JSC MFO Micro Business Capital

Rating report

Issuer rating

B

Outlook

Positive

Lead Analyst

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Summary and Outlook

Micro Business Capital (MBC)'s issuer rating of B reflects the following assessments:

- **Business model assessment: Focused (High)**. MBC is one of the largest microfinance organisations (MFO) in Georgia, with a business model focused on collateralised lending to micro-organisations, SMEs and the agricultural sector. MBC submitted an application for a microbank licence to the National Bank of Georgia and a decision is expected by November 2024 at the latest. Our assessment factors the possibility that MBC will continue to develop its business proposition.
- **Operating environment assessment**: **Constraining (Low).** The National Bank of Georgia supervises the MFO sector under a set of regulations that are less stringent than those for licensed banks and microbanks. The regulatory framework for microbanks has recently been enacted and is better aligned with the banking regulatory framework, which in our view will strengthen the operational set-up for entities that are currently subject to less stringent regulatory oversight.
- **Long-term sustainability assessment (ESG factor): Developing**. MBC remains committed and active in environmental, social and governance areas and investing in digitalisation (ESG factor). Recent examples include the company's integration into an e-commerce platform for its foreign exchange operations and the development of a remote loan application platform.
- **Earnings and risk exposures assessment: Neutral**. MBC's profitability is improving due to higher loan volume growth, lower hedging costs and lower provisions. Following the consolidation of its branch network and the adaptation of the commercial strategy to improve cross-selling, and the expected business expansion, we anticipate that MBC's revenue base will continue to grow in 2024.
- **Financial viability assessment: Adequate**. MBC maintains an adequate capital position with a buffer of approximately 380 bps above the 18% minimum regulatory capital requirement for MFOs. Due to management's objective to obtain funding at the lowest possible costs, MBC has experienced some periods of tight liquidity, but has managed to maintain levels above the regulatory requirement. MBC relies on a mix of local commercial banks, bond issuance and international financial institutions to fund its lending activities.

The Positive Outlook reflects Scope's view that the risks to the current rating are tilted to the upside.

The upside scenarios for the rating and Outlook:

- Confirmation that compliance with the microbank licence's requirements enhances MBC's creditworthiness, which could be reflected in a higher operating environment assessment.
- Evidence that the company is able to generate sustained and consistent earnings, e.g. by leveraging on the benefits of a microbank license.
- A material improvement in capital metrics, with a larger and stable excess buffer above the regulatory minimum, and sound liquidity management.

The downside scenarios for the rating and Outlook:

- Failure to obtain a microbank license.
- Pressure on profitability due to a lower ability to generate sustained revenue, higher funding costs and/or higher impairment charges.
- Material deterioration in the company's liquidity position as well as in its solvency metrics.

Rating drivers

<table>
<tr><th colspan="2">Rating drivers</th><th colspan="30">Assessment</th></tr>
<tr><td rowspan="7">STEP 1</td><td>Operating environment</td><td colspan="6">Very constraining</td><td colspan="6">Constraining</td><td colspan="6">Moderately supportive</td><td colspan="6">Supportive</td><td colspan="6">Very supportive</td></tr>
<tr><td>Low/High</td><td colspan="15">Low</td><td colspan="15">High</td></tr>
<tr><td>Business model</td><td colspan="6">Narrow</td><td colspan="6">Focused</td><td colspan="6">Consistent</td><td colspan="6">Resilient</td><td colspan="6">Very resilient</td></tr>
<tr><td>Low/High</td><td colspan="15">Low</td><td colspan="15">High</td></tr>
<tr><td>Initial mapping</td><td colspan="30">b</td></tr>
<tr><td>Long-term sustainability</td><td colspan="6">Lagging</td><td colspan="6">Constrained</td><td colspan="6">Developing</td><td colspan="6">Advanced</td><td colspan="6">Best in class</td></tr>
<tr><td>Adjusted anchor</td><td colspan="30">b</td></tr>
<tr><td rowspan="4">STEP 2</td><td>Earnings capacity & risk exposures</td><td colspan="6">Very constraining</td><td colspan="6">Constraining</td><td colspan="6">Neutral</td><td colspan="6">Supportive</td><td colspan="6">Very supportive</td></tr>
<tr><td>Financial viability management</td><td colspan="5">At risk</td><td colspan="5">Stretched</td><td colspan="5">Limited</td><td colspan="5">Adequate</td><td colspan="5">Comfortable</td><td colspan="5">Ample</td></tr>
<tr><td>Additional factors</td><td colspan="6">Significant downside factor</td><td colspan="6">Material downside factor</td><td colspan="6">Neutral</td><td colspan="6">Material upside factor</td><td colspan="6">Significant upside factor</td></tr>
<tr><td>Standalone rating</td><td colspan="30">b</td></tr>
<tr><td>STEP 3</td><td>External support</td><td colspan="30">Not applicable</td></tr>
<tr><td colspan="2">Issuer rating</td><td colspan="30">B</td></tr>
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Credit ratings

