# JSC MFO Micro Business Capital Issuer Rating Report

STABLE
B+

## Overview

Scope has assigned an issuer rating of B+ and a senior unsecured debt rating of B+ to JSC MFO Micro Business Capital. Both ratings carry a Stable Outlook.

## Highlights

- Despite a comparatively minor position in Georgia's microfinance market, MBC holds stronger market shares in selected segments. We deem the company well positioned to thrive in a tightening market.
- MBC has adequate financial, regulatory and credit metrics compared to peers. Management was quick to set up the organisation, infrastructure and governance to comply with forthcoming requirements and best risk practices.
- The rating is, however, constrained by the exclusively domestic nature of MBC's activities. The macro picture in Georgia is mixed, with a key weakness represented by the high dollarization of the financial sector
- The loan larization scheme, initiated by the government and the National Bank of Georgia (NBG) in 2017, and targeting foreign currency reliance, has affected the profitability of MBC and the microfinance sector. The currency mismatch will weigh on profitability in the medium term and is forcing the company to reshape its funding structure.

## Rating drivers (summary)

**The rating drivers, in decreasing order of importance in the rating assignment, are:**

- Lending book has adequate diversification and good credit quality
- Governance model points to long-term sustainability and value preservation on top of adherence to regulatory requirements
- Transition to a more balanced funding profile, currency mismatch will affect profitability in the medium term

### Ratings & Outlook

| | |
|---|---|
| Issuer rating | B+ |
| Senior unsecured debt rating | B+ |
| Outlook | Stable |


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Bloomberg: SCOP

## Rating-change drivers

**Successful transition to uncollateralised institutional funding** MBC is trying to shift from collateralised bank funding and financing from natural persons to uncollateralised funding from international financial institutions and capital markets funding. If successful, this would allow MBC to comply with regulatory requirements while decreasing its asset encumbrance.

**Deterioration in asset quality** Given MBC's fast-paced growth and sensitivity to the domestic macro environment, negative developments in the credit quality of its portfolio would put pressure on the rating.

**Currency mismatch** The larization plan de facto prohibits microfinance organisations from extending foreign currency loans. The resulting forex mismatch between assets and liabilities is affecting hedging costs and putting pressure on interest margins.

**Re-focus on business and agro lending.** Regulatory developments but also commercial convenience are driving management to refocus its lending towards lower risk (business) and less penetrated (agro) segments. We would view positively a market share increase which does not translate into greater credit risk.

## Rating drivers (details)

**Lending book has adequate diversification and good credit quality**

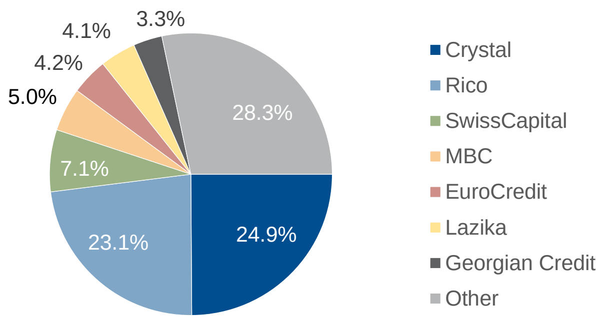
MBC is a microfinance organisation operating exclusively in Georgia, where it lends to micro and small businesses; self-employed individuals operating in trade and services, as well as production and manufacturing; and households for consumption and housing purposes. As of November 2019, it held a 5% market share on the basis of gross lending, although we estimate a higher market share in trade and services (13%) and 7% in consumption and housing as of YE 2018. As of November 2019, the Georgian microfinance sector comprises 48 organisations. It is strongly concentrated, with the top five players holding 65% of the total gross loan portfolio.

Increased regulatory pressure has pushed many players out of the market, with competition tightening around more professional and financially sound institutions with a specific focus on certain lending segments. From this perspective, Crystal, Lazika and Georgian Credit are MBC's closest peers. Location plays a significant role, with diversification allowing penetration into untapped rural areas and reducing seasonality risk.

As of YE 2018 the gross loan portfolio is composed of trade and services loans (49%), lending for housing (10%) and consumption (39%) and farming/agriculture (2%).

