JSC MFO Micro Business Capital Issuer Rating Report

B+ STABLE

Scope's credit view (summary)

Scope's B+ rating is driven by the leading position of JSC MFO Micro Business Capital (MBC) among major microfinance organisations (MFOs) in Georgia, with a business model focused on business and agro lending. MBC's market share has continued to increase in recent years. Its portfolio is essentially fully collateralised.

MBC's stand-alone rating of b+ is further underpinned by the increasing financing from international financial institutions, which contributes to safe and stable long-term foreign currency funding and reduces the reliance on a few commercial banks.

Solvency and liquidity metrics continue to be reassuring. As of Q1 2021, the company held comfortable buffers to both minimum capital and liquidity requirements, with a capital adequacy ratio of 28.9% (+11 pp above the requirement) and a liquidity ratio of 54.6% (+37 pp above the requirement) Under the National Bank of Georgia's regulation, MFOs must hold at least 18% of cash against debt maturing within six months.

MBC has had solid and resilient profitability in recent years as well as good asset quality metrics, although mildly increasing, compared to those of main peers.

MBC is continuously embracing change in environmental, social and governance (ESG) factors and preparedness for digital transition (D), especially in the social and governance area, although there is still room for improvement in the environmental area for further disclosure on specific targets, processes and strategy.

Outlook

The Outlook is Stable and reflects our view that MBC's performance will remain resilient in 2021. The expectation of an improving operating environment in Georgia further supports our view. We expect earnings to be sufficient to absorb potential credit losses.

Credit strengths

- A leading Georgian MFO, with a strong and increasing market share
- Limited asset quality metrics compared to main peers'
- Diversified funding; increasing share from international financial institutions

Credit weaknesses

- Open balance sheet mismatch due to exchange rate risk arising from larisation

Positive rating-change drivers

- Transformation into a microbank, which would improve product diversification, add safer and more predictable funding (e.g. deposits) and involve stricter regulation

Negative rating-change drivers

- Larger impact from foreign exchange losses due to lari depreciation that depresses bottom line
- Material deterioration in portfolio credit quality
- Higher domestic competition in agro loans reducing profitability in this product, which is key to MBC's medium-term strategy

Ratings & Outlook

Issuer rating	B+
Outlook	Stable

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Issuer profile

JSC MFO Micro Business Capital was founded in Georgia as a joint stock company on 6 December 2012.

MBC is an MFO operating only in Georgia. It lends to micro and small businesses, self-employed individuals operating in trade, services, production and crafts, and households for mortgage and consumer purposes.

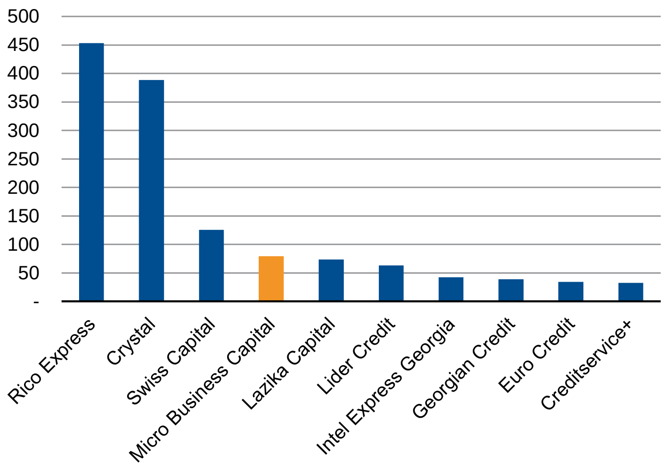
As of March 2021, the company employs 222 people in 14 branches in the main cities of Georgia.

One of the largest microfinance organisations in Georgia with a strong and increasing market share

Fourth largest microfinance organisation in Georgia by total assets

MBC is the fourth largest MFO in Georgia, after Rico Credit, Crystal and Swiss Capital. It has GEL 79.3m in total assets and a 6% market share in net loans as of March 2021.

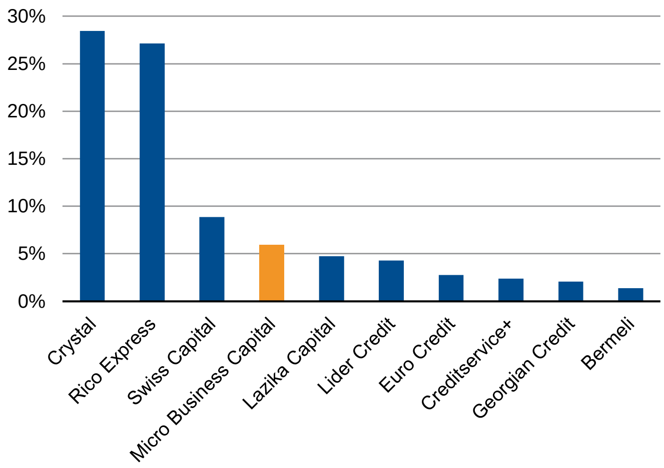
Figure 1: Georgian MFOs ranked by total assets (Q1 2021, GEL m)