		Credit rating	Outlook
Issuer	**JSC MFO Micro Business Capital**		
	Issuer rating	B	Positive

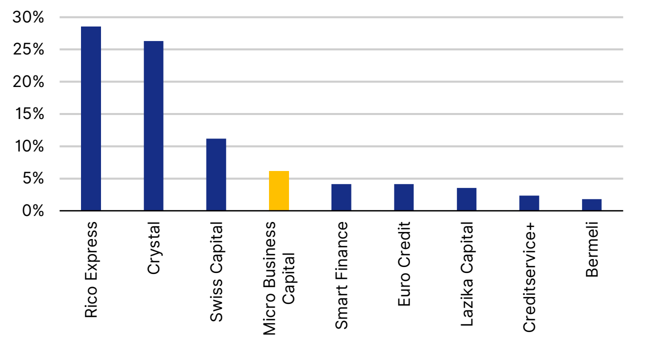
Business model

'Focused – high' business model assessment

MBC ranks fourth in the heterogenous Georgian MFO sector, with total assets of GEL 117m (roughly EUR 39m) and a 6% market share of net loans as of March 2024.

MBC's main financial products include trade and service loans, production and craft activity loans (business loans), consumer loans, agro loans and housing loans. Business loans and consumer loans represented about 80% of gross loans as of May 2024. Since 2019, MBC has been growing its agro loan business by expanding into rural Georgia. The share of consumer lending has also increased since 2022 reflecting the strong demand and attractive profitability for MFOs. Growing business lending remains a strategic focus and a lower-risk segment given the tighter regulation on loan-to-value and payment-to-income ratios.

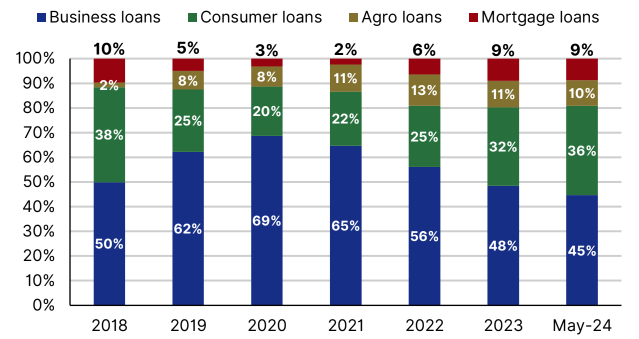
Figure 1: Georgian MFOs ranked by market share of net loans (Q1 2024)



Note: Not publicly available information for Leader Credit

Source: NBG, Company data, Scope Ratings

Figure 2: MBC's gross loan portfolio breakdown by product (2018-May 2024)



Source: Company data, Scope Ratings

Due to the consolidation of the MFO market in Georgia, and the competitive pressure, MBC has decided to apply for a microbank licence. MBC submitted an application for a microbank licence to the National Bank of Georgia in November 2023. The application is under review and a decision is expected by November 2024 at the latest. We view this strategic decision to apply for a microbank licence positively, as this status would allow for greater diversification on both sides of the balance sheet and access to a larger potential market. However, reaping the full benefits of this change will take some time, such as attracting customer deposits to further improve its funding diversification and reduce funding costs.

