RATING REPORT

Khushhali Microfinance Bank Limited

REPORT DATE:
May 04, 2021

RATING ANALYSTS:
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RATING DETAILS				
	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	A+	A-1	A+	A-1
PPTFC-I	A		A	
PPTFC-II	A		A *(Final)*	
Rating Outlook	Rating Watch-Developing		Rating Watch-Developing	
Rating Date	*April 30, 2021*		*April 29, 2020*	

COMPANY INFORMATION	
Incorporated in 2000	**External auditors:** EY Ford Rhodes
Public Limited 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)
VIS Entity Rating Criteria: Micro-Finance Banks (May 2016)   *http://www.vis.com.pk/kc-meth.aspx*

Khushhali Microfinance Bank Limited

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:

Mr. M.Ghalib Nishtar is the founding President of Khushhali Microfinance Bank Ltd., Pakistan's largest microfinance bank. He is regarded as a pioneer microfinance banker of Pakistan's burgeoning microfinance industry. Mr. 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

RATING RATIONALE

Khushhali Microfinance Bank Limited (KMBL) has cemented its prominent position as the leading provider of microcredit services in the microfinance sector of Pakistan, having a market share of 19% (FY19: 18%) in loan portfolio and 24% of deposits during the outgoing year. The ratings derive comfort from strong sponsor profile and implicit support of shareholders available. The ratings incorporate the uncertainty involving financial risk profile of the bank as around 40% of the total portfolio is categorized under rescheduled in light of SBP's direction to relax repayment terms for borrowers effected by the COVID-19. Stemming from the aforementioned one-off event, portfolio quality indicators exhibited improvement during the outgoing year. VIS expects that the real infection ratios will eventually come forth by end-HY22 on the maturity of rescheduled portfolio.The ratings factor in improvement in liquidity profile, sizable investment portfolio and maintained capitalization indicators. The Bank has planned TFC-III issue amounting to Rs. 600m to strengthen capital adequacy further; the issue is already approved by SBP. 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 was expected to be completed by end-FY20; however the same has been moved to end-FY21 in view of COVID disruption. 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.

Key Rating Drivers

Growth in micro-credit portfolio was contained owing to onslaught of COVID-19: The lending activities were largely curtailed during the outgoing year with management focusing more towards portfolio consolidation and recovery activities as the repayment capacity of micro-credit borrowers was adversely impacted even prior to the pandemic; the same worsened in line with depressed economic activity owing to corona virus. Moreover, with rollover of advances in retrospect of SBP's relaxation measures to mitigate economic slowdown, the Bank's cash flow cycle was confined therefore the bank fell well short of its disbursement target of Rs. 71.2b for FY20 with actual disbursement amounting to Rs.38.2b. Therefore, Gross Loan Portfolio (GLP) exhibited growth of 13.0% (FY19: 23.4%) and was recorded at Rs. 60.6b (FY19: Rs. 53.6b). Further, the number of new clients added to the bank's portfolio also dwindled to 167,271 (FY19: 290,070) during FY20. The concentration of group loans in total GLP was recorded lower while share of individual loans increased slightly along with higher proportion of MSME loans by end-FY20. In terms of sectoral composition, highest repayment risk is associated with consumption loans as there is no cash flow generation to support repayment; the proportion of same increased sizably 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. Similarly, the proportion of secured portfolio increased during FY20 and the bank further intends to enhance proportion of secured portfolio to 40% to manage credit exposure by end-FY21. The Bank has targeted around 7% growth in the loan book to reach Rs. 66.3b by end-FY21.