Note: Georgian Credit's total assets as of December 2020

Source: NBG, Scope Ratings

Figure 2: Georgian MFOs ranked by market share of net loans (Q1 2021)



Note: Georgian Credit's market share as of December 2020

Source: NBG, Scope Ratings

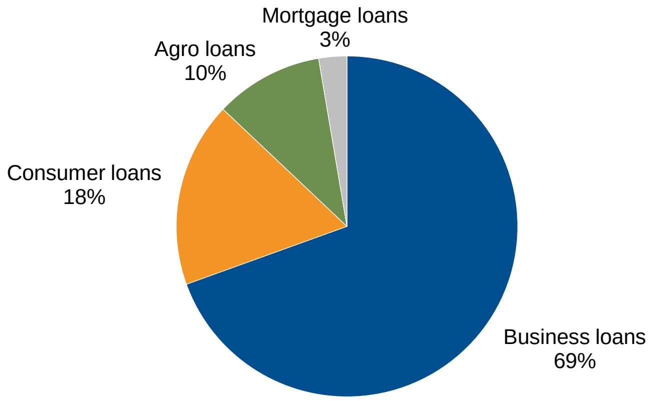
Georgia has 39 MFOs and the sector is highly concentrated: the five largest MFOs hold 73% of assets and 75% of net loans in the sector as of March 2021.

MBC's main financial products include trade and services loans, production and craft activity loans (business loans), consumer loans, agro loans and housing loans.

Business loans: around 70% of gross lending as of May 2021

Most of MBC's lending consists of business loans, which represented 69% of gross loans as of May 2021, followed by consumer loans (18%), agro loans (10%) and housing loans (3%)

Figure 3: MBC's gross loan portfolio breakdown by product (May 2021)

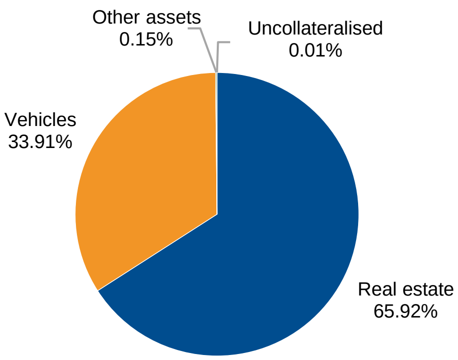


Source: Company, Scope Ratings

In recent years, the share of business loans has well surpassed that of consumer and housing loans. This is due to the strategic focus on lower-risk borrowers as well as tighter regulation on loan-to-value and payment-to-income ratios. Since 2019, MBC has been growing its agro loan business by expanding into the rural areas of Georgia.

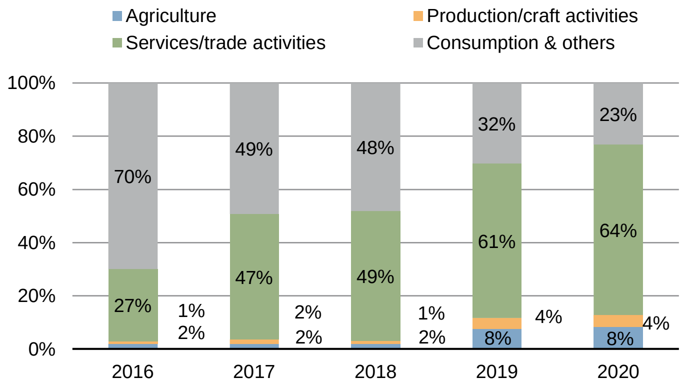
As of May 2021, most gross loans were collateralised by either real estate (65.9%) or vehicles (33.9%). MBC's internal controls and systems assess collateral quality as part of its loan approval process, which is divided into an inspection and a benchmarking phase.

Figure 4: MBC's gross loans by collateral (May 2021)



Source: Company, Scope Ratings

Figure 5: MBC's gross loan by product (2016-20)



Source: Company, Scope Ratings

Agro loans constitute cornerstone of medium-term strategy

MBC's medium-term strategy until 2023 targets i) significant growth in agro loans to 38% of gross lending; ii) moderate growth in business loans to about half of gross lending; iii) mild growth in consumer and other loans to 13% of gross lending; and iv) material expansion in the branch network across Georgia.

Positive governance model with continuously improving steps in social, IT and digitalisation

Social and digital factors improving over recent years

The role of MFOs – to empower local communities, improve financial inclusion and develop the domestic economy – has a positive weight on MBC's rating.