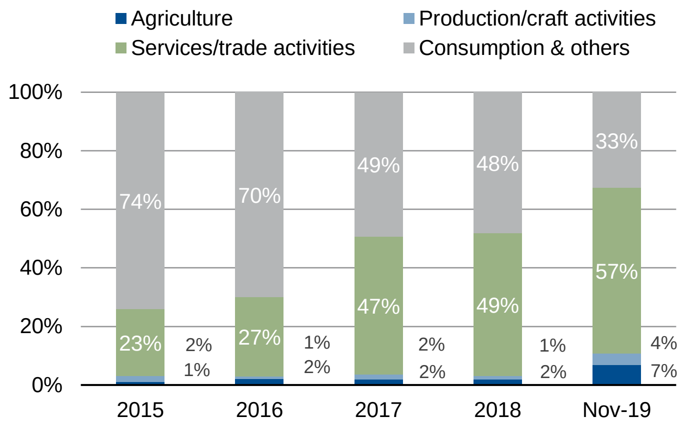
There has been a striking change in portfolio composition in the past few years. This is due to the short duration of assets, with an average loan maturity of 31 months. It also reflects MBC's increased focus on productive areas and declining focus on credit for consumption. As of YE 2018, the company's portfolio was fully collateralised: 63% by real estate, 36% by movable property (vehicles) and 1% by other forms of collateral (usually precious metals). MBC has systems in place to evaluate collateral quality. The collateral evaluation process has an inspection phase and a benchmarking phase (for the estimated selling price), both phases are carried out by MBC.

**Figure 1: Gross loan market share, Q3 2019**




Source: MBC

**Figure 2: Gross loans historical breakdown by activity**

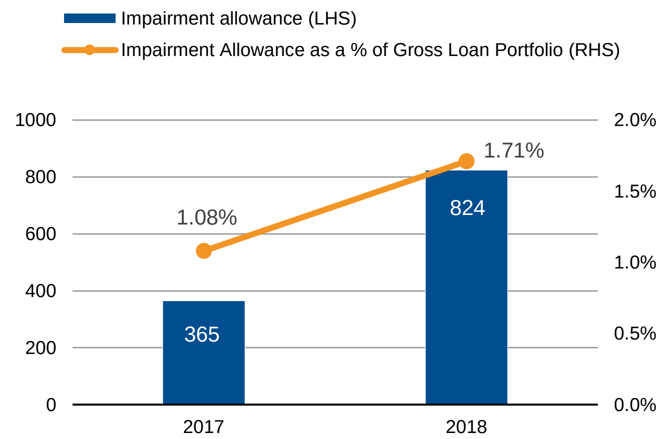



Source: MBC

Gross loans represent the great majority of assets (89% as of October 2019), cash is at 4.6%, the rest are tangible (properties) and intangible (software) with other (incl. foreclosed assets) representing 2%.

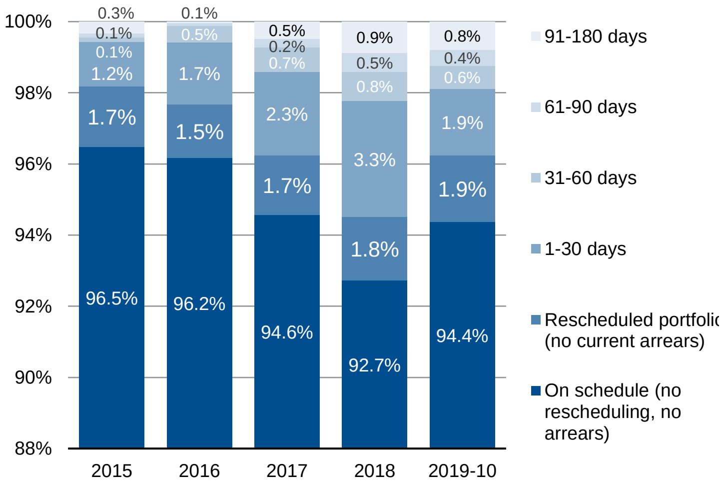
As of October 2019, 94.4% of the overall portfolio is in bonis, 2% is rescheduled and 2% is 1-30 days past due. The remainder (1.8%) is over 30 days past due. From an accounting perspective, IFRS 9 classifies loans which are 90 days past due as Stage 3 loans. Thus, as of YE 2018, the Stage 3 ratio stood at 1.1% with a 44% coverage, versus 0.7% with a 45.2% coverage at YE 2017. Stage 3 loans are concentrated in consumption (49%), services (28%) and trade (23%).

