12 June 2020

Financial Institutions

JSC MFO Swiss Capital
Issuer Rating Report

STABLE

B

Overview

Scope has assigned an issuer rating of B, with a Stable Outlook, to JSC MFO Swiss Capital (Swiss Capital).

Highlights

- The rating is supported by Swiss Capital's strong market position in the Georgian microfinance sector. It is constrained by limited diversification, with a business model focused on consumer micro lending in the organisation's domestic market.
- Although recent regulatory and accounting changes have put pressure on the sector´s returns, Swiss Capital's bottom-line profitability has proved resilient, allowing for organic capital formation.
- The loan book is almost entirely collateralised; however, asset quality metrics are comparatively weak. Changes in provisioning rules under the National Bank of Georgia (NBG) and international accounting standards (IFRS9) have significantly increased coverage levels across the board.
- Like most of the microfinance organisation (MFO) sector, Swiss Capital has been forced to reshape its funding profile following limits imposed by the loan larization plan and regulatory changes. The reliance on secured bank borrowings denominated in Georgian lari is reflected in a comparatively high asset encumbrance ratio.
- Swiss Capital is in full adherence with all remaining regulatory requirements, including on capital and liquidity.

Rating drivers (summary)

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

- One of the top MFOs in Georgia, with a business model supporting margins which are higher than peers'
- Comparatively weak asset quality metrics for an almost fully collateralised portfolio with adequate coverage
- Mostly reliant on secured bank funding, however capital and liquidity metrics are comfortably above requirements

Ratings & Outlook

Issuer rating	B
Outlook	Stable

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Bloomberg: SCOP

Rating-change drivers

Weaker credit fundamentals

Beyond the short-term impact of the economic slowdown caused by the Covid-19 pandemic on Swiss Capital's profitability, we would view negatively a weakening of credit fundamentals driven by a more prolonged recession in Georgia.

Improvement in asset quality

Management's intention to increase the share of collateralised micro business and dispose of the remaining share of uncollateralised consumer loans should help improve asset quality.

Downward pressure on profitability from increased cost of funding

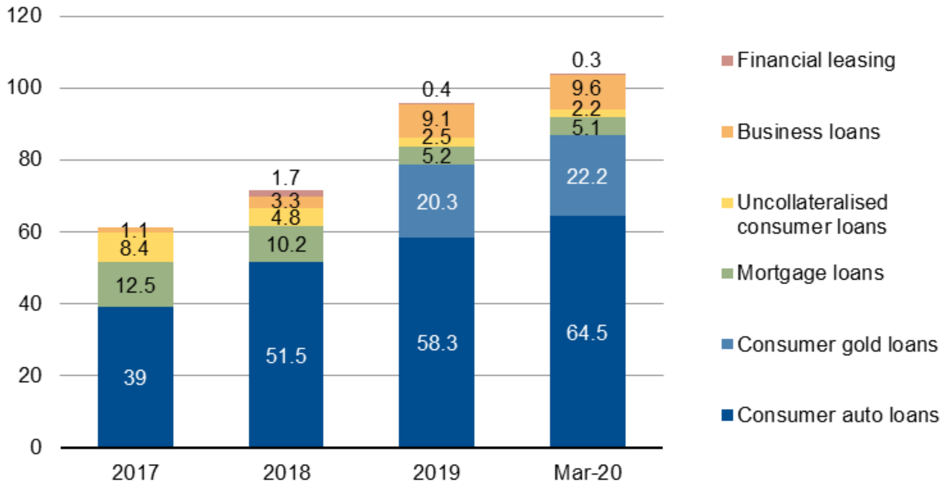
The larization plan has resulted in Swiss Capital's increasing reliance on domestic currency funding from commercial banks. This is typically tied to the NBG's main refinancing rate. Any tightening of conditions would therefore probably be reflected in increased funding costs, from a comparatively low level.