We positively assess MBC's governance model: all members of the top management also hold shares in the company, indicating a commitment to long-term company value.

Over recent years, MBC has made major investment in technological development, digital services, new software, licenses, cybersecurity and online and external channels. The company's Alta software, considered one of the most sophisticated banking software packages in Georgia, allows it to reduce operational risks and provide transparent reporting.

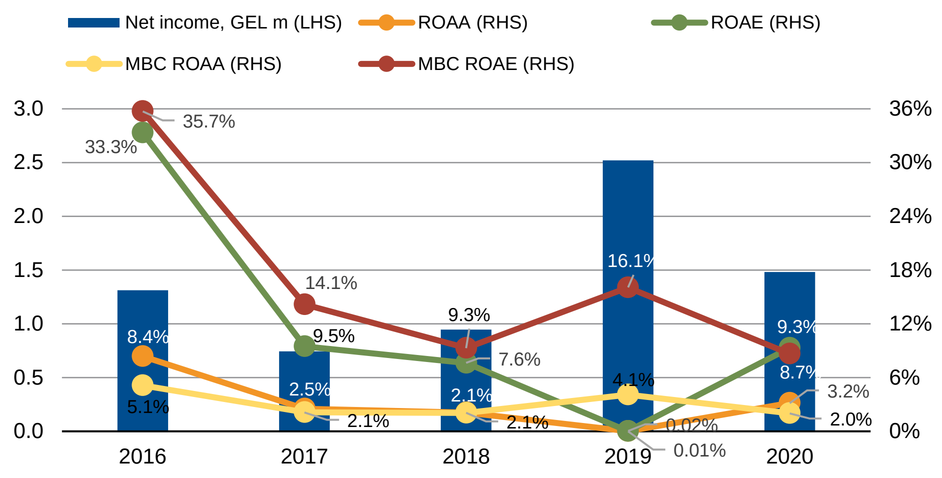
Resilient profitability over recent years coupled with limited asset quality metrics compared with main peers

Adequate profitability and returns in recent past compared with main peers

Operating income increased during 2016-19, driven by significantly higher loan volumes. In 2017, increased expenses hit the bottom line. In 2020, profitability indicators worsened, a result of the increased hedging costs, provisions and expenses that could not be offset by the increase in net interest income, especially from business loans (+GEL 9.7m YoY).

In 2020, the return on average equity was 8.7%, the return on average assets was 2%, and the net profit margin was 15.8%. These are mostly behind the peer averages of 9.3%, 3.2% and 8.4%, respectively.

Figure 6: Profitability metrics, MBC vs MFO sector (GEL m, 2016-20)



Source: Company, NBG, Scope Ratings

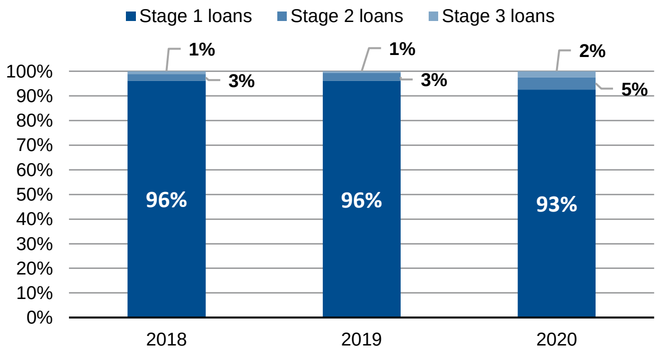
Asset quality

Low asset quality metrics, although mildly increasing, compared to peers

Asset quality indicators worsened in 2020, to a limited amount: loans past due by more than 30 days increased to 3% of gross loans, from 1.7% in 2019, with coverage on past due loans materially reinforced. As of March 2021, coverage on all past-due loans was around 50% and was around 84% on loans past due by more than 30 days. As of 2020, restructured loans amounted to 3% of gross loans. The reserve coverage ratio of Stage 3 loans decreased to 44% in 2020 versus 49% in 2019.

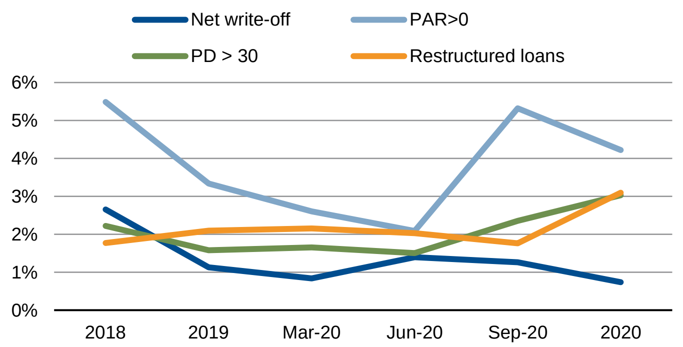
Current portfolio losses are very limited. Net write-offs were only 0.7% of gross loans in 2020, down from 2.7% in 2018 and 1.1% in 2019.