**Figure 3: Impairment allowance; Impairment allowance as a % of gross loan portfolio, GEL '000 (IFRS)**




Source: MBC

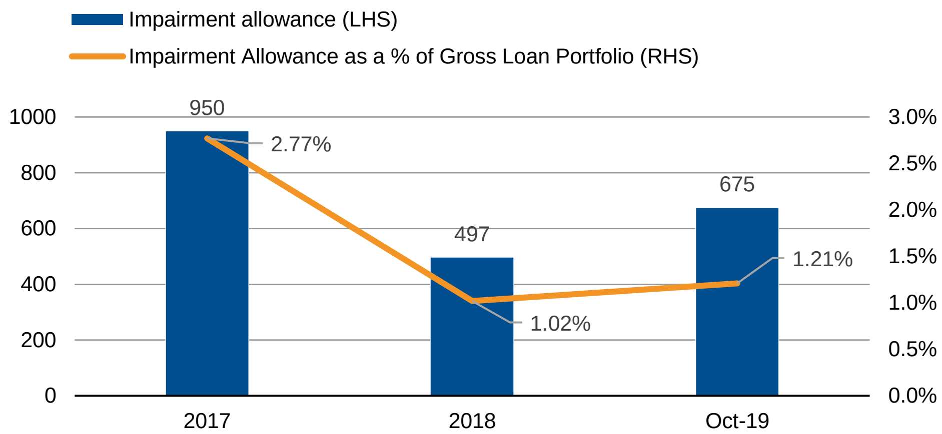
**Figure 4: Breakdown of loans by days overdue**




Source: MBC

In addition to the IFRS9 classification, microfinance organisations also calculate reserves according to NBG guidelines, which consider collateralisation status on top of the number of days past due. This rule entered into force in September 2018. For MBC the effect is visible in Q4 2018, for peers in Q1 2019. MBC has low reserves for the sector. This is because its portfolio is fully collateralised and also developing in a different direction to the market, with reserves declining after the introduction of the new NBG rule. MBC was previously following the NBG rule for commercial banks, which was stricter (see below).

**Figure 5: Impairment allowance; Impairment allowance as a % of gross loan portfolio, GEL '000 (NBG)**




Source: MBC

**Figure 6: Provisioning before and after NBG's new policy comparison**

<table>
<tr><th></th><th colspan="3">PROVISIONING BEFORE NBG's NEW POLICY (MBC used to calculate reserves according to the rule for Commercial Banks)</th><th colspan="2">PROVISIONING AFTER NBG's NEW POLICY (since September 2018)</th></tr>
<tr><th>Overdue days</th><th>Reserve rate for collateralized loans</th><th>Reserve rate for partially collateralized loans</th><th>Reserve rate for uncollateralized loans</th><th>Reserve rate for collateralized loans</th><th>Reserve rate for uncollateralized loans</th></tr>
<tr><td>0-30</td><td>2%</td><td>2%</td><td>2%</td><td>0%</td><td>0%</td></tr>
<tr><td>31-60</td><td>10%</td><td>10%</td><td rowspan="2">30%</td><td>10%</td><td>30%</td></tr>
<tr><td>61-90</td><td rowspan="2">30%</td><td>30%</td><td rowspan="2">30%</td><td rowspan="2">50%</td></tr>
<tr><td>91-120</td><td rowspan="2">50%</td><td rowspan="2">50%</td></tr>
<tr><td>121-150</td><td>50%</td><td rowspan="2">50%</td><td rowspan="2">100%</td></tr>
<tr><td>>150</td><td>100%</td><td>100%</td><td>100%</td></tr>
</table>