Rating drivers (details)

One of the top MFOs in Georgia, with a business model supporting margins which are higher than peers'

Swiss Capital is a Georgian MFO operating exclusively in its domestic market, where it lends to individuals and micro and small businesses. As of December 2019, it held a 9.7% market share in net loans and was the third largest MFO in Georgia, with GEL 104.2m in assets. The Georgian MFO sector has 43 players. The sector is strongly concentrated, with the top five organisations holding 57% of the total gross loan portfolio and 86% of total assets as of December 2019.

Figure 1: Swiss Capital, gross loan portfolio by product



Source: Company data, Scope Ratings

Swiss Capital offers three main products: consumer loans collateralised by private vehicles; consumer loans collateralised by gold and small and micro business loans, with either vehicles or real estate as collateral; and uncollateralised consumer and business loans.

As of Q1 2020, the gross loan portfolio is composed of auto loans (62%), gold loans (21%), business loans (9%), residential mortgage loans (5%) and uncollateralised consumer loans (2%).

The relative importance of business loans has increased recently, while the uncollateralised consumer portion of the portfolio has been managed down and is expected to be wound down by 2021.

Swiss Capital's residential mortgage volumes have also been decreasing, with the contribution to total lending more than halving in two years. This trend can be seen in the MFO sector as a whole, following the introduction of minimum loan-to-value and debt-to-income levels at origination and increased due diligence requirements regarding borrowers' credit history. In 2019, Swiss Capital acquired a gold portfolio, partially denominated in US dollars.

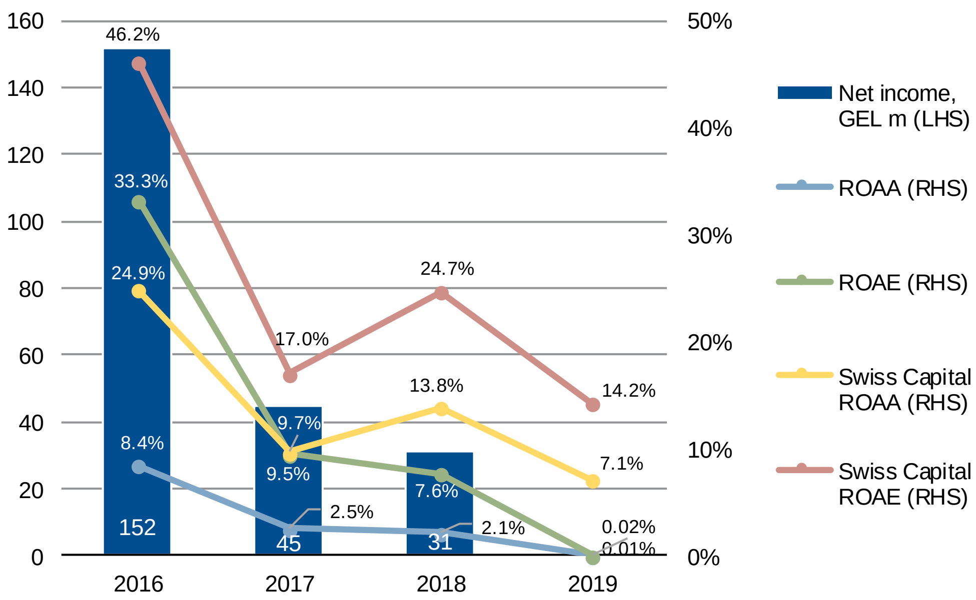
Since 2017-2018, increased regulatory pressure has pushed many players out of the market. New provisioning rules via IFRS9 and the NBG in 2018, the 'larization plan' de facto prohibiting MFOs from extending forex loans, and the 50% effective interest rate ceiling have compressed margins for the sector.

However, Swiss Capital has been able to maintain adequate profitability for the sector in the past few years.

The portfolio's high turnover rate and the significant share of repayments on high interest loans contributed to the 2018 hike in interest income, which more than offsets the increased loan impairments from changes in accounting. However, the cap on interest rates and a more normalised cost of risk drove the performance in 2019, which however reflects a number of one-offs mostly related to the gold portfolio acquisition. Excluding such exceptional items, the level of profitability closer to recurring would see a ROAA at 9.1% and ROAE at 18.1%.

