RATING REPORT

Khushhali Microfinance Bank Limited

REPORT DATE:
December 13, 2019

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
PPTFC-I	A		A	
PPTFC-II (Preliminary)	A		-	
Outlook	Stable		Stable	
Date	*December 11, 2019*		*April 30, 2019*	

COMPANY INFORMATION

Incorporated in 2000	**External auditors:** EY Ford Rhodes, Chartered Accountants
Limited Liability Company	**Chairman of the Board:** Mr. Aameer Mustaaly Karachiwalla
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)

Micro-Finance Banks (June 2019)
https://www.vis.com.pk/kc-meth.aspx
Notching The Issues (June 2016)
https://www.vis.com.pk/kc-meth.aspx

OVERVIEW OF THE INSTITUTION

Khushhali Microfinance Bank Limited (KMBL) (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.

Profile of CEO:

As the founder President of KMBL since 2000, Mr. Ghalib Nishtar was part of the process initiated by the Government of Pakistan to reform the financial sector under the Microfinance Sector Development Program. Prior to KMBL he has over 20 years of management experience with various financial institutions at senior management positions.

Financial Snapshot:

Total assets: 9MFY19: Rs. 75.4b; FY18: Rs. 70.5

Total Equity: 9MFY19: Rs. 9.1b; FY18: Rs. 8.2b

Profit After Tax: 9MFY19: Rs. 1.5b; FY18: Rs. 2.5b

RATING RATIONALE

Khushhali Microfinance Bank Limited (KMBL) is the leading provider of microcredit services in the microfinance sector in Pakistan, with 23.8% (FY18: 23.1%) market share in loan portfolio and 24.5% (FY18: 23.5%) in retail deposits amongst microfinance banks. The ratings also incorporate strong sponsor support. The ratings are supported by KMBL's expanding geographic presence, sustained growth in the microcredit portfolio along with increasing spreads, and enhanced focus on digitalization of core functions. However, the bank has recently witnessed pressure on asset quality indicators leading to decline in profitability. Moreover, liquidity and capitalization levels have also decreased. The ratings are dependent upon improvement in overall financial indicators of the bank.

Key Rating Drivers

Expanding business volumes: The bank was able to increase its market share, both in terms of loan and deposit portfolio, during 9MFY19. Growth in microcredit portfolio was mainly an outcome of higher average loan size during the period. The microcredit portfolio remained concentrated in agricultural/livestock segment which accounted for 82% of overall portfolio. Going forward, KMBL plans to gradually 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.

Pressure on asset quality: Asset quality remained under pressure during 9MFY19, mainly on account of overall slowdown in economic activity, low crops yields due to unpredictable weather conditions along with pest attack. Moreover, the elevated indebtedness of borrowers by increasing geographic concentration and aggressive portfolio growth policies of the industry players also contributed towards overall weakness in asset quality of the sector. Therefore, non-performing loans of the bank increased significantly to Rs. 2.4b by end-9MFY19 (FY18: Rs. 628m; FY17: 382m). Resultantly, the gross and net infection ratios of the bank increased to 4.9% and 3.3% (FY18: 1.4% and 1.0%) respectively. The management projects that the infection will ease off next year.

Lower profitability, though improving spreads: Profit before tax amounted to Rs. 1.9b during 9MFY19 (FY18: Rs. 3.5b) as the impact of growth in net markup income was partially offset by sizeable increase in provision against non-performing loans to Rs. 1.37b (FY18: Rs. 739m) and higher administrative expenses. Resultantly, Operational Self-Sufficiency declined to 107% (FY18: 132.7%). The increasing interest rate environment resulted in higher cost of funds during the period. While KMBL remained competitive on pricing in a bid to preserve its market share, the yield on markup bearing assets was positively impacted by notable increase in return rate on investment portfolio and placements with other financial institutions. Resultantly, the markup spread improved slightly to 12% during 9MFY19 (FY18: 11.7%).

Pressure on liquidity indicators: Customer deposits remained the primary source of lending activities. KMBL witnessed marginal growth in deposit base during 9MFY19, with some reduction in utilization of borrowings. Liquid assets in relation to deposits and borrowings decreased to 24% (FY18: 34%) as the bank used some liquid investment/placements to underpin growth in loan portfolio. Net advances to deposits ratio (ADR) increased to 83.8% (FY18: 77.7%), which is in line with the bank's target of 84.0% by end-FY19. The capital adequacy ratio (CAR) of the bank was recorded at 17.22% at end-9MFY19 (FY18: 18.93%) owing to increase in the risk weighted assets due to the implementation of IFRS 16. KMBL is in process of issuing another Tier-II capital of Rs. 1b to 1.5b, which along with the prior year's profits, will suffice for the capital adequacy requirements.

Debt Instrument: KMBL is in the process of issuing a rated, unsecured, subordinated and privately placed tier II term finance certificates (PPTFC)/subordinated term loan facility of up to Rs. 1.5b, including of green shoe option of Rs. 500m. The proceeds from the issue will contribute towards the bank's Tier-II capital and will be utilized to support growth in lending operations of the bank. The proposed instrument will carry a markup rate of 3-month KIBOR plus a spread of 2.7% per annum. The tenor will be up to eight years from issue date, inclusive of five years of grace period. The principal shall be redeemed in twelve equal quarterly installments, commencing from the 63th month from the issue date. The profit will be payable quarterly in arrears on the outstanding principal amount and shall be calculated on 365-day year basis. The first such profit payment shall fall due three months from the issue date, and subsequently, three months thereafter.