We expect operating expenses to increase in the medium-term due to additional headcount needed and additional investment on digital capabilities as the company prepares to become a microbank.

MBC will continue to access funding from international financial institutions (IFIs), grow its agricultural loan portfolio and improve efficiency to achieve a competitive size in the market.

Operating environment

Focus on Micro Business Capital's country of domicile: Georgia (BB/Stable)

Economic assessment:

- The Georgian economy is experiencing a strong recovery and robust medium-run growth potential. The growth of recent years has well exceeded this trend rate, benefitting from strong services-sector exports, financial inflows, transit trade and favourable arrivals of skilled workers from Russia, Belarus and Ukraine. After very strong real growth of 10.6% in 2021, 11.0% 2022, and 7.5% in 2023, growth is expected to stay strong at 7.5% this year before 5.4% next year.
- Russia's invasion of Ukraine creates significant economic uncertainties given the strong trade linkages of Georgia to the warring counterparties. So far, the economy has weathered the crisis exceptionally well.
- In addition, the economy is vulnerable to external shocks due to its small size alongside elevated reliance upon external funding and elevated dollarization.
- The Georgian parliament adopted a new foreign-agent law in May 2024, which was a source of political tensions in the country. It remains to be seen to what extent prolonged political tensions could alter economic momentum in the country.

Key economic indicators	2021	2022	2023	2024E	2025F
Real GDP growth, %	10.6	11.0	5.0	7.5	5.4
Inflation (HICP), % change	9.6	11.9	2.5	1.6	2.9
Unemployment rate, %	20.6	17.3	16.4	13.5	13.0
Policy rate, %	10.5	11.0	9.5	7.5	7.0
Public debt, % of GDP	49	39	39	40	39
General government balance, % of GDP	-6.0	-2.6	-2.3	-2.6	-2.2

Source: Scope Ratings

Soundness of the Georgian financial sector:

- Commercial banks dominate the Georgian domestic financial sector, accounting for over 90% of assets as of December 2023. Pension funds, insurance companies, microfinance organizations (MFOs) and loan issuing entities (LIEs) account for less than 10% of total assets combined.
- As of March 2024, about 34 MFOs were operating in Georgia. The sector comprises a diverse set of players, some concentrating on a selection of business products (e.g. Rico Express, Swiss Capital, Euro Credit) and others covering a broader product range (e.g. Crystal, Micro Business Capital)
- MFOs mainly provide consumer loans (over 80% of the total as of March 2024), followed by trade and services loans (10%) and agriculture and forestry loans (7%).
- The MFO sector is highly concentrated: the five largest MFOs hold approx. 75% of total assets and total net loans of the sector as of March 2024. Since 2016, the number of active MFOs has more than halved. The consolidation was mainly driven by the introduction of more demanding regulatory requirements. which include: i) lending limit of up to GEL 200,000; ii) a minimum threshold for borrowings from individuals was set at GEL 100,000 where there are more than 20 individual investors to incentivise MFOs to shift to qualified investors; iii) cap on the effective interest rate to 50% from 100%; iv) minimum regulatory capital of GEL 1m; v) minimum capital and liquidity ratios (at 18% each); vi) implementation of macroprudential policy instruments such as maximum payment-to-income ratios and loan-to-value ratios.
- Recent reforms also include the development of a new regulatory framework for microbanks, better aligned with the banking regulatory framework.

Banking system indicators	2019	2020	2021	2022	2023
ROAA, %	2.9	1.3	3.0	3.3	3.6
ROAE, %	20.3	10.2	22.1	22.8	24.8
Net interest margin, %	5.3	4.4	4.8	5.2	5.8
CET1 ratio, %	13.3	12.5	14.3	17.3	22.8
Problem loans/gross customer loans, %	4.3	5.4	3.9	3.1	2.6
Loan-to-deposit ratio, %	124.3	114.9	119.0	102.8	106.9

Source: SNL, Scope Ratings

Long-term sustainability (ESG-D)

'Developing' long-term sustainability assessment

MBC remains committed and active in environmental, social and governance areas and investing in digitalisation.

