit after tax	1,272.7	1,800.6	2,458.8
RATIO ANALYSIS	**Dec 31, 2016**	**Dec 31, 2017**	**Dec 31, 2018**
Gross Infection (%)	1.8	1.2	1.4
Incremental Infection (%)	2.6	1.5	2.4
Provisioning Coverage (%)	34.9	27.8	34.1
Net Infection (%)	1.2	0.9	1.0
Net NPLs to Tier-1 Capital (%)	5.6	4.3	5.0
Capital Adequacy Ratio	20.2	18.4	18.9
Cost of Funds	7.5	8.1	8.6
Markup Spreads (%)	14.1	12.9	11.7
OSS (%)	129.2	130.6	132.7
ROAA (%)	3.8	4.0	3.8
Liquid Assets to deposits & borrowings (%)	26.3	41.2	34.0

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix IV

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 V
Name of Rated Entity	Khushhali Microfinance Bank limited (KMBL)
Sector	Microfinance Bank (MFB)
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
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
04/30/2015	A+	A-1	Stable	Upgrade
04/23/2014	A	A-1	Positive	Maintained
04/30/2013	A	A-1	Stable	Reaffirmed
11/12/2012	A	A-1	Stable	Reaffirmed

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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