



The Pakistan Credit Rating Agency Limited

SME BANK LIMITED

	UPDATE [APR-17]	PREVIOUS APR-16]
Long-Term	B	B
Short-Term	B	B
Outlook	RW- Developing	Negative

REPORT CONTENTS
1. RATING ANALYSIS
2. FINANCIAL INFORMATION
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APRIL 2017

Profile & Ownership

- SME Bank Limited (SMEBL), incorporated in January 2002, 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.

Governance & Management

- The overall control of SMEBL lies with government nominated seven-member Board of Directors. Currently, the position of two independent director and non-executive 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 Pakistan commission, only five parties have submitted the statement of qualification that had obtained documents at the initial stage.
- Later Government targets to complete the process before June 30, 2017.
- SBP will conduct the fit and proper and after evaluating potential investors will file a bid thereafter.
- 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 build 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-Sep 16, 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 45% of the total book.
- Asset book has higher infection ratio (end-Dec 16: 67%; end-Dec15: 68 %; end-Dec14: 68%).

Investment Book:

- SMEBL's investment book, dominated by government securities (96%), increased on YoY basis (CY16: PKR 4,870mln; CY15: PKR 4,117mln).
- A major portion (49%) of this book, invested in PIBs maturing within three years, carries interest rate risk.
- The bank holds 73% in SME Leasing (SMEL). SMEL is in losses and SMEBL has booked a provision of PKR 145mln against the investment value of PKR 215mln at end-Decmber16.

Performance

- During CY16, decline in asset yield as compared to CY15 (CY16: PKR 134mln; CY15 PKR 269mln). However, despite increased other operating income – virtue of higher gain on sale of investments – the bank continued to incur pre-provision operating loss owing to continued non markup based expenses.

Funding & Capital

- The main source of SMEBL's funding is its deposit base, spread over few accounts (Total Deposits for CY16: PKR 5229mln; CY15: PKR 4770mln)
- Top-20 deposits' concentration decline (CY16: 56%; CY15: 59%).
- With increased investment in government securities, SMEBL's liquidity profile has improved (Liquid Assets/Deposits and Borrowings: CY16:67%; CY15: 64%; end Dec-14: 53%).

RATING RATIONALE

In a recent development, a number of parties have submitted their applications, containing expressions of interest and statement of qualifications, for acquiring up to 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). Expressions of interest have been submitted. The government targets to complete the process before June 30, 2017. 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 build in a staggered manner with initial injection of PKR 2bln and PKR 1bln each year for the next 4 years. On a standalone basis, SME Bank Limited has a stressed profile. Due to subdued performance of the bank, the equity base has been almost eroded (PKR 21mln at end December 2016). Deposits are pre-dominantly from government linked entities; hence, relatively stable. Notably, more than half of this is deployed in the form of investments, providing adequate liquidity. However, rest of the assets has significant quantum of non-earning assets. Given continuous operational losses and limited equity base, timely completion of privatization process is critical.

KEY RATING DRIVERS

PACRA has placed the entity ratings of SME Bank on rating watch. PACRA would monitor the related developments. Rating would be reviewed once the clarity as to the new ownership structure and pursuant strategy and capital injection plan is achieved.



Financials [Summary]

The Pakistan Credit Rating Agency Limited

SME Bank Limited

PKR (mln)

BALANCE SHEET	31-Dec-16	31-Dec-15	31-Dec-14
	Annual	Annual	Annual
Earning Assets			
Advances	2,610	2,494	2,613
Debt Instruments	-	-	-
Total Finances	2,610	2,494	2,613
Investments	4,870	4,117	1,446
Others	450	886	217
	7,929	7,498	4,277
Non Earning Assets			
Non-Earning Cash	561	390	367
Deferred Tax	256	-	-
Net Non-Performing Finances	162	257	316
Fixed Assets & Others	471	471	341
	1,450	1,118	1,024
TOTAL ASSETS	9,379	8,617	5,300
Interest Bearing Liabilities			
Deposits	5,229	4,770	3,343
Borrowings	3,460	2,889	776
	8,689	7,659	4,119
Non Interest Bearing Liabilities	669	601	492
TOTAL LIABILITIES	9,358	8,260	4,611
EQUITY (including revaluation surplus)	21	356	689
Total Liabilities & Equity	9,379	8,617	5,300
INCOME STATEMENT	31-Dec-16	31-Dec-15	31-Dec-14
	Annual	Annual	Annual
Interest / Mark up Earned	615	705	789
Interest / Mark up Expensed	(441)	(436)	(543)
Net Interest / Markup revenue	174	269	246
Other Income	47	48	88
Total Revenue	221	317	334
Non-Interest / Non-Mark up Expensed	(740)	(646)	(597)
Pre-provision operating profit	(519)	(329)	(263)
Provisions	62	55	(115)
Pre-tax profit	(457)	(275)	(378)
Taxes	258	(8)	(9)
Net Income	(199)	(282)	(387)
Ratio Analysis	31-Dec-16	31-Dec-15	31-Dec-14
	Annual	Annual	Annual
Performance			
ROE	-128.1%	-65.2%	-47.4%
Cost-to-Total Net Revenue	334.8%	203.9%	178.9%
Provision Expense / Pre Provision Profit	12.0%	16.6%	-43.8%
Capital Adequacy			
Equity/Total Assets	0.1%	3.5%	11.8%
Capital Adequacy Ratio as per SBP	-2.8%	N/A	26.1%
Funding & Liquidity			
Liquid Assets / Deposits and Borrowings	67.2%	64.6%	52.6%
Advances / Deposits	53.0%	57.7%	87.6%
CASA deposits / Total Customer Deposits	77.7%	74.2%	69.5%
Intermediation Efficiency			
Asset Yield	7.9%	9.2%	21.9%
Cost of Funds	5.4%	5.6%	11.3%
Spread	2.5%	3.6%	10.6%
Outreach			
Branches	13	13	13

Apr-17

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		SHORT TERM RATINGS
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.	<p>A1+: The highest capacity for timely repayment.</p> <p>A1: A strong capacity for timely repayment.</p> <p>A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.</p> <p>A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.</p> <p>B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.</p> <p>C: An inadequate capacity to ensure timely repayment.</p>
AA+	Very high credit quality. Very low expectation of credit risk.	
AA	Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.	
AA-		
A+	High credit quality. Low expectation of credit risk.	
A	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.	
A-		
BBB+	Good credit quality. Currently a low expectation of credit risk.	
BBB	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.	
BBB-		
BB+	Moderate risk. Possibility of credit risk developing.	
BB	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.	
BB-		
B+	High credit risk.	
B	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.	
B-		
CCC	Very high credit risk. Substantial credit risk	
CC	“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.	
C		
D	Obligations are currently in default.	

<p>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’.</p>	<p>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.</p>	<p>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.</p>	<p>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 surveil the opinion due to lack of requisite information</p>
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Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.



Regulatory and Supplementary Disclosure

Rated Entity

Name of Rated Entity
Sector
Type of Relationship

SME Bank Limited
Banking
Solicited

Purpose of the Rating

Regulatory Requirement
Independent Risk Assessment

Rating History

Dissemination Date	Long Term	Short Term	Outlook	Action
14-Apr-16	B	B	Negative	Maintain
30-Jun-15	BB	B	Negative	Maintain
11-Feb-15	BB	B	Negative	Downgrade
16-Apr-14	BBB-	A3	Stable	Maintain
27-Feb-13	BBB-	A3	Stable	Downgrade

Related Criteria and Research

Banking Sector - Viewpoint | Jun-16

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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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

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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.

Probability of Default (PD)