In 2019, Swiss Capital's results included a 14.2% return on average equity (ROAE), a 7.1% return on average assets (ROAA), and a 25.1% net profit margin. These levels clearly outperformed Georgian MFO sector profitability metrics, which are characterised by flattish ROAE and ROAA levels and negative double-digit net profit margins.

Figure 2: Profitability metrics, Swiss Capital versus sector



Source: Company data, NBG, Scope Ratings

Comparatively weak asset quality metrics for an almost fully collateralised portfolio with adequate coverage

Swiss Capital focuses on collateralised lending, which as of March 2020 represents 97% of the overall portfolio. As of YE 2019, Stage 3 loans represented 14.2% of total gross loans, versus 17% in 2018, with a flat coverage of 57% YoY.

The impact of the change of provisioning rules under both the NBG and IFRS9 is visible in Figure 4: in 2017, coverage stood at 13% against a 90 days past due (PD90) ratio of 15%, increasing to 57% on a 16% PD90 ratio in 2018.

Asset quality and risk metrics differ greatly depending on the portfolio: loans backed by gold have a reported average loan-to-value ratio of 90% but against a conservative valuation of collateral which provides for additional protection against losses. The portfolio displays a PD90 ratio of 5% and a coverage of 10% as of YE 2019.

The portfolio collateralised by vehicles as of YE 2019 had a PD90 ratio of 14% and a coverage on PD90 loans of 58%.

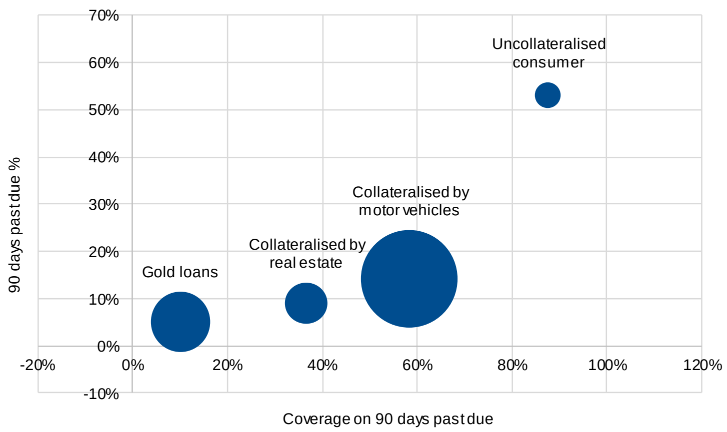
However, losses on the portfolio are relatively low: net write-offs peaked at 5% of the gross loan portfolio in 2018. As of YE 2019 and YE 2017 they stood at 2%.

From a final borrower perspective, collateralised business loans perform better than consumer loans, with an average PD90 ratio of 1.1% versus 11% at YE 2019.

We deem the current level of profitability sufficient to sustain weaker asset quality and reflecting the management´s risk-return appetite.

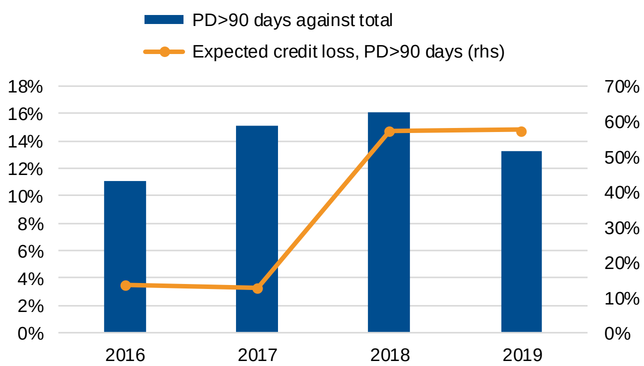
Swiss Capital is exposed to an adjustment in collateral market values, especially private and commercial vehicles, which represent the vast majority of its collateral, however given the average LTV of approx. 51% the portfolio could withstand to some degree a drop in collateral values. We view positively management’s intention to increase the share of business lending and work out the uncollateralised portion of the consumer portfolio (which alone accounts for 4% of total gross loans and 18% of loans over 90 days past due).