Figure 7: Gross loan portfolio by stage (%, 2018-20)



Source: Company, Scope Ratings

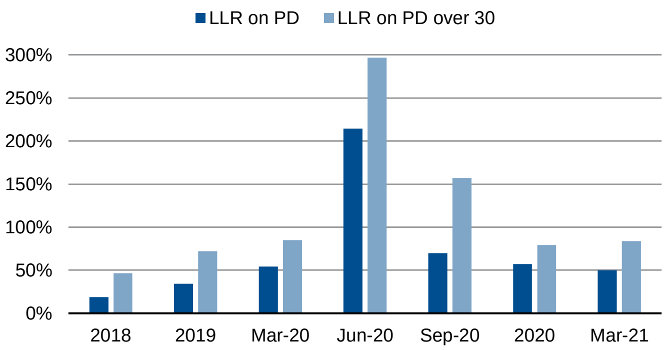
Figure 8: Asset quality metrics (%, 2018-20)



Source: Company, Scope Ratings

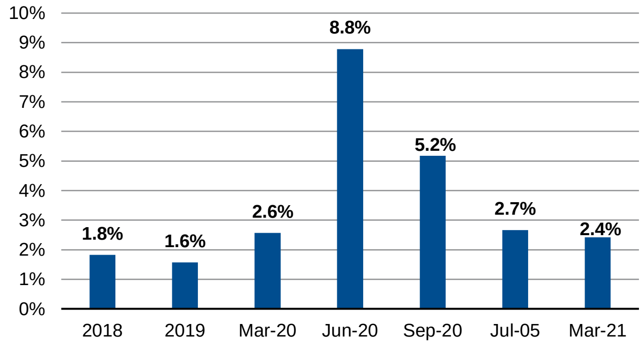
The cost of risk peaked in June 2020 at 8.8%. This was due to the National Bank of Georgia requiring 5% of general provisions raised on the loan portfolio, though this will decline to 2.6% because the central bank has acknowledged MBC's lower risk profile compared to peers. Since June 2020, MBC's cost of risk has materially decreased and stood at 2.4% as of March 2021.

Figure 9: Coverage on past due loans (2018 to March 2021)



Source: Company, Scope Ratings

Figure 10: Provision expenses (included on foreclosed loans) to gross loans (cost of risk, %, 2018 to March 2021)



Source: Company, Scope Ratings

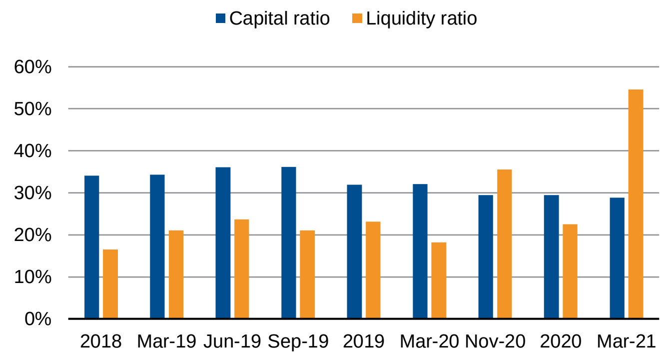
From the end of March to April 2020, MBC offered three-month interest and principal moratoriums; 90% of clients that utilised them have since resumed payment as of July 2020. The moratoriums ended in November 2020, and affected clients are paying on revised schedules. Restructurings stemming from the Covid-19 crisis caused Stage 2 and 3 loans to increase mildly to respectively 5% and 2% of gross loans as of December 2020, against 3% and 1% in 2019.

Diversified funding profile, with increasing support from international financial institutions

Ample buffers to both capital and liquidity requirements

Solvency and liquidity metrics continue to be reassuring. As of Q1 2021, MBC held comfortable buffers to both minimum capital and liquidity requirements, with a capital adequacy ratio of 28.9% (+11 pp above the requirement) and a liquidity ratio of 54.6% (+37 pp above the requirement). Under the National Bank of Georgia's regulation, MFOs must hold at least 18% of cash against debt maturing within six months.

