Micro-Finance Rating - Risk Assessment

Kazakhstan Community Loan Fund (KCLF)

Almaty, Kazakhstan

Rating grade	α **alpha**	**Assessment**: Highly recommended High safety, good systems
Visit dates: 20-26 January, 2002 **Operational head**: Mr Shalkar Zhusupov **Maximum validity of rating***: till 26 January, 2003		

Rating

KCLF shows consistently good performance on governance, management and financial parameters. It has well laid-out systems, good portfolio quality and a reasonable return on operations. Some areas that would need to be addressed over the next year include establishing an effective governance structure, increasing its depth of concentration in existing markets, upgrading its accounting system and most importantly, putting in place a formal internal audit mechanism. Over a longer term of 1-2 years, it would also need to achieve cost efficiency in order to handle competition from the formal banking sector and to realise the projected growth rate.

In M-CRIL's view, on account of KCLF's excellent systems, good portfolio quality, emphasis on strong groups and high demand for loans from its members, it can absorb – from all sources – loan funds of Tenge 30 million (around US$200,000) for the next one year for on-lending to its clients. However, projections show that KCLF's sustainability would depend on the mobilization of equity (donor grants) to the extent of Tenge 100 million (around US$650,000) by the institution.

Provision of debt should be in tranches and contingent on a simultaneous inflow of equity (grants). The first tranche of 50% of the recommended loan amount (US$100,000) should be provided after an equity inflow of at least US$300,000. The remaining debt should be provided after mobilisation of additional equity capital of US$350,000, as indicated above.

A rating update of the organisation after one year is suggested to reassess the absorptive potential and risk profile of this fast growing organisation. **This rating is valid, subject to no other substantial inflows of loan funds into the organisation beyond the limits specified here** and to no other significant changes in the organisational structure and external operating environment.

- for Micro-Credit Ratings and Guarantees India Ltd

Sanjay Sinha, Managing Director

***Validity** This rating is valid till the next loan proposal made by the MFI to any financial institution or till any other significant change in the structure of the loan programme or in its external environment. A **rating update** (comprehensive repeat rating) is recommended whenever such changes take place or at the end of **one year** from the date of the initial assessment, whichever is earlier. Any substantial additional information that becomes available could also result in a rating update or a rating review (revision of rating grade based on a desk analysis).

Liability The rating assigned is a professional opinion of the assessors and M-CRIL does not guarantee the information and cannot accept any legal responsibility for actions arising out of the recommendations made.

Category wise rating

Category	Rating grade[1]
A *Governance aspects*	α
B *Managerial factors*	α
C *Financial performance*	α
Overall	α

Key Risk Factors

1 **Diversification of loan portfolio**: The organisation faces a challenge in achieving some degree of diversification among its primarily trading loans. This is an extraneous risk factor for KCLF, as possible uses of small finance in its areas of operation are limited. However, this exposes the institution to market risks and has the potential to impact its portfolio quality if such a situation arises.

2 **High operating costs and potential to expand**: High operating costs, coupled with high interest rates that are not competitive with the local financial institutions can impact the growth potential and can wean away bigger clients from KCLF's portfolio. This would affect the organisation's capacity to expand operations at sustainable rates.

Key Programme Strengths

Governance, experience and strategy	Management and operations	Financial
1 Clear focus and strategy on m-f	**1** Strong computerised management systems **2** Qualified management and staff, with good understanding of m-f **3** Rigorous systems for staff induction and training; strong emphasis on discipline	1 Good portfolio quality and credit performance 2 High capital adequacy 3 Good performance on sustainability

[1] M-CRIL's grading sheet is attached at the end of the report.