Figure 3: Credit quality by collateral type, size of bubble is gross loan volume



Source: Company data, Scope Ratings

Figure 4: Historical over 90 days past due % and coverage



Source: Company data, Scope Ratings

Mostly reliant on secured bank funding, however capital and liquidity metrics are comfortably above requirements

Like the majority of its peers, Swiss Capital has been recalibrating its funding sources as MFOs are prohibited from attracting deposits and regulation has been disincentivising reliance on borrowings from individuals.

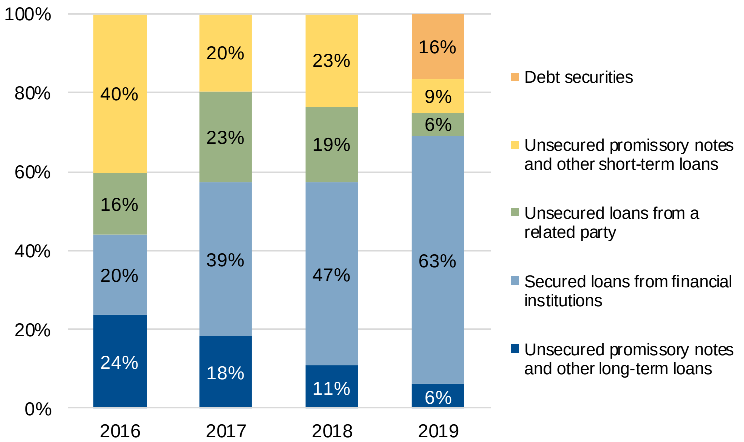
At the same time, the government's larization plan has put pressure on the MFO to close the resulting mismatch by increasing its share of lari-denominated borrowings or incurring significant hedging costs.

Swiss Capital has been able to manage the arising currency mismatch relatively well, with the cost of funding remaining around 15% over the past few years.

In 2019, Swiss Capital issued a GEL 8m bond, placed within the public sector and maturing in 2021. On the one hand, the increasing reliance on secured bank funding makes inflows more predictable. On the other hand, it worsens asset encumbrance vis-à-vis Swiss Capital's other (unsecured) creditors.

We view positively Swiss Capital's adherence to all other regulatory requirements: the capital coefficient ratio leverages on profit retention as well as a comparatively conservative dividend policy so far.

Figure 5: Funding structure



Source: Company data, Scope Ratings

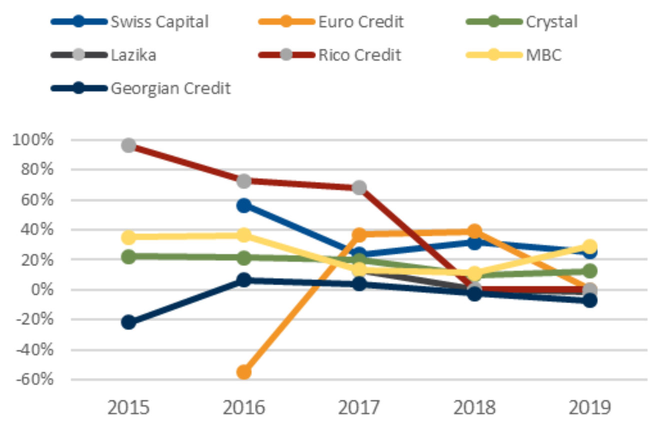
Figure 6: Regulatory ratios, December 2019

	NBG requirement	Current figure
Capital coefficient	Min. 18%	44.4%
Liquidity coefficient	Min. 18%	26.7%
Property investment coefficient	Max. 40%	1.7%
Investment coefficient	Max. 15%	0.0%
Insider coefficient	Max. 15%	0.0%
Pledged asset coefficient	Max. 90%	116.4%

