The Pakistan Credit Rating Agency Limited

SME BANK LIMITED
RATING REPORT

	NEW [NOV-17]	PREVIOUS [APR-17]
Long-Term	B	B
Short-Term	B	B
Outlook	Developing	Developing

REPORT CONTENTS

NOVEMBER 2017

Profile &Ownership

- SME Bank Limited (SMEBL), incorporated in January 2002, Scheduled Bank commenced commercial banking operations in 2005.
- It operates a network of 13 branches, five recovery offices and is ~94% owned by Federal Government through Ministry of Finance and remaining 6% kept by financial institutions.

Governance & Management

- The overall control of SMEBL lies with government nominated seven-member Board of Directors. Currently, the position of three positions are vacant.
- The CEO, Mr. Ihsan ul Haq Khan, assumed the role in Jun-14 and has prior experience in banking and finance.

Privatization:

- Government of Pakistan is in the process of divesting its equity stake (~94%) in bank along with the management control.
- A number of parties submitted their applications containing expression of interest and statement of qualifications on April 7, 2017. In response to the privatization commission (PC), only five parties have submitted the statement of qualification that had obtained documents at the initial stage.
- PC has shortlisted three investors and now bidding process will be commence under the auspices of the Privatisation commission.
- State Bank of Pakistan has incentivized the transaction to provide support to the potential investors.
- The major highlight is the reduction of minimum capital requirement to PKR 6bln, that would be built in a staggered manner with the initial injection of PKR 2bln and PKR 1bln each year for the next 4 years.
- The bank will be granted a specialized banking license by SBP requiring to it to maintain majority at least 60% of exposure to SME and remaining 40% towards commercial and retail sector.

Asset Composition and Quality

- At end-Sep17, the average loan size of SMEBL's own book was ~PKR 2mln, with majority of loans extended for working capital purpose followed by fixed term loans.
- The advances' book is moderately concentrated in top-20 loans constituting 48% of the total book.
- Asset book has higher infection ratio (9MCY17: 71%; end-Dec 16: 67%; end-Dec15: 68 %; end-Dec14: 68%).

Investment Book:

- SMEBL's investment book, dominated by government securities (64%), increased on YoY basis (9MCY17: PKR 6,006mln; CY16: PKR 4,659mln; CY15: PKR 4,117mln).
- Half portion (50%) of this book, invested in PIBs maturing within three years, carries interest rate risk.
- Deposits are from few entities; repo borrowings have been made from financial institutions on the back of government securities – leaving loss coverage to the deposit holders.
- The bank holds 73% in SME Leasing (SMEL). SMEL is in losses and SMEBL has booked a provision of PKR 125mln against the investment value of PKR 215mln at end-Sep17.

Performance

- During 9MCY17, decline in asset yield as compared to 9MCY16 (9MCY17: PKR 91mln; CY16 PKR 174mln). However, despite increased other operating income – virtue of higher gain on sale of investments – the bank continued to incur loss (9MCY17: Negative PKR 126mln; CY16: Negative PKR199mln).

Funding & Capital

- The main source of SMEBL's funding is its deposit base, spread over few accounts (Total Deposits for 9MCY17: PKR 5,012mln; CY16: PKR 5,229mln; CY15: PKR 4,770mln).
- Top-20 deposits' concentration improved (9MCY17: 36%; CY16: 56%; CY15: 59%).
- Continuous subdued performance of the bank, the equity base has been fully eroded (negative PKR 117mln at end-Sep17).

RATING RATIONALE

Recently, decision for five parties those have submitted the statement of qualification for SME Bank Limited, three of them are finalized and now bidding process will be commence under the auspices of the Privatisation. Government is in process of divesting 93.88 percent shareholding of the SME Bank. This is an outcome of Government of Pakistan's endeavors to make SME Bank a vibrant institution by divesting GOP's equity stake in bank along with the management control to a strategic investor. The Privatization commission has appointed Financial Advisory Consortium (FAC). A number of parties submitted their applications containing expression of interest and statement of qualifications on April 7, 2017. In response to the Privatisation commission, only five parties submitted the statement of qualification that had obtained documents at the initial stage and three of them are shortlisted. Privatization Commission is planning to complete this transaction by March, 2018. SBP has incentivised the transaction to provide support to the potential sponsors. The key highlight is the reduction in minimum paid up capital to PKR 6bln. This capital would be built in a staggered manner with initial injection of PKR 2bln and PKR 1bln each year for the next 4 years. The Bank will also be granted specialized Banking license by utilizing 60% to SME Sector and remaining 40% to the Commercial and Retail Sector. On a standalone basis, SME Bank Limited has a stressed profile owing no announcement of budget by the Government. Due to continuous subdued performance of the bank, the equity base has been fully eroded (negative PKR 19mln at end-Jun17). Deposits are pre-dominantly from government linked entities; repo borrowings have been made from financial institutions on the back of government securities – leaving loss coverage to the deposit holders. Given continuous operational losses and no equity base, timely completion of privatization process is critical for the Bank.

KEY RATING DRIVERS

PACRA would monitor the related developments which are going on. Rating would be reviewed once the transaction will complete and clarity as to the new ownership structure and pursuant strategy and capital injection plan is achieved.

