RATING REPORT

Khushhali Microfinance Bank Limited

REPORT DATE:
May 04, 2020

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	A *(Final)*		A *(Preliminary)*	
Rating Outlook	Rating Watch-Developing		Stable	
Rating Date	*April 29, 2020*		*April 30, 2019*	

COMPANY INFORMATION

Incorporated in 2000	**External auditors:** EY Ford Rhodes
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%	
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)

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 35 years 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: end-FY19: Rs. 81.5b; end-FY18: Rs. 70.5b

Total Equity: end-FY19: Rs. 9.4b; end- FY18: Rs. 8.2b

Profit After Tax: FY19: Rs. 1.8b; FY18: Rs. 2.5b

RATING RATIONALE

Khushhali Microfinance Bank Limited (KMBL) is the leading provider of microcredit services in the microfinance sector in Pakistan, having 17.50% market share in loan portfolio and 23.90% in retail deposits amongst microfinance banks. The assigned ratings take into account strong sponsor profile and implicit support of shareholders as and when required. Three major shareholders are considering the aggregate stake sale of 58.6% to a consortium of renowned strategic investors; the divestment process in underway and is expected to be completed by end-FY20. While the financial and experience profile of overall sponsor base is expected to remain intact, VIS will review the same upon completion of the divestment process. The ratings also incorporate growth in microcredit portfolio, expanding geographic outreach and enhancing focus on digitization to remain competitive. The ratings also factor in largely maintained Capital Adequacy Ratio (CAR) on back of profit retention and issuance of Tier-II capital, despite considerable increase in risk weighted assets. Meanwhile, asset quality indicators were under stress during FY19, as evident from considerable increase in infection, leading to decline in profitability.

In the aftermath of current pandemic and the resultant lockdown have impacted various sectors across the globe; it will also have implications on microfinance industry, having major client base of rural population and underserved segment nationwide. With the reduction in disposable income and economic slowdown, the bank's targeted growth and profitability may get affected, the extent of which remain to be seen.

Key Rating Drivers

Maintained industry leadership, despite slower business growth: Growth in loan portfolio during FY19 slowed down to 23% vis-à-vis 35% in the preceding year. Growth in microcredit portfolio was driven by higher disbursement, with increasing focus on higher ticket loans, progression of existing clients towards successive loan cycle and higher number of active borrowers, the same was supported by expansion in branch network. Given the holistic strategy of higher ticket loans and reducing concentration in group loans, the bank has introduced 13 new products with an upper limit of Rs. 1.0m, which is expected to improve market penetration and customer base. The sector-wise concentration witnessed a slight change as agriculture (crop & livestock) loans constituted 79% (FY18: 84.5%) along with some increase in enterprise and general purpose loans.

Asset quality under stress: In the backdrop of economic slowdown and decline in wheat and cotton crop yield due to heavy rains, portfolio quality of the bank witnessed decline during FY19. The same was further fueled by aggressive growth strategies by industry players, resulting in geographical concentration and over indebtedness of clients amid multiple lending by MFBs. Therefore, the non-performing loans (NPLs) of the bank inclusive of principal and interest, surged to Rs. 2.5b (FY18: Rs. 627.8m) by end-FY19. Resultantly, the gross and net infection ratios increased to 4.7% and 3.4% (FY18: 1.4% and 1.0%) respectively. In line with increase in NPLs and higher write-offs against provisions amounting Rs. 1.7b (FY18: Rs. 615.2m), incremental infection stood higher at 7.4% (FY18: 2.4%) by end-FY19.

The management has taken various initiatives to control increasing trend in non-performing loans. These included implementation of list of negative areas for lending, focus on monitoring weather conditions with real time update to all branches via circulars, aligning of industry experience of loan officers with the risk level of portfolio, capping of sales incentives to discourage overburdening of LOs, deployment of additional relationship managers for selected high volume/high default branches, CIB enquiry from private credit bureaus (in order to mitigate risk of over indebtedness) and further split of areas in order to reduce the work load from front end staff.

Low market risk: More than half of the investment portfolio constituted investment in T-bills while the rest comprised Term Deposit Receipts placed with other microfinance banks. Market risk relating to the investment portfolio is considered low given short-term nature of investments, while credit risk is deemed minimal given investment in government securities and financial institutions having sound credit ratings.

Lower profitability on account of higher incidence of provisions against NPLs: Despite increase in core income, higher incidence of NPLs has resulted in decline in overall profitability of the bank. Resultantly, KMBL profit before tax decreased to Rs. 2.5b (FY18: Rs. 3.5b) during FY19. Operational Self-Sufficiency also declined to 115.8% (FY18: 132.7%) during FY19. Overall yield on markup bearing assets increased during the year on back of higher yield on investment and placement and largely sustained yield on net advances. Cost of funds increased on account of increasing interest rates during outgoing year, however, with higher yield on interest bearing assets, the bank managed to largely maintain markup spread at 13.0% (FY18: 13.1%) during FY19.