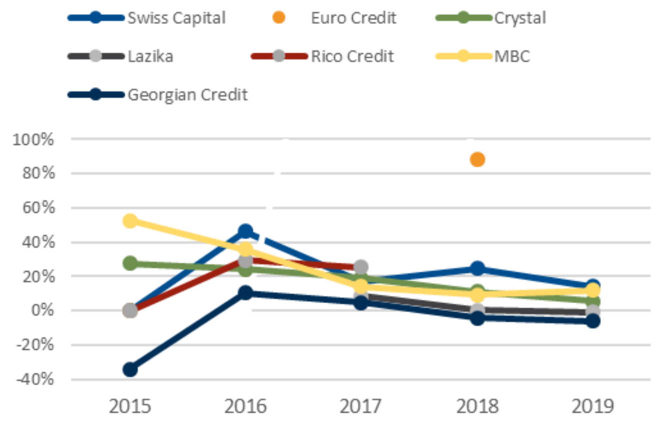
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

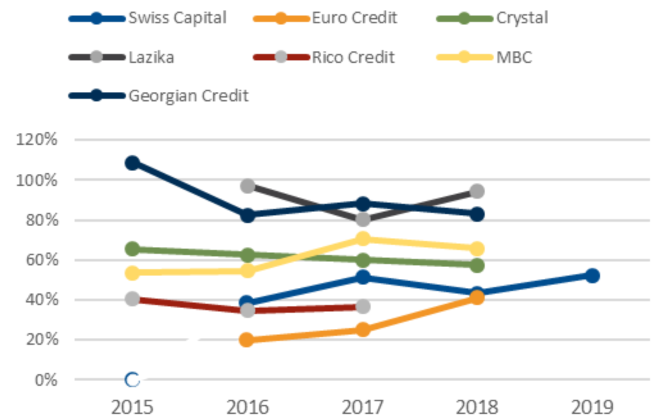
Net profit margin (%)



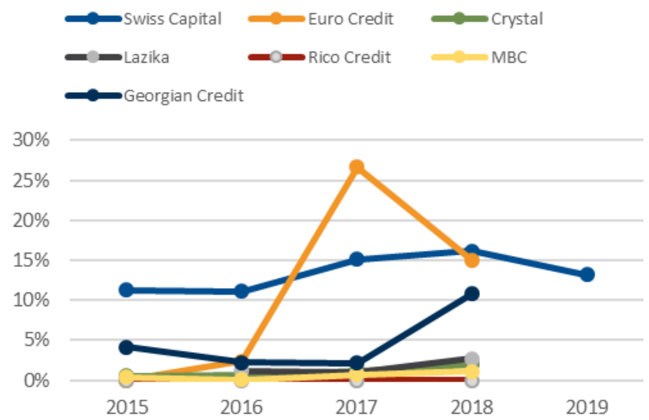
Return on average equity (%)



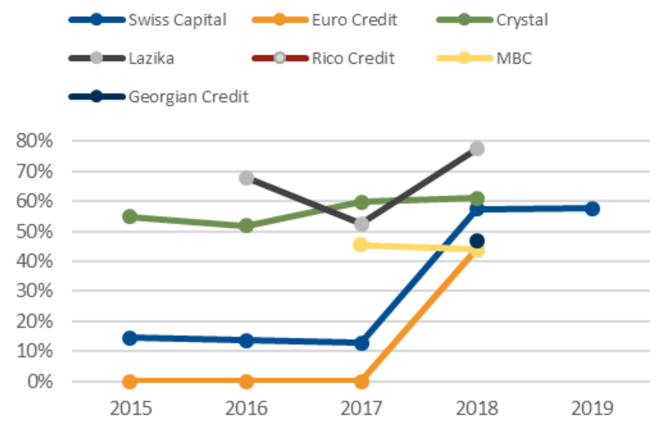
Cost-to-income ratio (%)