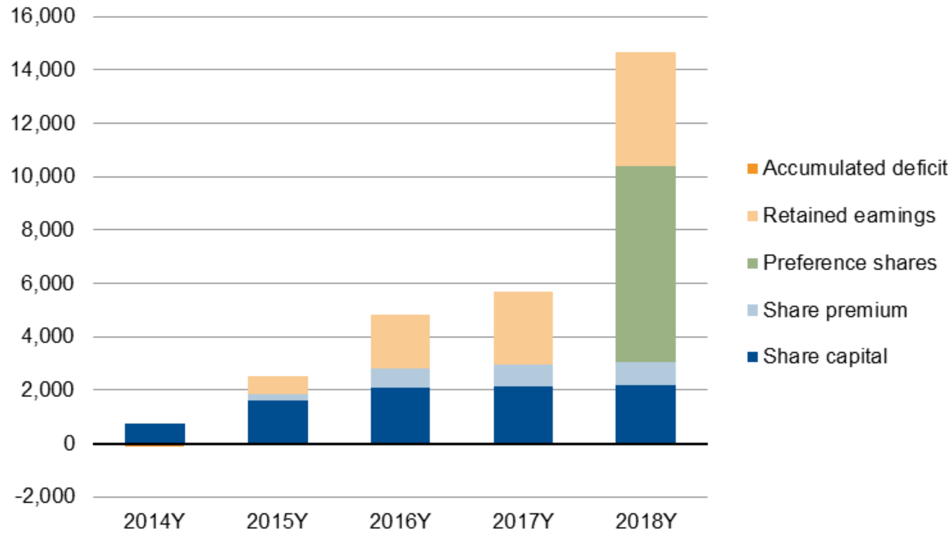
Source: MBC

**Governance model points to long-term sustainability and value preservation on top of adherence to regulatory requirements**

MBC is privately owned, by 12 individuals, including some from the top management and supervisory board, and a company. MBC has been profitable since 2014 and has so far elected not to distribute dividends.

In accordance with the existing Georgian legislation, microfinance organisations have to maintain authorised capital of no less than GEL 1m. MBC complied with this requirement as of 31 December 2018. Microfinance organisations are prohibited from raising finance though subordinated or convertible loans to individuals except partners/owners of the organisation. This results in an alignment of interests between shareholders, financiers and management, which indicates a stronger commitment to the long-term sustainability of the organisation. We view this governance model positively. MBC's adherence to international reporting standards, audited financials, professional management and the close supervision from the National Bank of Georgia reinforce this positive view.

**Figure 7: Historical equity composition**




Source: MBC

In 2018, MBC issued 2,800 convertible noncumulative preferred shares (placed among ordinary shareholders) with a nominal value of USD 1000 (for a total of GEL 7.4m), increasing its authorised capital to GEL 15m. There are no voting rights attached to the shares, but they have a higher priority of claims over ordinary shareholders and carry a fixed dividend of 12.5% pa., payable semi-annually subject to the approval of the supervisory board. If the dividend is not paid twice in a row or if it decreases in value, the preferred shareholders have the right to convert. In 2019 MBC paid a dividend on preferred shares.

The NBG introduced the first significant set of regulatory requirements in 2018, with some more stringent covenants for microfinance organisations starting in 2019. MBC has been continuously compliant with most of the requirements, including the investment coefficient and the insider credit coefficient.

**Figure 8: NBG regulatory ratios against covenants (Dec-18/Nov-19)**

| | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Nov-19 |
|---|---|---|---|---|---|
| **Capital adequacy** (>18% from January, before >16%) | 34.1% | 34.3% | 36.1% | 36.1% | 34.5% |
| **Liquidity** (>18% from January, before >16%) | 16.5% | 21.0% | 23.7% | 21.1% | 24.0% |
| **Investments in property** (< 40%) | 13.1% | 12.6% | 11.9% | 12.1% | 12.8% |
| **Pledged assets to equity** (<90%) | 205.8% | 207.7% | 210.6% | 198.1% | 195.3% |

Source: MBC

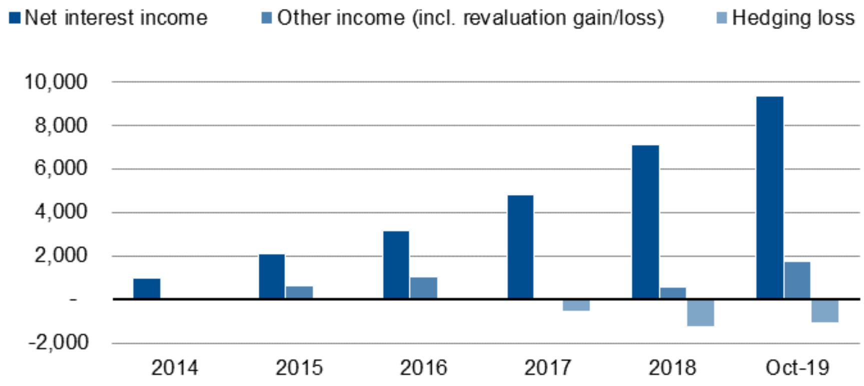
**Transition to a more balanced funding profile, currency mismatch will affect profitability in the medium term**

Microfinance organisations in Georgia are not allowed to raise funding through deposits.