Credit risk; asset quality indicators exhibited improvement from last year numbers mainly on account of Regulatory relief: The non-performing loans (NPLs) of the bank were recorded lower at end-FY20, mainly on account of regulatory relief, provided by the apex bank, of extension of repayment by a year to microfinance borrowers to dampen the impact of COVID-19. By end-FY20, the deferred portfolio amounted to Rs. 7.1b while the rescheduled loans stood at Rs. 18.4b; both aggregating to Rs. 25.4b. The Bank's current recovery ratio that precisely reflects cash collection as a proportion of loan amounts (principal & interest) took a sharp dip to 50.6% (4QFY19: 128.6%) in the last quarter of FY20;

Total assets: end-FY20: Rs. 107.1b; end-FY19: Rs. 81.5b;

Total Equity: end-FY20: Rs. 10.8b; end-FY19: Rs. 9.4b;

Profit After Tax: FY20: 1.7b; FY19: Rs. 1.8b;

meanwhile the cumulative recovery ratio for FY20 was also dismal at 57.9% (FY19: 125.5%). Given, the window of rescheduled/restructured loans was accessible till end-1QFY21 whereby the repayment terms of mark-up amount can also be relaxed, the total loans rescheduled amounted to Rs. 21.5b taking the aggregate of deferred portfolio to Rs. 28.3b at end-1QFY21. Out of the total rolled over portfolio quoted, Rs. 25.5b was done under SBP's relief and was simultaneously reported to the latter; however, the mangment extended refief to EMI borrowers also amounting to Rs. 2.9b at end-1QFY21. The majority of deferred portfolio pertained to agriculture (Rs.15.3b) followed by livestock loans (Rs. 12.4b) both entailing bullet repayment structure at end-1QFY21. Out of the total rescheduled portfolio, Rs. 7.3b was due from July'20 till Mar'21 out of which Rs.5.9b has been recovered showing a composite recovery rate of around 80%. Further, Rs.796m has already been recovered showing early recovery rate of around 3%; the remaining amount is Rs. 21.6b. As per the management, going forward the average rate of recovery is expected around 65%; late recovery proportion estimated at 15% while the remaining 20% may be classified as NPL. Holistically, out of the total classified portfolio after recovery of interest the management expects write-off of 15% of deferred portfolio as against the industry forecast of around 20%. In line with the bank's historical practice, the write-offs are majorly expected to be against provisions suitably provided for in the budget. Owing to three-fourth of the bank's advances portfolio involving bullet repayment, around 40% of the total micro-credit is categorized under restructured loans under regulatory relief; the proportion is relatively on a higher side in comparison to peer banks. The same remains a key rating concern for VIS; hence the asset quality indicators will be stringently monitored over the due course, any adverse movement in the same may warrant revision in ratings.

The advances charged off against provisions stood higher at Rs. 2.8b (FY19: Rs. 1.7b) at end-FY20; meanwhile, bad debts directly written off also increased during the outgoing year; however the proportion of the same is insignificant in comparison to total write-offs for the year. Despite sizable quantum of write-offs added, the incremental infection also exhibited an improved position at end-FY20 owing to differential in value of NPLs with FY19 creating a positive spread for offsetting higher quantum of write-offs incurred during FY20. In addition, the provisioning coverage also improved in line with reduction in NPLs along with major charge-offs against provision. The general provisioning is now maintained at 1.33% of the total micro-credit portfolio as opposed to regulatory requirement of 1.00% in FY19 as a subjective cover for the expected loan losses. The Bank was awarded "The Best Microfinace Bank" for the third time in a row by the Institute of Bankers of Pakistan. In addition, the CFA society also awarded best microfinance bank of Pakistan during the year.

To mitigate credit risk going forward, various steps have been taken by the management including 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 and deployment of additional relationship managers for selected high volume/high default branches to manage default. Further to improve recovery of deferred portfolio, vigilant monitoring of deferred/rescheduled portfolio is being carried out at HO level with recovery efforts of LO's analyzed. In this regard a special dashboard has been designed. Moreover, monthly meeting with these borrowers is being conducted for improved client liaison to aide timely repayment. Further, staff incentive structure has been revamped with improved payout percentage along with shift of incentive calculation basis from sales to recovery. Furthermore, special incentive in form of waiver of markup is given to borrowers upon full loan settlement. The incentive is being given to selected borrowers who availed rescheduling facility and their markup had doubled in line with non-payment.