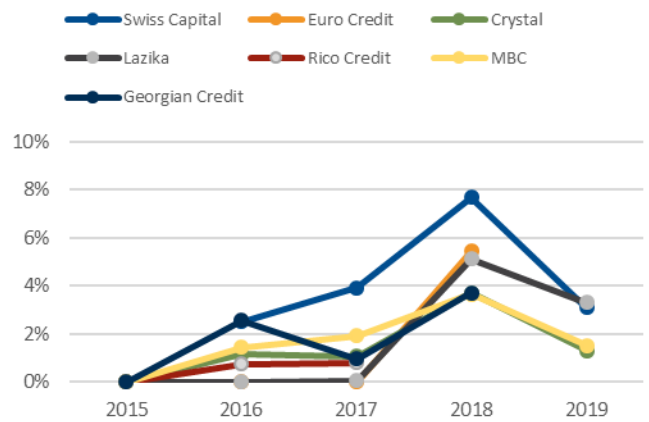
PD>90 days / total gross loans (%)



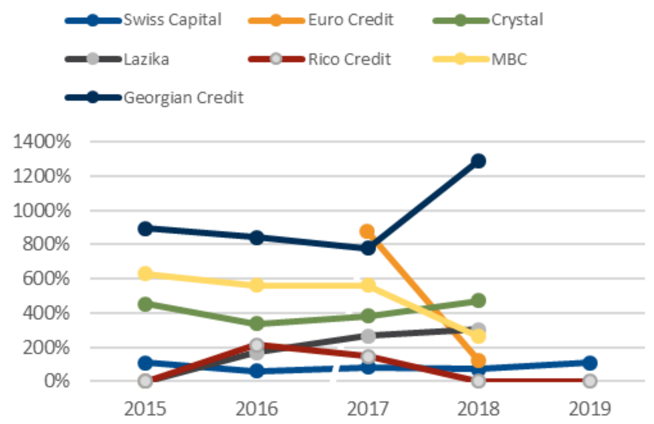
Expected credit loss on PD>90 days / PD>90 days



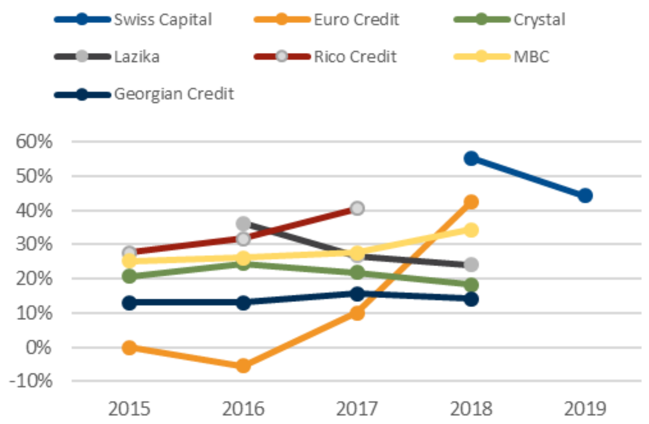
Loan loss provisions / average total gross loans



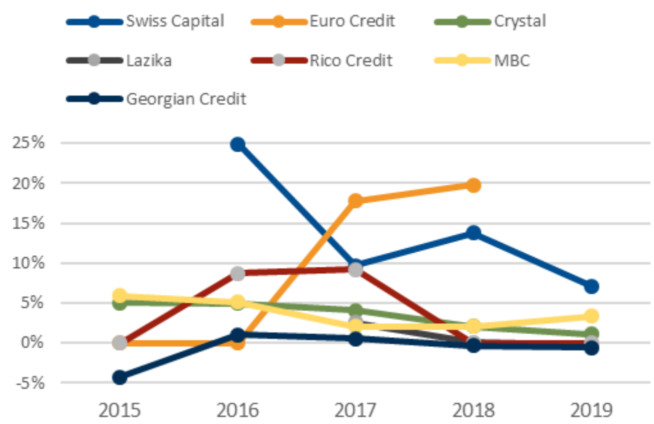
Leverage (%)