Figure 11: MBC's capital and liquidity ratio (2018 to Q1 2021)



Source: Company, Scope Ratings

Figure 12: Regulatory ratios (2018-20)

	NBG requirement	2018	2019	2020
Capital coefficient	Min 18%	34.1%	31.9%	29.5%
Liquidity coefficient	Min 18%	16.5%	23.2%	22.5%
Property investment coefficient	Max 40%	13.1%	13.2%	13.0%
Investment coefficient	Max 15%	0%	0%	0.0%
Insider coefficient	Max 15%	0%	0%	0.0%
Pledged asset coefficient	Max 90%	205.8%	209.8%	175.7%

Note: NBG set up a waiver on the pledged asset coefficient to MFOs and plans to cancel or loosen them as local bank loans are a main source of MFO funding

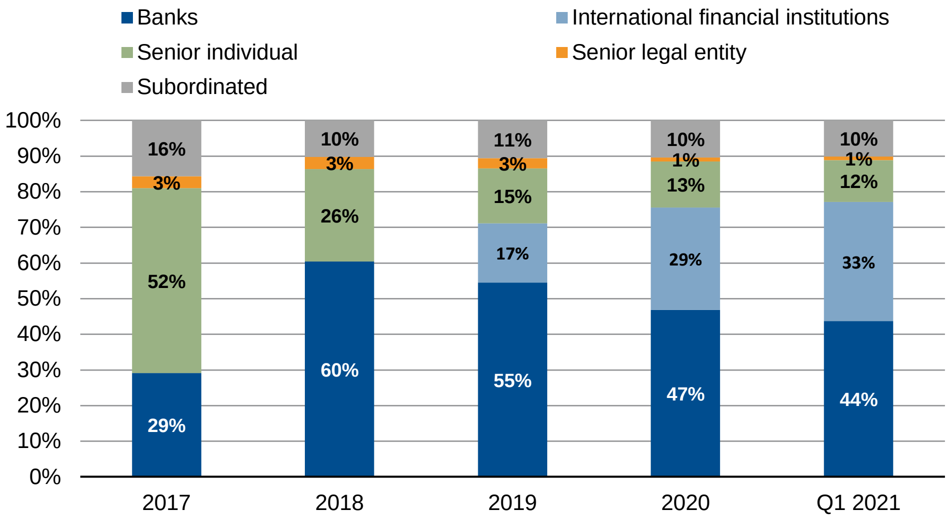
Source: Company, Scope Ratings

MBC has had to diversify funding in recent years after Georgian legislation prohibited MFOs from taking deposits and limited individual borrowings to above GEL 100,000 in 2017 (minimum threshold for borrowings from each individual when there are more than 20 investors).

Sound funding profile, benefitting from international financial institutions' financing

As of Q1 2021, MBC's funding comes mostly from banks with 44%, followed by 33% from international financial institutions, 13% from individuals, and 10% subordinated from related parties.

Figure 13: MBC's funding structure (2017 to Q1 2021)



Source: Company, Scope Ratings

As of March 2021, most major Georgian banks are providing secured lending to MBC. International financial institutions have become increasingly important, lending around GEL 19.5m to MBC, which represents a third of its funding as of March 2021.

A Georgian regulatory regime for microbanks is currently in the legislative process. This licence will allow microbanks to raise deposits, which would benefit MBC by adding a source of funds.

Foreign currency risk

Due to the Georgian government's larisation programme since 2017, the share of US dollar loans in MBC's portfolio fell to just 7% in 2020 from 35%. Its balance sheet is now mismatched, with 50% of longer-term funding in US dollars as of March 2021 with the associated foreign exchange risk.

Pricing on euro, lari and US dollar funding has improved on average since late 2019, with the company decreasing its reliance on US dollars (-400 bps since end of October 2019)

Figure 14: MBC's funding and average interest rate split by currency (October 2019 vs March 2021)

	Oct-19		Mar-21	
Currency	Average interest rate	% of outstanding in GEL	Average interest rate	% of outstanding in GeEL
EUR	5.5%	0%	4.8%	0%
GEL	14.3%	45%	13.8%	50%
USD	8.4%	54%	7.4%	50%

Source: Company info, Scope Ratings

Foreign exchange volatility has increased hedging costs, now equivalent to 26% of net revenues before foreign exchange income in 2020. In 2021, MBC expects these costs to be balanced by a lower interest rate on US dollar borrowings from international financial institutions.

We expect less foreign exchange volatility in 2021, which will allow the company to better manage its foreign currency position.