Considerable growth in investment portfolio; credit risk is negligible with market risk being manageable: Given limited lending, the liquid resources were vested in investments primarily government securities. Therefore, credit risk emanating from investment portfolio remained negligible as around 88% of the total investments constituted sovereign securities. The remaining investment portfolio comprised term deposit receipts, which were placed with other microfinance banks financial having sound repayment history and credit ratings. Further, the market risk is considered also manageable given short to medium term nature of investments. At end-FY20, there was asset liability mismatch in up to one-month bracket mainly due to considerable amount of cost bearing deposits falling due in the said bracket. The risk is mitigated to a certain extent given un-availed credit lines available with the local banks.

Depressed profitability; high provisioning expense is the main contributing factor: Despite no major decline in mark-up spreads and slight increase in the number of loans disbursed, profitability of the bank took a downward trend primarily owing to increase in cost of funds coupled with increase in administrative and provisioning expense of the bank. As a result, Operational self-sufficiency (OSS) ratio decreased in line with higher provisioning recorded on account of increased incidence of non-performing loans emanating from the agri and livestock portfolio during the outgoing year. The markup income earned was reported higher largely on back of increase in average microcredit portfolio. Moreover, the yield on net advances increased owing to higher disbursement under MSME segment entailing higher interest rates. However, yield on investments reduced in line with reduced benchmark rates to cater to financial shocks to the economy amid COVID-19; therefore there was no net impact on overall yield on interest bearing assets during the review period.

Despite decline in benchmark rates during the period under review, cost of borrowing remained unchanged owing to highest borrowing quantum in 1QFY20 whereby the policy rate was high at 13.25%; the borrowings exhibited a declining trend from 2QFY20 on account of contractual maturity of these borrowings. Further, the rescheduling of loans under the SBP's directive put a cap on cash flows available for the disbursement of new loans coupled with management decision to reduce micro-credit exposure, led to decline in number of loans disbursed during FY20, therefore, microcredit application processing fee declined in FY20; putting a dent on non-interest income. As a combined impact of reduction in spreads and fee income along with increase in operating and provision expenses profit before tax of the bank marginally decreased during the outgoing year despite increase in quantum of earning assets. The management has projected profit before taxation of Rs. 1.6b for FY21; which is realistic in line with additional provisioning requirements of around Rs. 4.3b.

Sound liquidity profile underpinned with sizable investments and balances held with financial institutions: Liquidity profile of the bank has exhibited improvement and is considered sound in line with sizable quantum of investments carried on the books along with growth in cash avenues including balances with other banks. The same is a function of excess liquidity available owing to streamlined lending activities as part of the prudent strategy with increased focus on recoveries for curtailment of NPLs. The liquidity is further supported by drop in the advances to deposit ratio during the rating review period. Deposits continued to remain the primary source of funding for the bank during the period under review. The increase in the deposit base is in sync with the industry growth as with the ongoing pandemic the consumers have put spending on hold and opted for saving strategy rather than investing to avoid excessive risk taking. 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. Going forward, the management intends to secure the deposit base at around currents levels while shedding high cost deposits so relieve pressure on spreads. In addition, the bank intends to increase the proportion of CASA; internet and mobile banking launched in the outgoing year will enable the bank to offer more competitive services. Concentration risk on the liability side largely remained at prior year's level as contribution of top 50 depositors stood at 27.3% (FY19: 27.2%) at end-FY20. With significant growth in deposits; KMBL's reliance on borrowings has dwindled over time.

Capitalization indicators intact; management plans to issue another Tier-II instrument during the current year: Capital Adequacy Ratio (CAR) of the bank improved slightly on back of profit retention. No dividend was paid out during the outgoing year as compared to Rs.167.4m in FY19 to strengthen the loss absorption capacity of the bank in line with heightened credit risk scenario. However, the management projects a dividend payment for FY21. In addition, the management plans to issue another Tier II capital instrument of Rs. 600m to support capital adequacy during the ongoing year.