Digitalisation

MBC has been making major investments in technological development, digital services, software, licences, cybersecurity, data protection and online and external channels. Recent examples include the company's integration into an e-commerce platform for its foreign exchange operations and the development of a remote loan application platform.

The transformation to a microbank requires further investment and the implementation of core banking modules, including real-time gross settlements, the SWIFT platform, as well as deposit modules and internet banking.

Environment

Unlike most of its domestic peers, MBC has been publishing a corporate social responsibility report since 2019. Sustainability initiatives have been integrated gradually in the company's strategy and are focused on efficient use of resources, optimized energy consumption and optimized waste management. In the past year, MBC has been involved in different initiatives and events focused on the environment and sustainability. Examples include winning the Corporate Sustainability Award within the category of small and medium business in November 2023.

Governance

MBC's governance model is adequate compared to peers. The MFO has a two-tier corporate governance structure, with a Supervisory Board and a Board of Directors comprised of executive members of the MFO. All members of top management hold shares in the company, indicating a commitment to the company's long-term value. The company has a clear strategy in terms of transparency and social impact. For the third year in a row, MBC has won the Transparency Bartas Honorary Award within the category of small and medium business as a result of its quality of reporting and transparency.

Social

The role of MFOs in empowering local communities, improving financial inclusion and developing the domestic economy weighs positively on MBC's strategy. The role of microfinance organisations in Georgia reinforces the company's business relevance.

Figure 3: Long-term sustainability overview table[1]

	Industry level			Issuer level						
	Materiality			Exposure			Management			
	Low	Medium	High	Low	Neutral	High	Weak	Needs attention	Adequate	Strong
E Factor		◇			◇				◇	
S Factor	◇					◇			◇	
G Factor			◇		◇				◇	
D Factor			◇		◇				◇	

Source: Scope Ratings

[1] The overview table illustrates how each factor informs our overall assessment. Materiality refers to our assessment of the credit relevance of each factor for the banking industry. Exposure refers to what extent the bank is exposed to risks or benefits from opportunities compared to peers, given its business model and countries of operation. Management refers to how we view the bank's navigation through transitions.

Earnings capacity and risk exposures

'Neutral' earnings capacity and risks exposures' assessment

MBC's profitability is on an improving trend as a result of higher loan volume, lower hedging costs and lower provisioning charges. Given the consolidation of MBC's branch network and the adaptation of the commercial strategy to improve cross-selling, we expect that the revenue base will continue to expand. Meanwhile, MBC continues to invest and adapt its business setup in order to operate in line with the newly established requirements for microbanks and develop its renewed business proposition.

In 2023, the company's profitability metrics more than trebled the year-end 2022's bottom line This positive trend has continued during the first months of 2024. In Q1 2024, MBC reported one of the highest profitability metrics in the last five years. MBC's return on average equity (ROAE) increased to 19% as of March 2024 and its average return on equity amounted to 21% in May 2024.

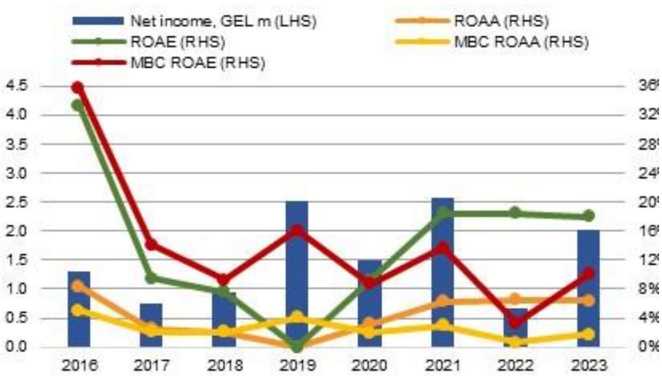
We note the decreasing hedging costs, which were equivalent to 15% of net revenue before foreign exchange income in 2023. MBC expects these costs to continue decreasing in 2024 as the company intends to decrease the share of borrowings in foreign currency.