Organisational Profile

Legal form	Years of m-f operation	Number of			
		Active borrowers	*Members*	*Staff*	*Branches*
Non Banking Finance Company	4	3,133	7,308	62	3

Microfinance programme: Operational highlights

Savings mobilised (Tenge; US$)	Outstanding borrowings of MFI (Million Tenge; US$)	Loan portfolio of MFI (Million Tenge; US$)	Cumulative loans disbursed by MFI (Million Tenge; US$)	Average loan disbursed (Tenge; US$)
Not applicable	20.8; 138 820	120.1; 800 399	1 196; 8 275 743	39 000; 270

Key financial ratios

Portfolio at risk		Cumulative repayment rate	Risk weighted capital adequacy ratio	Subsidy dependence index	Yield to APR ratio
>=30 days	>=60 days				
0.9%	0.85%	99.6%	197.9%	64.3%	87.3%

Yield on portfolio	Other financial income to average portfolio	Financial cost ratio	Loan loss provisioning ratio	Operating cost ratio
55.5%	6.6%	1.6%	3.23%	51.6%

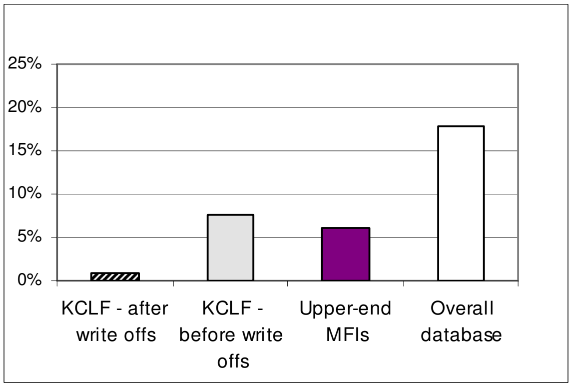
Total income to average total assets	Total expenses to average total assets	Return on average total assets	Operational Self Sufficiency	Financial Self Sufficiency
32.0%	29.1%	2.9%	110.0%	86.5%

Notes

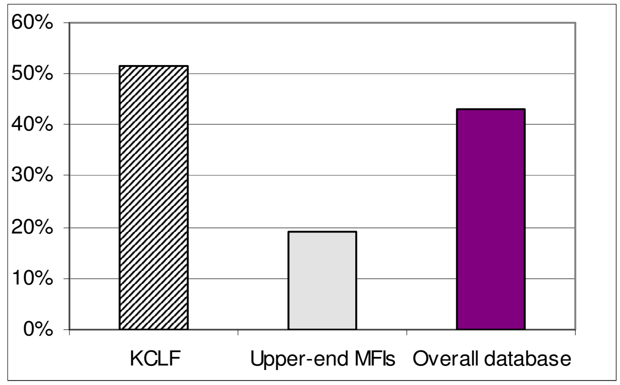
1. All figures are estimated for the organisation's microfinance programme as on 31 December 2001.
2. The members of KCLF comprise <u>7,308 members</u> including <u>3,133 clients with loans outstanding against their account and organised in 648 groups</u>. More than 80% of KCLF clients are women.
3. Savings mobilisation from members is prohibited for non-banking companies in Kazakhstan and therefore, the organisation does not collect deposits.
4. The ratios of repayment rate and portfolio at risk have been calculated on the basis of a detailed examination of the MIS and accounting system of the organisation, cross verification from office ledgers and other office records and during field visits to groups. The methodology used to measure such ratios is a function of the data with the organisation and the quality of that data.
5. Other financial income includes income that the organisation earns from membership and registration fees.