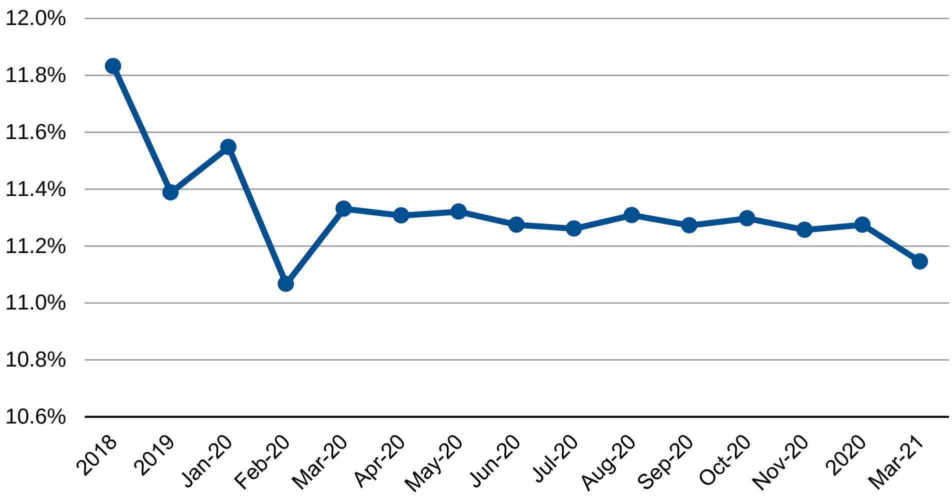
Figure 15: MBC's foreign exchange income elements (IFRS, 2020)

	2020
Hedging cost	-2,920,476
Foreign exchange	198,123
Translation gain/loss	1,510,160
IFRS 16 difference (operating leases)	-608,472
Total	**-1,820,665**

Source: Company, Scope Ratings

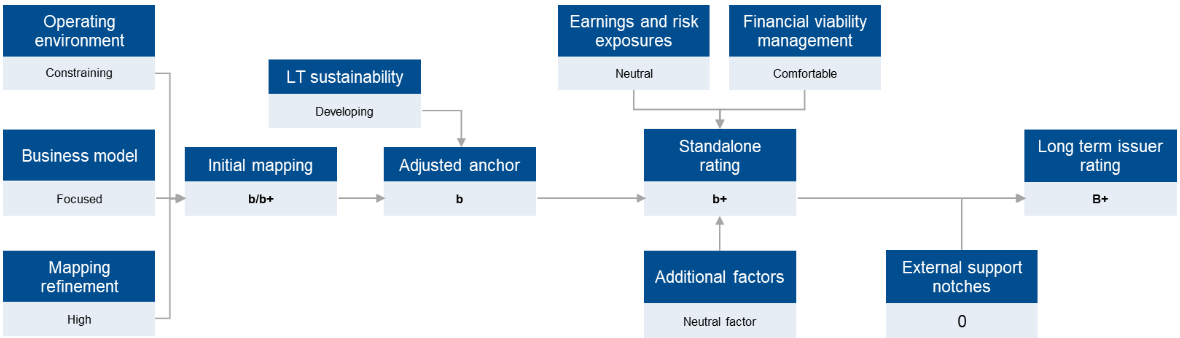
MBC's cost of funding has remained fairly stable since March 2020 after the decrease in 2019 and the volatility in the first quarter of 2020, amounting to 11.1% as of March 2021.

Figure 16: MBC's cost of funding (2018 to Q1 2021)



Source: Company, Scope Ratings

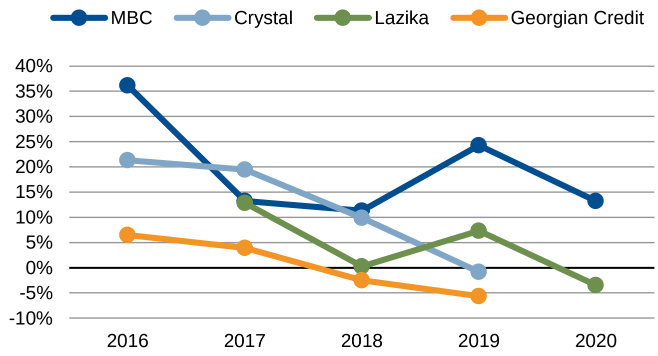
I. Appendix: Overview of the rating process