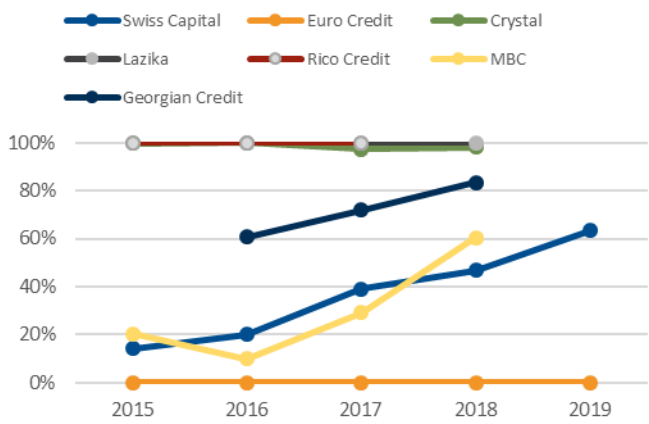
Capital adequacy ratio (%)



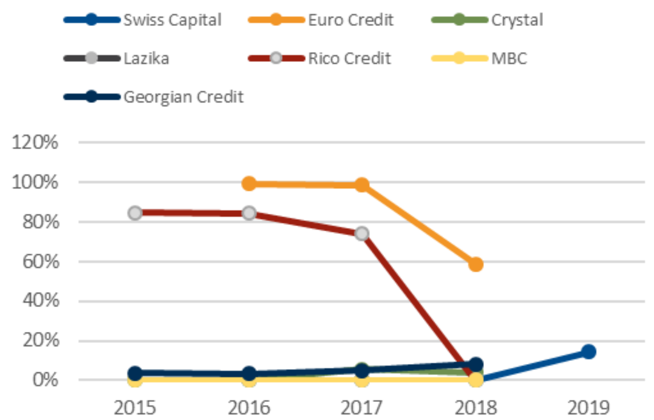
Return on average assets (%)



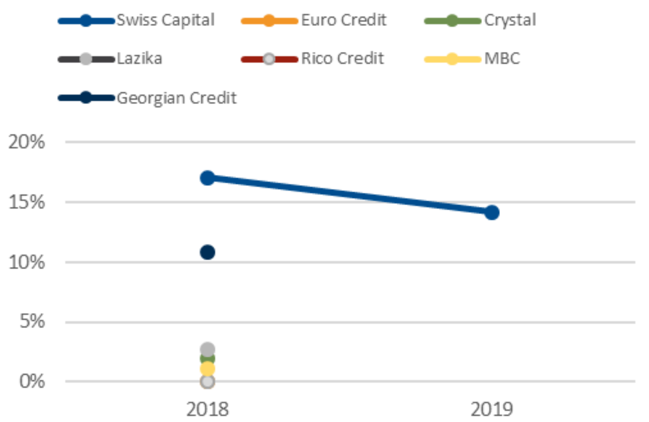
Bank funding / borrowings



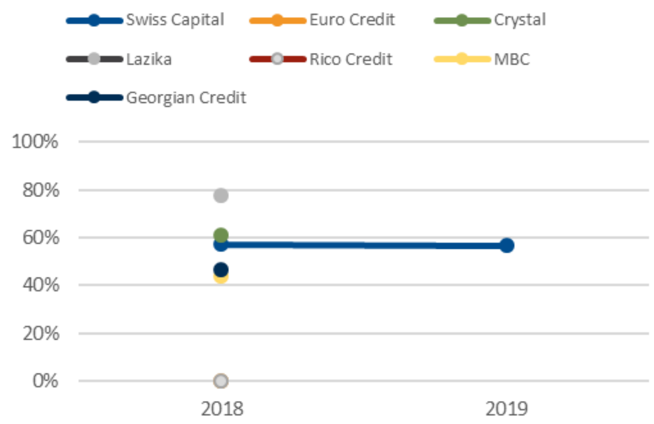
Issued debt / liabilities (%)



Stage 3 ratio (%)



Stage 3 coverage ratio (%)



*National peers: Euro Credit, Crystal, Lazika Capital, Rico Credit, MBC, Georgian Credit
Source: Companies information