The larization loan scheme initiated by the government and the NBG in 2017 has de facto prohibited microfinance organisations from extending loans in foreign currencies. Given the especially short duration of microfinance assets, the share of loans in USD in MBC's total portfolio fell from 35% in 2017 to just 12% in 2019. This resulted in a significant balance sheet mismatch, with over 50% of outstanding longer-term funding in USD.

So far, profitability metrics have been supported by revaluation income from the open positive currency position (assets in forex being greater than liabilities net of forex derivatives), with gains of approx. GEL 1.6m in the first 10 months of 2019. However, the currency mismatch is having a negative effect on net interest income and affecting hedging costs, which cannot be fully transferred to borrowers.

**Figure 9: Forex gains vs hedging costs impact**




Source: MBC

Hedging expenses for the mismatch between liabilities are expected to keep affecting operating performance.

As of YE 2018, 61% of borrowings were from financial institutions against pledged assets, 29% were unsecured from individuals and legal entities and 10% were subordinated (from related parties). The liability structure reflects the sector's heavy reliance on bank financing, with lending from individuals on the decline. This is because regulatory developments are limiting microfinance organisations' reliance on individuals, shifting it towards more qualified investors.

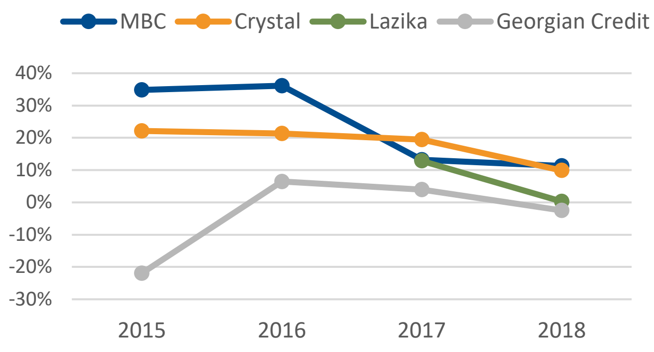
In MBC's case, bank financing is fully secured by pledged assets. The NBG requires the pledged assets-to-equity ratio to stand at a maximum of 90%. MBC secured a two-year waiver from the NBG, which will be extended if it is not able to shift its funding towards unsecured debt or loan financing.

Of the financing from legal entities, unsecured loans from the Microfinance Enhancement Facility and the Incofin Inclusive Finance Fund, stood at approx. GEL 7.9m during 2019. The Microfinance Enhancement Facility SA, SICAV-SIF (MEF) was set up in February 2009 by KfW and the International Finance Corporation to support microfinance institutions facing difficulties in securing financing. These revolving facilities have an initial duration of two years but are extendable up to 2025 (MEF) and 2024 (Incofin).

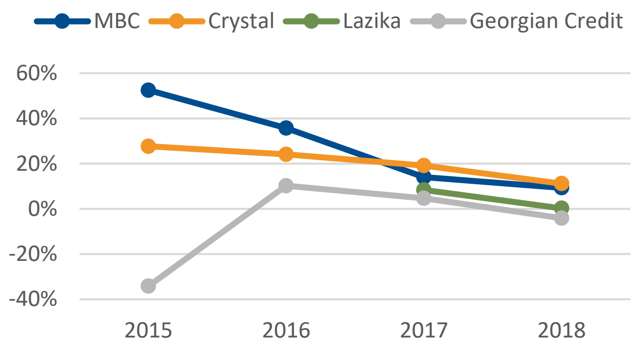
As of YE2018, funding from individuals outside the organization (approx. GEL 7m) was all unsecured and mostly in USD. We expect this source of funding to decrease in importance as it is not part of MBC's funding strategy and the NBG is limiting reliance on this funding source.