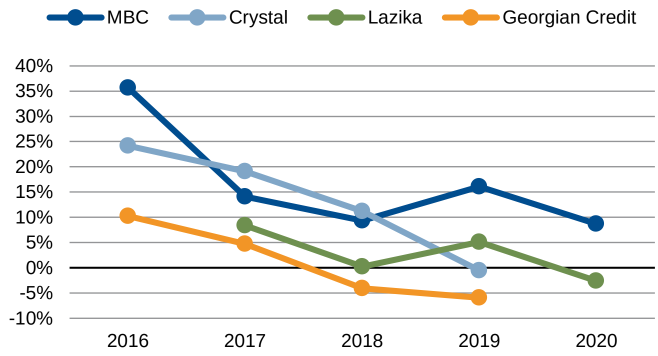
Step		Assessment	Summary rationale
STEP 1	Operating environment	Very supportive Supportive Moderately supportive **Constraining** Very constraining	• Small emerging market that still lags regional peers for most economic indicators, despite gradual improvements and reforms in previous years • MFO market is concentrated and started to be regulated in 2017
	Business model	Very resilient Resilient Consistent **Focused** Narrow	• Purely domestic activities • Well-diversified business model focused on growing micro and agro loans • Increasing market share
	Mapping refinement	**High** Low	• Higher product diversification than peers'
	Initial mapping	**b/b+**	
	Long-term sustainability	Best in class Advanced **Developing** Lagging	• MFO role to develop domestic economy is positive for MBC • MBC's governance shows clear alignment of interests between shareholders and managers, indicating commitment to long-term value • Improving steps in environmental and digitalisation areas, but further disclosure on specific environmental targets, processes and strategy needed
	Adjusted anchor	**b**	
STEP 2	Earnings capacity & risk exposures	Very supportive Supportive **Neutral** Constraining Very constraining	• Solid and resilient profitability in recent years • Good asset quality metrics compared to main peers' • Essentially fully collateralised portfolio
	Financial viability management	Ample **Comfortable** Adequate Limited Stretched At risk	• Increasing financing from international financial institutions contributing to safe and stable long-term foreign currency funding and reducing reliance on a few commercial banks • Healthy buffers to both capital and liquidity requirements
	Additional factors	Significant support factor Material support factor **Neutral** Material downside factor Significant downside factor	• No further considerations
	Standalone	**b+**	
STEP 3	External support	Not applicable	
Issuer rating		**B+**	

II. Appendix: Peer comparison

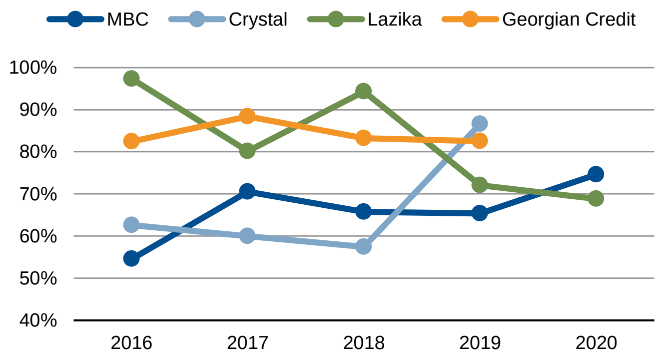
Net profit margin (%)



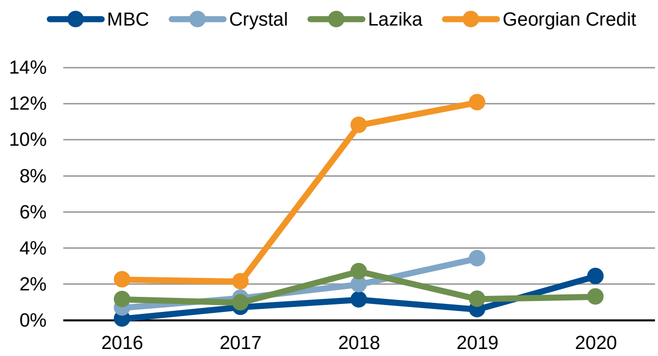
Return on average equity (%)



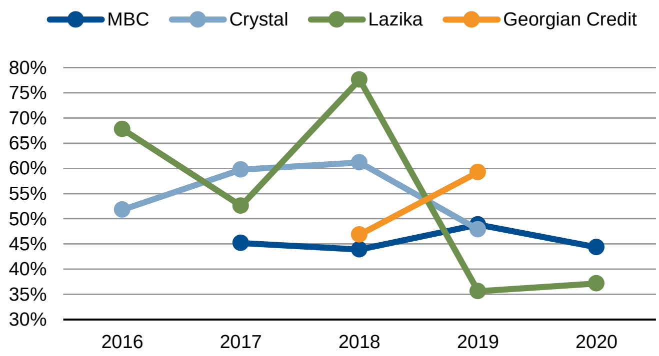
Cost-to-income (%)



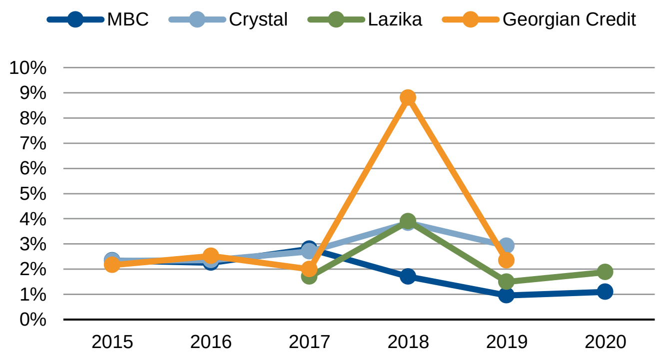
Stage 3 ratio (%)



Stage 3 coverage ratio (%)



Loan-loss provisions/gross loans (%)