Cost of risk has also been one of the main sources of bottom-line volatility in recent years. MBC's cost of risk has materially decreased since its peak in June 2020 and stood at 1.6% as at May 2024, the lowest level since December 2022. We expect cost of risk to remain at a similar level in 2024 given MBC's conservative risk management approach and controlled lending growth.

Asset quality is also on an improving trend. In May 2024, total past due loans decreased to 3% of gross loans, from 3.7% in August 2022; loans past due > 30 days decreased to 1.6% (from 1.8%) and restructured loans amounted to 1.4% of gross loans (from 1.9%).

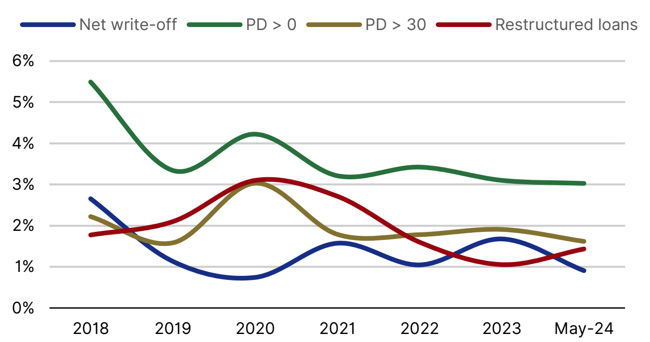
Due to the large portion of collateralised loans in the portfolio, mainly by real estate or vehicles, MBC's loan losses are limited. Net write-offs represented less than 1% of gross loans in May 2024, down from 1.7% in 2023. The weighted average loan-to-value ratio for loans collateralised by real estate and by vehicles amounted to 39% and 52% respectively, as of December 2023. MBC's internal controls and systems assess collateral quality as a key part of its loan approval process.

Figure 4: Profitability, MBC versus MFO sector (IFRS, GEL m, 2016-2023)



Source: NBG, Company data, Scope Ratings

Figure 5: Asset quality metrics according to Georgian local GAPP (% over gross loans, 2018-May 2024)



Source: Company data, Scope Ratings

Financial viability management

'Adequate' financial viability management assessment

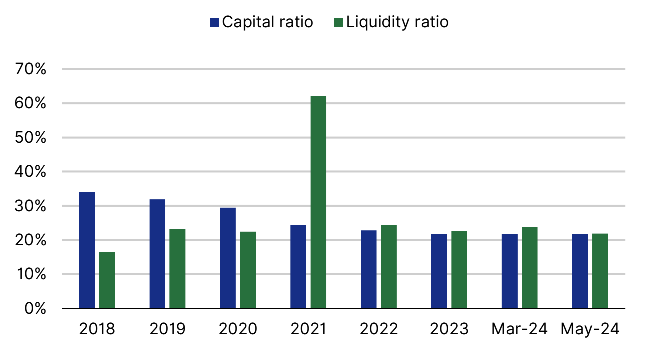
Over the past years, MBC's capital position has been reduced significantly to support the planned loan portfolio expansion. We understand that the capital position is now stabilised at the target level, around 350-400bps above the minimum regulatory requirements for MFOs. In our view, the size of the buffer is only adequate based on the risk profile of the business and does not provide a rating uplift at this stage.

As part of the business case for MBC's transformation into a microbank, we expect capital to continue to decline and get closer to the new regulatory minimum for microbanks. However, we view positively the implementation of a more sophisticated capital adequacy framework and regulatory oversight, which would provide comfort as the capital position continues to be adjusted downward to accompany business growth. In any case, we expect a steady organic capital generation to maintain the buffer at an adequate level while supporting loan book expansion.

Due to management's objective to obtain funding at the lowest possible costs, MBC has experienced some periods of tight liquidity, but has managed to maintain levels above the regulatory requirement. The national regulator requires MFOs to hold at least 18% of cash against debt maturing within six months.