## I. Appendix: Peer comparison

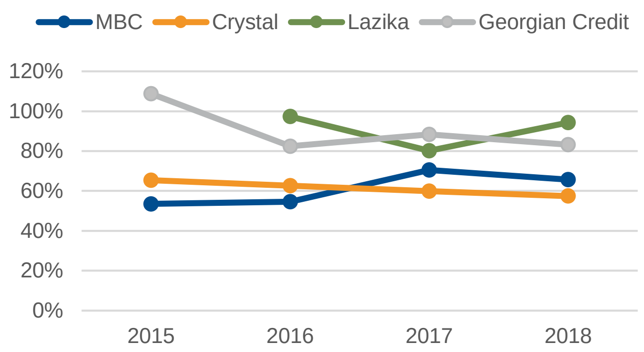
**Net profit margin (%)**



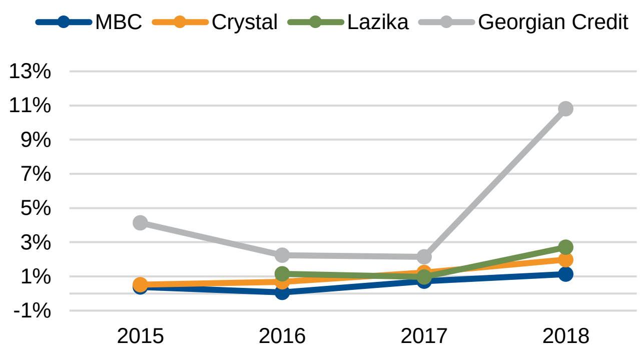

**Return on average equity (%)**



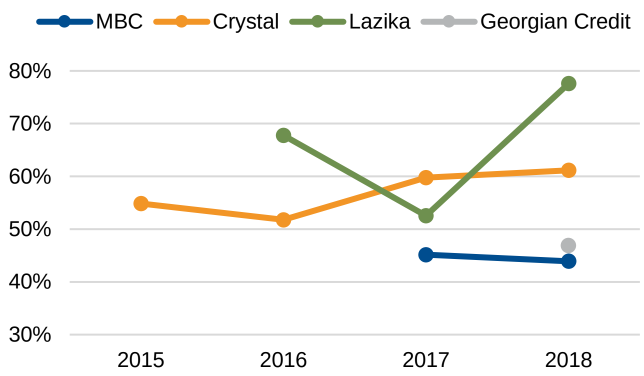

**Cost-to-income (%)**



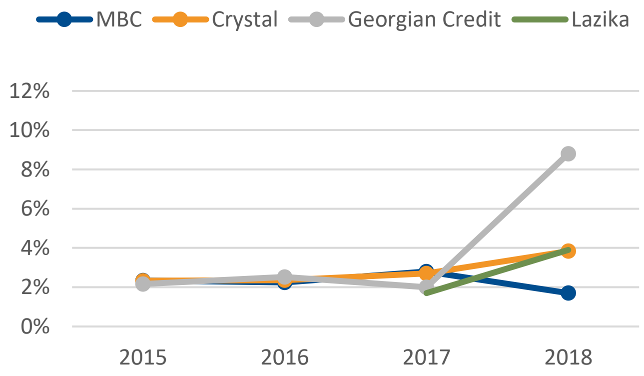

**Stage 3 ratio (%)**



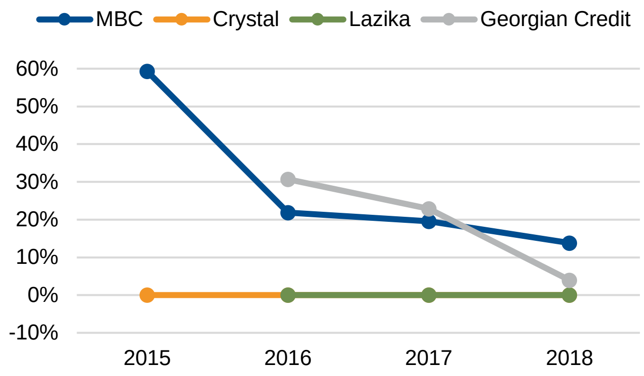

**Stage 3 coverage ratio (%)**



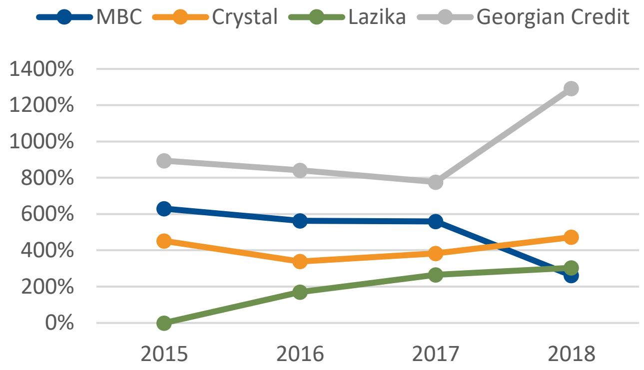

**LLPs % gross loans**



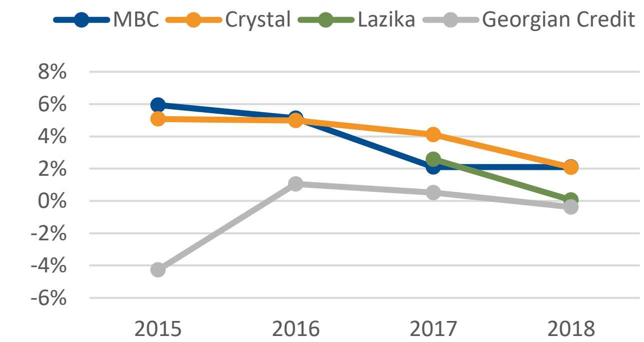
**Funding from individuals/borrowings (%, excl. related parties)**



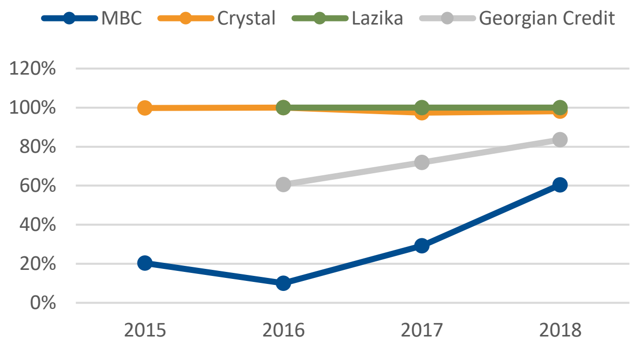

**Leverage (%)**




**Return on average assets (%)**




**Bank funding/borrowings (%)**




*National peers: Crystal, Lazika Capital, Georgian credit
Source: Company info

## II. Appendix: Selected Financial Information – JSC MFO Micro Business Capital

| | 2014Y | 2015Y | 2016Y | 2017Y | 2018Y |
|---|---|---|---|---|---|
| **Balance sheet summary (GEL '000)** | | | | | |
| **Assets** | | | | | |
| Cash and cash equivalents | 836 | 1,138 | 3,893 | 1,134 | 1,771 |
| Loans to customers | 7,790 | 17,162 | 27,757 | 33,464 | 48,348 |
| Property and equipment | 182 | 313 | 459 | 1,363 | 1,933 |
| Intangible assets | 35 | 25 | 198 | 228 | 236 |
| Deferred tax assets | 27 | 88 | 148 | 167 | 346 |
| Current tax assets | 0 | 0 | 0 | 151 | 0 |
| Other assets | 70 | 109 | 107 | 1,554 | 1,020 |
| **Total assets** | **8,939** | **18,835** | **32,561** | **38,061** | **53,654** |
| **Liabilities** | | | | | |
| Subordinated borrowings and other borrowed funds | 8,261 | 15,923 | 27,200 | 31,946 | 38,429 |