National peers: Crystal, Lazika Capital, Georgian Credit

Source: Company

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

	2016Y	2017Y	2018Y	2019Y	2020Y
Balance sheet summary (GEL '000)					
Assets					
Cash and cash equivalents	3,893	1,134	1,771	3,046	2,673
Loans to customers	27,757	33,464	48,348	58,219	66,858
Property and equipment	459	1,363	1,933	2,262	2,404
Intangible assets	198	228	236	262	237
Deferred tax assets	148	167	346	194	356
Right-of-use assets	0	0	0	4,483	4,050
Current tax assets	0	151	0	0	0
Other assets	107	1,554	1,020	1,391	1,624
Total assets	**32,561**	**38,061**	**53,654**	**69,857**	**78,202**
Liabilities					
Subordinated borrowings and other borrowed funds	23,377	31,946	38,429	48,084	54,928
Subordinated debt	3,823	0	0	0	0
Lease liabilities	0	0	0	4,700	4,947
Current tax liability	107	0	186	19	0
Other liabilities	426	411	370	355	765
Total liabilities	**27,733**	**32,357**	**38,985**	**53,158**	**60,640**
Share capital	2,100	2,155	2,185	2,200	2,225
Share premium	719	795	852	900	996
Preference shares	0	0	7,347	7,347	7,347
Retained earnings	2,009	2,754	4,285	6,252	6,994
Accumulated deficit	0	0	0	0	0
Current year profit/loss	0	0	0	0	0
Total equity	**4,828**	**5,704**	**14,669**	**16,699**	**17,562**
Total liabilities and equity	**32,561**	**38,061**	**53,654**	**69,857**	**78,202**
Income statement summary (GEL '000)					
Interest income	5,555	8,243	11,284	14,080	15,858
Interest expense	-2,389	-3,439	-4,172	-4,971	-6,290
Net interest income	3,166	4,804	7,112	9,109	9,568
Fee and commission income	470	830	1,293	1,658	1,647
Net foreign exchange income/(loss)	563	-797	-458	-853	-3,776
Net (loss)/ income from trading in foreign currency	0	239	-213	480	1,955
Operating income	**4,198**	**5,076**	**7,734**	**10,394**	**9,394**
Impairment losses on debt financial assets	-330	-601	-1,523	-554	-748
Personnel expenses	-1,237	-2,034	-2,988	-4,187	-4,238
General administrative expenses	-1,054	-1,545	-2,095	-2,605	-2,773
Profit before income tax	**1,576**	**896**	**1,128**	**3,048**	**1,635**
Income tax expense	-263	-151	-182	-528	-152
Profit for the year	**1,314**	**745**	**946**	**2,520**	**1,483**

Source: Company info, Scope Ratings

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

Earnings and profitability	2016	2017	2018	2019	2020
Yield on gross loans (%)	19.6%	24.0%	22.9%	23.9%	23.1%
Cost of funding (%)	10.2%	10.8%	10.9%	10.3%	11.5%
Net interest income/ operating income (%)	75.4%	94.6%	92.0%	87.6%	101.9%
Net fees & commissions/ operating income (%)	11.2%	16.4%	16.7%	16.0%	17.5%
FX income / operating income (%)	13.4%	-15.7%	-5.9%	-8.2%	-40.2%
Trading income / operating income (%)	0.0%	4.7%	-2.8%	4.6%	20.8%
Cost/ income ratio (%)	54.6%	70.5%	65.7%	65.3%	74.6%
Impairment on financial assets / pre-impairment income (%)	17.3%	40.1%	57.5%	15.4%	31.4%
Loan loss provisions / average gross loans (%)	2.8%	3.0%	2.0%	1.4%	2.7%
Return on average assets (%)	5.1%	2.1%	2.1%	4.1%	2.0%
Return on average equity (%)	35.7%	14.1%	9.3%	16.1%	8.7%
NBG covenants	**2016**	**2017**	**2018**	**2019**	**2020**
Capital adequacy ratio (%)		26.6%	34.1%	31.9%	29.5%
Liquidity ratio (%)	NA	NA	16.5%	23.2%	22.5%
Pledged assets to equity ratio (%)	NA	NA	205.8%	209.8%	175.7%
Asset mix, quality and growth	**2016**	**2017**	**2018**	**2019**	**2020**
Net loans/ assets (%)	85.2%	87.9%	90.1%	83.3%	85.5%
Past due > 30 / tangible equity & reserves (%)	3.7%	11.4%	18.6%	11.1%	29.4%
Past due > 30 / total gross loans (%)	0.6%	1.8%	2.7%	1.7%	3.0%
Loan loss allowance for stage 2 & 3 loans / Past due > 30	15.0%	25.2%	34.4%	30.3%	35.1%
Net loan growth (%)	61.7%	20.6%	44.5%	20.4%	14.8%

Source: Company, Scope Ratings

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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