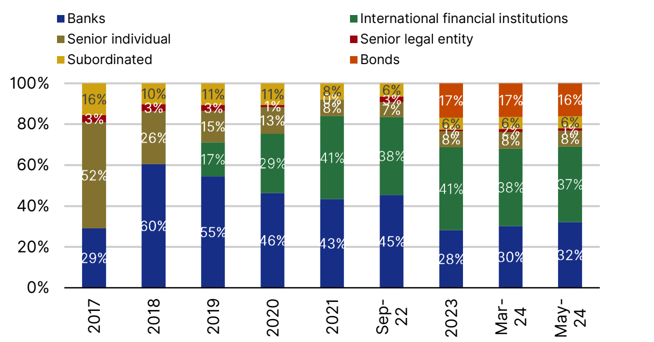
MBC's liquidity ratio has been volatile in recent years, reflecting the challenges of optimizing refinancing costs, in particular the reliance on costly foreign currency hedging. As of May 2024, the liquidity ratio was approx. at 22%, 3.9 pp above the minimum regulatory requirement, which is also only adequate in our views. With a microbank license, MBC would be able to diversify its funding base, including the possibility to collect and grow over time customer deposits.

Figure 6: MBC's capital and liquidity ratios (2018-May 2024, Georgian local GAAP)



Source: Company data, Scope Ratings

Figure 7: MBC's funding structure (2017-May 2024)



Source: Company data, Scope Ratings

MBC relies on a mix of local commercial banks, bond issuance and international financial institutions to fund its lending activities. International financial institutions have become the most important funding source, with around 37% of total funding as of May 2024. Most major Georgian banks provide secured funding to MBC. In addition, MBC was able to issue its first corporate bond in December 2022, for an amount of GEL 15m and tenor 2-years, to partially replace borrowing from commercial banks, diversifying further its funding structure. The bond matures towards the end of 2024 and MBC is considering various options, also considering potential business developments.

MBC is exposed to a significant foreign currency mismatch given that 44% of financial liabilities are in foreign currency while only 3% of financial assets are in foreign currency as of December 2023. We view positively the fact that MBC continues hedging its liabilities via domestic bank swaps or back-to-back loans to limit foreign exchange risk. MBC also wants to reduce this mismatch by growing its funding sources in local currency.

Financial appendix

I. Appendix: Selected financial information – JSC MFO Micro Business Capital

	2019Y	2020Y	2021Y	2022Y	2023Y
Balance sheet summary (GEL '000)					
Assets					
Cash and cash equivalents	3,046	2,673	13,879	6,778	6,286
Loans to customers	58,219	66,858	72,817	90,241	101,144
Property and equipment	2,262	2,404	2,880	2,785	2,532
Intangible assets	262	237	327	407	370
Deferred tax assets	194	356	394	137	0
Right-of-use assets	4,483	4,050	5,328	5,511	4,733
Current tax assets	0	0	0	267	0
Other assets	1,391	1,624	1,545	4,109	2,019
Total assets	**69,857**	**78,202**	**97,170**	**110,235**	**117,084**
Liabilities					
Subordinated borrowings and other borrowed funds	48,084	54,928	70,146	84,214	90,046
Subordinated debt	0	0	0	0	0
Lease liabilities	4,700	4,947	5,941	5,348	4,750
Current tax liability	19	0	0	0	51
Other liabilities	355	765	790	719	1,660
Total liabilities	**53,158**	**60,640**	**76,877**	**90,281**	**96,507**
Share capital	2,200	2,225	2,250	2,255	2,255
Share premium	900	996	1,117	1,136	1,136
Preference shares	7,347	7,347	7,347	7,464	6,989
Retained earnings	6,252	6,994	9,579	9,099	10,197
Accumulated deficit	0	0	0	0	0
Current year profit/loss	0	0	0	0	0
Total equity	**16,699**	**17,562**	**20,293**	**19,954**	**20,577**
Total liabilities and equity	**69,857**	**78,202**	**97,170**	**110,235**	**117,084**
Income statement summary (GEL '000)					
Interest income	14,080	15,858	20,123	22,684	25,026
Interest expense	-4,971	-6,290	-7,270	-8,273	-10,015
Net interest income	9,109	9,568	12,853	14,411	15,011
Fee and commission income	1,658	1,647	1,923	2,268	3,743
Net foreign exchange income/(loss)	-853	-3,776	1,356	4,821	56
Net (loss)/ income from trading in foreign currency	480	1,955	-3,515	-8,658	-2,445
Operating income	**10,394**	**9,394**	**12,617**	**12,842**	**16,365**
Impairment losses on debt financial assets	-554	-748	-458	-853	-1,546
Personnel expenses	-4,187	-4,238	-5,836	-6,947	-7,201
General administrative expenses	-2,605	-2,773	-3,388	-4,034	-4,771
Profit before income tax	**3,048**	**1,635**	**2,935**	**1,008**	**2,847**
Income tax expense	-528	-152	-350	-351	-814
Profit for the year	**2,520**	**1,483**	**2,585**	**657**	**2,033**