II. Appendix: Selected financial information – JSC MFO Swiss Capital

	2016	2017	2018	2019
Balance sheet summary (GEL '000)				
Assets				
Cash and cash equivalents	2,154	5,048	6,464	5,197
Financial instruments at fair value through profit or loss	1,809	0	0	0
Loans to customers	46,320	60,906	62,124	90,113
Financial leasing	0	0	1,524	307
Other assets	963	758	473	334
Property and equipment	1,326	1,258	893	732
Intangible assets	518	470	383	329
Right-of-use asset	0	0	0	5,517
Current income tax asset	0	780	0	63
Deferred tax asset	563	861	1,981	1,627
Investments in subsidiaries	1,366	919	717	0
Total assets	**55,019**	**71,000**	**74,559**	**104,219**
Liabilities				
Borrowed funds	20,267	31,858	31,076	50,788
Current income tax liability	745	0	424	0
Other liabilities	498	785	378	6,767
Total liabilities	**21,510**	**32,643**	**31,878**	**57,555**
Share capital	4,175	4,175	4,175	4,175
Share premium	2,068	2,068	2,068	2,068
Retained earnings	27,266	32,114	36,438	40,421
Total equity	**33,509**	**38,357**	**42,681**	**46,664**
Total liabilities and equity	**55,019**	**71,000**	**74,559**	**104,219**
Income statement summary (GEL '000)				
Interest income	23,531	28,448	34,519	28,199
Interest expense	-2,940	-3,493	-4,135	-5,102
Net interest income	20,591	24,955	30,384	23,097
Other income	2,002	1,193	1,245	2,241
Net loss on financial instruments at fair value through profit or loss	863	-1,204	-351	99
Operating income	**23,456**	**24,944**	**31,278**	**25,437**
Personnel expenses	-3,629	-5,920	-6,340	-6,607
Operating and administrative expenses	-5,336	-6,861	-7,172	-6,724
Total expenses	-8,965	-12,781	-13,512	-13,331
Pre-provision income	**14,491**	**12,163**	**17,766**	**12,106**
Loan impairment charge	-1,133	-2,234	-5,322	-2,705
Impairment of investment in subsidiaries	-308	-447	-202	-717
Foreign exchange loss, net	2,144	-1,884	-440	-445
Profit before income tax	**15,194**	**7,598**	**11,802**	**8,239**
Income tax expense	-2,408	-1,491	-1,775	-1,886
Net profit for the year	**12,786**	**6,107**	**10,027**	**6,353**

Source: Company data, Scope Ratings

III. Appendix: Ratios – JSC MFO Swiss Capital

Earnings and profitability	2016	2017	2018	2019
Yield on gross customer loans (%)	47.9%	43.5%	47.1%	27.5%
Yield on net customer loans (%)	50.8%	46.6%	55.4%	31.1%
Cost of funding (%)	12.3%	17.2%	13.0%	15.0%
Net interest income/ operating income (%)	87.8%	100.0%	97.1%	90.8%
Cost/ income ratio (%)	38.2%	51.2%	43.2%	52.4%
Impairment on financial assets / pre-impairment income (%)	7.8%	18.4%	30.0%	22.3%
Loan loss provision/ average gross loans (%)	2.5%	3.9%	7.7%	3.1%
Return on average assets (%)	24.9%	9.7%	13.8%	7.1%
Return on average equity (%)	46.2%	17.0%	24.7%	14.2%
NBG covenants	**2016**	**2017**	**2018**	**2019**
Capital adequacy ratio (%)			55.3%	44.4%
Liquidity ratio (%)			47.7%	26.7%
Pledged assets to equity ratio (%)			75.7%	116.4%
Asset mix, quality and growth	**2016**	**2017**	**2018**	**2019**
Net loans / assets (%)	84.2%	85.8%	83.3%	86.5%
Net loan growth (%)	17.6%	31.5%	2.0%	45.1%
Stage 3 loans / total gross loans (%)			17.0%	14.2%
Stage 3 coverage ratio (%)			57.1%	56.9%
PD>90 days / total gross loans (%)	11.1%	15.2%	16.1%	13.2%
Expected credit loss, PD>90 days (%)	13.6%	12.7%	57.5%	57.6%
Write-offs – recoveries / Stage 3 (PD90 for 2017)		11.2%	35.3%	13.1%

Source: Company data, 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 (%) = (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 payable with maturity more than six 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 over 90 days past due) / total gross loans

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