Liquidity position witnessed some weakness while capitalization indicators remained largely intact: Deposits remained the primary source of funding for the bank. The proportion of current and saving accounts (CASA) in overall deposit mix decreased slightly to 34% (FY18: 35%) owing to increase in term deposits while current deposits remained largely stagnant during FY19. Advances to deposit ratio (ADR) increased to 83.8% (FY18: 77.7%) by end-FY19. Going forward, the management plans to maintain ADR at 80%. Concentration risk on the liability side increased slightly, as contribution of top 50 depositors increased to 27.2% (FY18: 21.9%) by end-FY19. According to the management, about two third of deposits are contract based having maturity of more than one year, that provides cushion in an unforeseen event of deposit withdrawals. Liquid assets to total deposit and borrowings decreased to 27.1% (FY18: 34.0%). The deferment of a portion of repayments against advances, in accordance with the SBP guidelines, may impact liquidity position of the bank, going forward. KMBL plans to continue growing its customer deposit base and phase out commercial borrowings on back of planned deposit growth.

Capital Adequacy Ratio (CAR) of the bank was largely maintained at 19.1% (FY18: 18.9%) on back of profit retention and issuance of Tier-II capital of Rs. 1.4b, despite higher risk weighted assets by end-FY19. However, as per management, CAR is expected to decrease marginally to 18.8% by the end-FY20 on account of growth in business.

Digitization to support competitive positioning: With the deployment of new core banking system, Temenos T-24, in 2019, KMBL further embarks upon digitizing the lending process and scoring models which is expected to assist in portfolio growth, improve workload management, support cross selling and effective use of resources. In FY19, with the establishment of a dedicated unit of Digital Financial Service (DFS), the management envisaged different projects to enhance productivity and customer experience. KMBL has signed an agreement in November, 2019 with International Finance Corporation (IFC) having a duration of two years to empower farmers through digital-agri transformation program and identify potential market in Agri value chain. The banks plans to launch its own ATM platform and implement enterprise level Human Resource System (Oracle HCM) in the ongoing year.

Khushhali Microfinance Bank Limited Annexure I

FINANCIAL SUMMARY			*(amounts in PKR millions)*
BALANCE SHEET	**Dec 31, 2017**	**Dec 31, 2018**	**Dec 31, 2019**
Cash and Bank Balances with SBP and NBP	1,664.3	1,792.7	2,926.2
Balances with other Banks and/NBFIs/MFBs	2,399.1	7,498.4	4,181.1
Lending to Financial Institutions	474.5	1,837.7	450.0
Total Investments	16,297.6	8,915.7	10,111.7
Net Advances	32,216.0	43,500.5	53,541.2
Operating Fixed Assets	1,141.6	1,353.5	3,612.3
Other Assets	4,768.1	5,573.3	6,670.6
Total Assets	**58,961.2**	**70,472.0**	**81,493.1**
Total Deposits	45,746.9	56,018.0	63,882.3
Borrowings	4,782.7	2,964.9	1,326.0
Subordinated Debt	-	1,000.0	2,400.0
Other Liabilities	2,075.9	2,289.6	4,486.1
Tier-1 Equity	6,354.3	8,198.5	9,399.2
Net Worth	6,355.8	8,199.5	9,398.7
Paid-Up Capital	1,705	1,705	1,705
INCOME STATEMENT	**Dec 31, 2017**	**Dec 31, 2018**	**Dec 31, 2019**
Net Mark-up Income	5,744.9	7,335.9	8,459.5
Net Provisioning / (Reversal)	712.7	778.2	2,259.4
Non-Markup Income	1,339.9	1,638.6	1,973.5
Operating Expenses	3,857.0	4,725.9	5,655.1
Profit Before Tax	2,489.0	3,470.3	2,518.5
Profit after tax	1,800.6	2,458.8	1,836.2
RATIO ANALYSIS	**Dec 31, 2017**	**Dec 31, 2018**	**Dec 31, 2019**
Gross Infection (%)	1.2	1.4	4.7
Incremental Infection (%)	1.5	2.4	7.3
Provisioning Coverage (%)	27.8	34.1	29.9
Net Infection (%)	0.9	1.0	3.4
Net NPLs to Tier-1 Capital (%)	4.3	5.0	19.0
Capital Adequacy Ratio (%)	18.9	18.9	19.1
Cost of Funds (%)	8.1	8.6	11.0
Markup Spreads (%)	14.6	13.1	13.0
OSS (%)	130.6	132.7	115.8
ROAA (%)	4.0	3.8	2.4
ROAE (%)	31.9	33.8	20.9
Gearing (x)	N/A	N/A	N/A
Current Ratio (x)	N/A	N/A	N/A
Liquid Assets to deposits & borrowings (%)	41.2	34.0	27.1

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 Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
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				
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				
04/29/2020	A		Rating Watch-Developing	Final
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)	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 28, 2020
2	Mr. Niaz Ahamd	Manager Financial Reporting	April 09, 2020