| o/w Subordinated debt | 1,279 | 2,232 | 3,823 | 4,991 | 3,913 |
| Current tax liability | 0 | 203 | 107 | 0 | 186 |
| Other liabilities | 65 | 181 | 426 | 411 | 370 |
| **Total liabilities** | **8,326** | **16,307** | **27,733** | **32,357** | **38,985** |
| Share capital | 743 | 1,614 | 2,100 | 2,155 | 2,185 |
| Share premium | 0 | 219 | 719 | 795 | 852 |
| Preference shares | 0 | 0 | 0 | 0 | 7,347 |
| Retained earnings | 0 | 696 | 2,009 | 2,754 | 4,285 |
| Accumulated deficit | -130 | 0 | 0 | 0 | 0 |
| Total equity | 613 | 2,528 | 4,828 | 5,704 | 14,669 |
| **Total liabilities and equity** | **8,939** | **18,835** | **32,561** | **38,061** | **53,654** |
| **Income statement summary (GEL '000)** | | | | | |
| Interest income | 1,808 | 3,728 | 5,555 | 8,243 | 11,284 |
| Interest expense | -829 | -1,637 | -2,389 | -3,439 | -4,172 |
| Net interest income | 980 | 2,091 | 3,166 | 4,804 | 7,112 |
| Fee and commission income | 0 | 277 | 470 | 830 | 1,293 |
| Net foreign exchange income/(loss) | 39 | 342 | 563 | -797 | -458 |
| Net (loss)/ income from trading in foreign currency | 0 | 0 | 0 | 239 | -213 |
| **Operating income** | **1,018** | **2,710** | **4,198** | **5,076** | **7,734** |
| Impairment losses on debt financial assets | -158 | -279 | -330 | -601 | -1,523 |
| Personnel expenses | -341 | -843 | -1,237 | -2,034 | -2,988 |
| General administrative expenses | -428 | -608 | -1,054 | -1,545 | -2,095 |
| **Profit before income tax** | **91** | **980** | **1,576** | **896** | **1,128** |
| Income tax expense | -23 | -155 | -263 | -151 | -182 |
| **Profit for the year** | **68** | **825** | **1,314** | **745** | **946** |