Financials [Summary]

The Pakistan Credit Rating Agency Limited PKR (mln)

SME Bank Limited

BALANCE SHEET	30-Sep-17	31-Dec-16	31-Dec-15	31-Dec-14
	3QCY17	Annual	Annual	Annual
Earning Assets				
Advances	2,188	2,610	2,494	2,613
Debt Instruments	-	-	-	-
Total Finances	2,188	2,610	2,494	2,613
Investments	6,200	4,870	4,117	1,446
Others	305	450	886	217
	8,693	**7,929**	**7,498**	**4,277**
Non Earning Assets				
Non-Earning Cash	407	561	390	367
Deferred Tax	428	256	-	-
Net Non-Performing Finances	166	162	257	316
Fixed Assets & Others	730	471	471	341
	1,730	**1,450**	**1,118**	**1,024**
TOTAL ASSETS	**10,424**	**9,379**	**8,617**	**5,300**
Interest Bearning Liabilities				
Deposits	5,012	5,229	4,770	3,343
Borrowings	4,893	3,460	2,889	776
	9,905	8,689	7,659	4,119
Non Interest Bearing Liabilities	633	669	601	492
TOTAL LIABILITIES	**10,538**	**9,358**	**8,260**	**4,611**
EQUITY (including revaluation surplus)	**(115)**	**21**	**356**	**689**
Total Liabilities & Equity	**10,424**	**9,379**	**8,617**	**5,300**

INCOME STATEMENT	30-Sep-17	31-Dec-16	31-Dec-15	31-Dec-14
	3QCY17	Annual	Annual	Annual
Interest / Mark up Earned	463	615	705	789
Interest / Mark up Expensed	(372)	(441)	(436)	(543)
Net Interest / Markup revenue	**91**	**174**	**269**	**246**
Other Income	18	47	48	88
Total Revenue	**109**	**221**	**317**	**334**
Non-Interest / Non-Mark up Expensed	(612)	(740)	(646)	(597)
Pre-provision operating profit	(503)	(519)	(329)	(263)
Provisions	19	62	55	(115)
Pre-tax profit	(484)	(457)	(275)	(378)
Taxes	358	258	(8)	(9)
Net Income	**(126)**	**(199)**	**(282)**	**(387)**

Ratio Analysis	30-Sep-17	31-Dec-16	31-Dec-15	31-Dec-14
	3QCY17	Annual	Annual	Annual
Performance				
ROE	309.3%	-128.1%	-60.7%	-47.4%
Cost-to-Total Net Revenue	559.8%	334.8%	203.9%	178.9%
Provision Expense / Pre Provision Profit	3.7%	12.0%	16.6%	-43.8%
Capital Adequacy				
Equity/Total Assets	-1.1%	0.1%	3.5%	11.8%
Capital Adequacy Ratio as per SBP	-6.3%	-2.8%	N/A	26.1%
Funding & Liquidity				
Liquid Assets / Deposits and Borrowings	70.0%	67.2%	64.6%	52.6%
Advances / Deposits	47.0%	53.0%	57.7%	87.6%
CASA deposits / Total Customer Deposits	69.6%	77.7%	74.2%	69.5%
Intermediation Efficiency				
Asset Yield	7.4%	7.9%	11.9%	21.9%
Cost of Funds	5.3%	5.4%	7.4%	11.3%
Spread	2.0%	2.5%	4.5%	10.6%
Outreach				
Branches	13	13	13	13

CREDIT RATING
SCALE & DEFINITIONS

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+: The highest capacity for timely repayment.

A1:. A strong capacity for timely repayment.

A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.

A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.

B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

C: An inadequate capacity to ensure timely repayment.

Outlook (Stable, Positive, Negative, Developing)
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension
It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn
A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information

Regulatory and Supplementary Disclosure

Rated Entity

Name of Rated Entity SME Bank Limited
Sector Banking
Type of Relationship Solicited

Purpose of the Rating
Regulatory Requirement
Independent Risk Assessment

Rating History

Dissemination Date	Long Term	Short Term	Outlook	Action
13-Nov-17	B	B	Developing	Maintain
14-Apr-17	B	B	Developing	Maintain
14-Apr-16	B	B	Negative	Downgrade
30-Jun-15	BB	B	Negative	Maintain
11-Feb-15	BB	B	Negative	Downgrade

Related Criteria and Research
Banking Sector - Viewpoint | Jun-17

Methodology:
Bank Rating Methodology

Rating Analysts

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Rating Team Statement

Rating Procedure
Rating is an opinion on relative credit worthiness of an entity or debt instrument. It does not constitute recommendation to buy, hold or sell any security. The rating team for this assignment does not have any beneficial interest, direct or indirect in the rated entity/instrument.

Disclaimer

Rating Shopping
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PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA's opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and ii) fee mandate - signed with the payer, which can be different from the entity
PACRA ensures that the credit rating assigned to an entity or instrument should not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship

Surveillance
PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the rated entity/ issuer, the security arrangement, the industry etc, is disseminated to the market, in a timely and effective manner, after appropriate consultation with the entity/issuer
PACRA reviews all the outstanding ratings on annual basis or as and when required by any stakeholder (including creditor) or upon the occurrence of such an event which requires to do so
PACRA initiates immediate review of the outstanding rating(s) upon becoming aware of any information that may be reasonable be expected to result in any change (including downgrade) in the rating

Reporting of Misconduct
PACRA has framed and implemented whistle-blower policy encouraging all employees to intimate the compliance officer any unethical practice or misconduct relating to the credit rating by another employees of the company that came to his/her knowledge. The Compliance Officer reports to the BoD and SECP

Confidentiality
PACRA has framed a confidentiality policy to prevent abuse of the non-public information by its employees and other persons involved in the rating process, sharing and dissemination of the non-public information by such persons to outside parties
Where feasible and appropriate, prior to issuing or revising a rating, PACRA informs the issuer of the critical information and principal considerations upon which a rating will be based and provide the opportunity to clarify any likely factual misperception or other matter that PACRA would wish to be made aware of in order to produce a fair rating. PACRA duly evaluates the response. Where in a particular circumstance PACRA has not informed the entity/issuer prior to issuing or revising a rating, it informs the entity/issuer as soon as practical thereafter

Prohibition

Probability of Default (PD)
PACRA's Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA's transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA's Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past.