Source: Company data, Scope Ratings
Note: Figures above may differ from reported figures.

II. Appendix: Selected financial information – JSC MFO Micro Business Capital

Earnings and profitability	2019	2020	2021	2022	2023
Yield on gross loans (%)	23.9%	23.1%	26.8%	24.3%	23.7%
Cost of funding (%)	10.3%	11.5%	10.4%	9.8%	11.1%
Net interest income/ operating income (%)	87.6%	101.9%	101.9%	112.2%	91.7%
Net fees & commissions/ operating income (%)	16.0%	17.5%	15.2%	17.7%	22.9%
FX income / operating income (%)	-8.2%	-40.2%	10.7%	37.5%	0.3%
Trading income / operating income (%)	4.6%	20.8%	-27.9%	-67.4%	-14.9%
Cost/ income ratio (%)	65.3%	74.6%	73.1%	85.5%	73.2%
Impairment on financial assets / pre-impairment income (%)	15.4%	31.4%	13.5%	45.8%	35.2%
Loan loss provisions / average gross loans (%)	1.4%	2.7%	3.1%	3.8%	4.5%
Return on average assets (%)	4.1%	2.0%	2.9%	0.6%	1.8%
Return on average equity (%)	16.1%	8.7%	13.7%	3.3%	10.0%
NBG covenants	**2019**	**2020**	**2021**	**2022**	**2023**
Capital adequacy ratio (%)	31.9%	29.5%	24.3%	22.8%	21.8%
Liquidity ratio (%)	23.2%	22.5%	62.2%	24.5%	22.6%
Pledged assets to equity ratio (%)	209.8%	175.7%	106.0%	66.4%	70.8%
Asset mix, quality and growth	**2019**	**2020**	**2021**	**2022**	**2023**
Net loans/ assets (%)	83.3%	85.5%	74.9%	81.9%	86.4%
Past due > 30 / tangible equity & reserves (%)	11.1%	29.4%	28.0%	40.2%	50.9%
Past due > 30 / total gross loans (%)	1.7%	3.0%	1.8%	1.8%	1.9%
Loan loss allowance for stage 2 & 3 loans / Past due > 30	30.3%	35.1%	40.3%	39.9%	47.2%
Net loan growth (%)	20.4%	14.8%	8.9%	23.9%	12.1%

Source: Company data, Scope Ratings
Note: Figures above may differ from reported figures.

Note: Ratio calculation

a) Yield on gross loans (%) = interest income/total gross loans to customers

b) Cost of funding (%) = interest expense/total borrowings

c) Capital adequacy ratio (%) = (total equity - asset revaluation reserve - intangible assets - investments in subsidiaries) / (total assets - asset revaluation reserve - intangible assets - investments in subsidiaries)

d) Liquidity ratio (%) = cash and cash equivalents/ (total liabilities - debts maturing after six months)

e) Return on average assets (%) = net income/average assets

f) Return on average equity (%) = net income/average equity

g) Profit margin (%) = net income/gross financial margin

h) Leverage (%) = debt/equity

i) Stage 3 ratio (%) = Stage 3 loans (or past due over 90 days)/total gross loans

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Applied methodology

Financial Institutions Rating Methodology, February 2024

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