Source: SNL, Scope Ratings

## III. Appendix: Ratios – JSC MFO Micro Business Capital

| Earnings and profitability | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| Yield on gross loans (%) | 22.7% | 21.2% | 19.6% | 24.0% | 22.9% |
| Cost of funding (%) | 11.9% | 12.0% | 10.2% | 10.8% | 10.9% |
| Net interest income/ operating income (%) | 96.2% | 77.1% | 75.4% | 94.6% | 92.0% |
| Net fees & commissions/ operating income (%) | 0.0% | 10.2% | 11.2% | 16.4% | 16.7% |
| FX income / operating income (%) | 3.8% | 12.6% | 13.4% | -15.7% | -5.9% |
| Trading income / operating income (%) | 0.0% | 0.0% | 0.0% | 4.7% | -2.8% |
| Cost/ income ratio (%) | 75.5% | 53.6% | 54.6% | 70.5% | 65.7% |
| Impairment on financial assets / pre-impairment income (%) | 63.5% | 22.2% | 17.3% | 40.1% | 57.5% |
| Loan loss provisions / average gross loans (%) | 3.2% | 3.2% | 2.8% | 3.0% | 2.0% |
| Return on average assets (%) | 0.8% | 5.9% | 5.1% | 2.1% | 2.1% |
| Return on average equity (%) | 11.1% | 52.5% | 35.7% | 14.1% | 9.3% |
| **NBG covenants** | | | | | |
| Capital adequacy ratio (%) | | | | 26.6% | 34.1% |
| Liquidity ratio (%) | NA | NA | NA | NA | 16.5% |
| Pledged assets to equity ratio (%) | NA | NA | NA | NA | 205.8% |
| **Asset mix, quality and growth** | | | | | |
| Net loans / assets (%) | 87.1% | 91.1% | 85.2% | 87.9% | 90.1% |
| Past due > 30 / tangible equity & reserves (%) | 17.1% | 4.7% | 3.7% | 11.4% | 18.6% |
| Past due > 30 / total gross loans (%) | 1.2% | 0.7% | 0.6% | 1.8% | 2.7% |
| Loan loss allowance for stage 2 & 3 loans / Past due > 30 | NA | NA | 15.0% | 25.2% | 34.4% |
| Net loan growth (%) | 104.4% | 120.3% | 61.7% | 20.6% | 44.5% |

Source: Company info, Scope Ratings

## Note: Ratios 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 (%) = (Share capital + share premium + retained earnings – intangible assets + subordinated loans*) / (total assets – intangible assets)

d) Liquidity ratio (%) = Assets / (All liabilities – liabilities from financial institutions and subordinated loans ending in more than 6 months)

e) Return on average assets (ROAA,%) = Net income / Average assets

f) Return on average equity (ROAE,%) = 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

*Subordinated loans are amortized by 20% in the last 5 years of its term

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