As per the lock-in clause requirement for Tier II Issues, neither profit nor principal will be payable (even at maturity) in respect of the PPTFC, if such payment will result in a shortfall in the Bank's Minimum Capital Requirement or Capital Adequacy Ratio or results in an increase in any existing shortfall in Minimum Capital Requirement or Capital Adequacy Ratio or results in an increase in any existing shortfall in MCR or CAR. As per Loss Absorbency Clause requirement for Tier II capital purpose, the PPTFC will be subject to loss absorbency and/or any other requirements under SBP's instructions on the subject. Upon the occurrence of a Point of Non-Viability event, SBP may at its option, fully and permanently convert the PPTFC/Loan Facility into common shares of the bank and/or have them immediately written off (either partially or in full). The conversion shall be based on the price as agreed with SBP. The instrument is embedded with a call option, enabling the issuer to call the instrument, in part or full subject to SBP approval, after five years or on any profit payment date thereafter during the tenor with not less than forty-five days prior notice to the trustee and the investors. The call option is exercisable only if KMBL's MCR and CAR requirement is in compliance. The instrument is also embedded with some financial covenants, including I) PAR>30 days should not exceed 4.0%, II) Operational Self Sufficiency (OSS) Ratio not to fall below 100%, III) KMBL to maintain its capital adequacy ratio over and above 1.5% of the minimum capital adequacy requirement prescribed by SBP for MFBs during redemption period (6th – 8th year).

FINANCIAL SUMMARY			*(amounts in PKR millions)*
BALANCE SHEET	**Dec 31, 2017**	**Dec 31, 2018**	**Sep 30, 2019**
Total Investments	16,297.6	8,915.7	12,031.1
Cash and Balance with other Banks/NBFIs/MFBs	4,063.4	9,291.1	2,562.4
Lending to Financial Institutions	474.5	1,837.7	-
Net Advanced	32,216.0	43,374.3	49,278.5
Operating Fixed Assets	1,141.6	1,353.5	3,763.1
Other Assets	4,768.1	5,699.6	7,805.5
Total Assets	**58,961.2**	**70,472.0**	**75,440.5**
Total Deposits	45,746.9	56,018.0	58,839.2
Borrowings	4,782.7	3,964.9	2,904.0
Other Liabilities	2,075.9	2,289.6	4,576.5
Total Liabilities	52,605.4	62,272.5	66,319.8
Net Worth	**6,355.8**	**8,199.5**	**9,120.8**
Share Capital	1,705.0	1,705.0	1,705.0
Statutory Reserve	1,201.3	1,693.0	1,790.5
Capital Reserve	24.3	24.3	-
Unappropriated Profit	3,423.7	4,776.2	5,625.3
Tier-1 Equity	**6,354.3**	**8,198.5**	**9,120.8**
Paid-up Capital	1,705.0	1,705.0	1,705.0
INCOME STATEMENT	**Dec 31, 2017**	**Dec 31, 2018**	**Sep 30, 2019**
Net Mark-up Income	5,744.9	7,335.9	6,478.3
Net Provisioning / (Reversal)	712.7	738.7	1,365.3
Non-Markup Income	1,339.9	1,638.6	1,142.8
Operating Expenses	3,857.0	4,706.6	4,147.5
Profit Before Tax	2,489.0	3,470.3	1,939.7
Profit after tax	1,800.6	2,458.8	1,473.1
RATIO ANALYSIS	**Dec 31, 2017**	**Dec 31, 2018**	**Sep 30, 2019**
Gross Infection (%)	1.2	1.4	4.9
Incremental Infection (%)	1.5	2.4	5.6
Provisioning Coverage (%)	27.8	34.1	33.9
Net Infection (%)	0.9	1.0	3.3
Net NPLs to Tier-1 Capital (%)	4.3	5.0	17.5
Capital Adequacy Ratio	18.4	18.9	17.2
Cost of Funds	8.1	8.6	10.8
Markup Spreads (%)	12.9	11.7	13.2
OSS (%)	130.6	132.7	107.0
Liquid Assets to deposits & borrowings (%)	41.2	34.0	24.0

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix 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	Microfinance Bank (MFB)
Type of Relationship	Solicited
Purpose of Rating	Entity & Instrument 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
RATING TYPE: PPTFC-I				
4/30/2019	A		Stable	Reaffirmed
4/26/2018	A		Stable	Final
12/13/2017	A		Stable	Preliminary
RATING TYPE: PPTFC-2				
12/11/2019	A		Stable	Preliminary

Instrument Structure (PPTFC-1, Tier-II)

Unsecured subordinated TFC amounting to Rs. 1.0b, having tenor of eight years.

(PPTFC-2, Tier-II)

KMBL is in the process of issuing a rated, unsecured, subordinated and privately placed tier II term finance certificates (PPTFC)/subordinated term loan facility of up to Rs. 1.5b, including of green shoe option of Rs. 500m. The proceeds from the issue will contribute towards the bank's Tier-II capital and will be utilized to support continued growth in lending operations of the bank. The proposed instrument will carry a markup rate of 3-month KIBOR plus a spread of 2.7% per annum. The tenor will be up to eight years from issue date, inclusive of five years of grace period.

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.

Disclaimer

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