Khushhali Microfinance Bank Limited Appendix I

FINANCIAL SUMMARY	*(amounts in PKR millions)*			
BALANCE SHEET	**Dec 31, 2017**	**Dec 31, 2018**	**Dec 31, 2019**	**Dec 31, 2020**
Cash and Bank Balances with SBP and NBP	1,664.3	1,792.7	2,926.2	2,8503
Balances with other Banks and/NBFIs/MFBs	2,399.1	7,498.4	4,181.1	10,752.2
Lending to Financial Institutions	474.5	1,837.7	450.0	796.0
Total Investments	16,297.6	8,915.7	10,111.7	17,679.9
Net Advances	32,216.0	43,500.5	53,541.2	60,640.8
Operating Fixed Assets	1,141.6	1,353.5	3,612.3	3,688.2
Other Assets	4,768.1	5,573.3	6,670.6	10,695.5
Total Assets	**58,961.2**	**70,472.0**	**81,493.1**	**107,102.9**
Total Deposits	45,746.9	56,018.0	f,882.3	88,649.8
Borrowings	4,782.7	2,964.9	1,326.0	427.7
Subordinated Debt	-	1,000.0	2,400.0	2,400.0
Other Liabilities	2,075.9	2,289.6	4,486.1	4,831.5
Tier-1 Equity	6,354.3	8,198.5	9,399.2	10,801.4
Net Worth	6,355.8	8,199.5	9,398.7	10,793.9
Paid-Up Capital	1,705	1,705	1,705	1,705
INCOME STATEMENT	**Dec 31, 2017**	**Dec 31, 2018**	**Dec 31, 2019**	**Dec 31, 2020**
Net Mark-up Income	5,744.9	7,335.9	8,459.5	9,938.2
Net Provisioning / (Reversal)	712.7	778.2	2,259.4	2,992.4
Non-Markup Income	1,339.9	1,638.6	1,973.5	1,543.0
Operating Expenses	3,857.0	4,725.9	5,655.1	6,097.1
Profit Before Tax	2,489.0	3,470.3	2,518.5	2,391.8
Profit after tax	1,800.6	2,458.8	1,836.2	1,739.8
RATIO ANALYSIS	**Dec 31, 2017**	**Dec 31, 2018**	**Dec 31, 2019**	**Dec 31, 2020**
Gross Infection (%)	1.2	1.4	4.7	3.1
Incremental Infection (%)	1.5	2.4	7.3	3.6
Provisioning Coverage (%)	27.8	34.1	29.9	34.3
Net Infection (%)	0.9	1.0	3.4	2.1
Net NPLs to Tier-1 Capital (%)	4.3	5.0	19.0	11.5
Capital Adequacy Ratio (%)	18.9	18.9	19.1	19.6
Cost of Funds (%)	8.1	8.6	10.8	11.2
Markup Spreads (%)	14.6	13.1	11.9	11.4
OSS (%)	130.6	132.7	115.8	112.9
ROAA (%)	4.0	3.8	2.4	1.8
ROAE (%)	31.9	33.8	20.9	17.2
Gearing (x)	N/A	N/A	N/A	N/A
Current Ratio (x)	N/A	N/A	1.63	1.18
Liquid Assets to deposits & borrowings (%)	41.2	34.0	27.1	36.0

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	Micro Finance Bank (MFB)
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
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				
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				
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.
Disclaimer	Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. VIS is not an NRSRO and its ratings are not NRSRO credit ratings. Copyright

Due Diligence Meetings Conducted

	Name	Designation	Date
1	Mr. F. S. Hamad Haider	Head of Operations	April 06, 2021
2	Mr. Saleem Akhtar Bhatti	Group Head Finance & CFO	April 06, 2021
3	Ms. Amna Hassan	Group Head Business	April 06, 2021
3	Mr. Aftab Alam	Head of Distribution	April 06, 2021
4	Mr. Ali Imran Bokhari	Chief Risk Officer	April 06, 2021
5	Mr. Daniyal Haq Awan	Chief Internal Auditor	April 06, 2021
6	Mr. Atif Aziz Ahmed	Chief Information Officer	April 06, 2021