KCLF – financial overview

Portfolio at risk (>=60 days): 31 December 2001

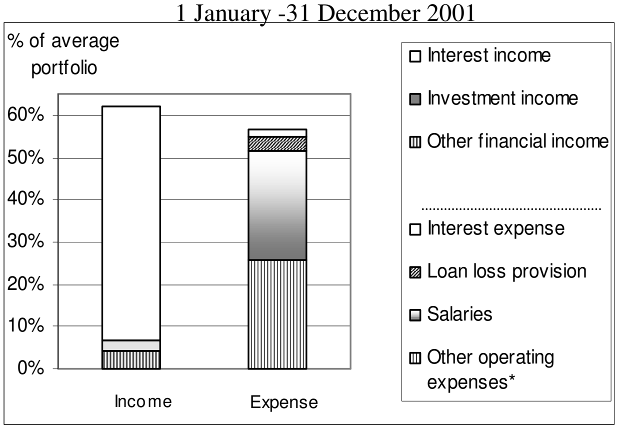


Operating cost ratio: 1 January -31 December 2001

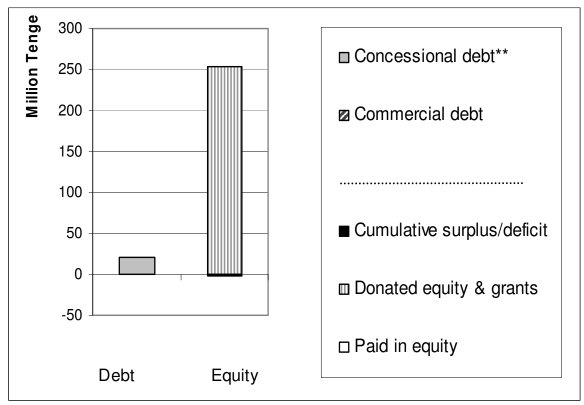


Note: 1. $n_{upper\text{-}end} = 8$ $n_{database} = 70$; Database of MFIs in Asia (South and East) rated by M-CRIL, updated as on 31 August 2001.
2. Outliers and rated NGOs with no direct lending have been removed for analysis. Upper-end figures reflect MFIs with top 10% scores.
3. The upper-end MFIs and overall database ratios represent simple averages for their respective samples.
4. The performance of either the Upper-end MFIs or all MFIs (overall database), do not necessarily reflect M-CRIL's rating standards.

Income and expense distribution:
1 January -31 December 2001



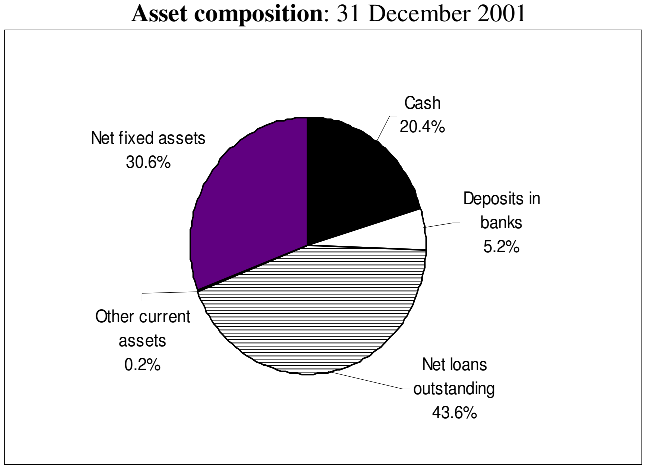
Debt and equity composition:
31 December 2001



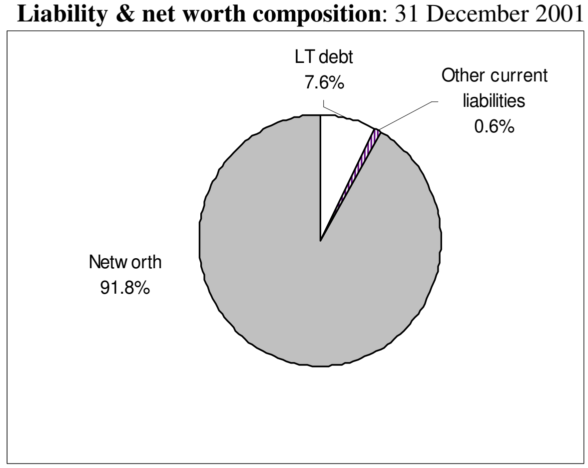
* Other operating expenses include travel, depreciation and administrative expenses

** Concessional debt is borrowing+comp.savings taken at < Bank PLR +50 basis points, & voluntary savings taken at < bank deposit rates

Asset composition: 31 December 2001



Liability & net worth composition: 31 December 2001



1 Organisational background

Kazakhstan Community Loan Fund (KCLF) was started as a specialised microfinance institution in Kazakhstan in 1997 with the support of USAID. Initial operationalisation of KCLF has been carried out with active technical support from ACDI/VOCA, an international NGO based in Washington, DC. It was also the first institution to be provided with a license of a non-banking finance company (NBFC) from the National Bank of Kazakhstan in 1997. During 2001, the organisation shifted its headquarters from Taldykorgan to Almaty, the commercial capital of Kazakhstan.

KCLF is currently governed by a ten-member board, consisting of two staff members and five KCLF clients. In addition, representatives of ACDI/VOCA, USAID and the Open Society Institute (a support institution) are ex-officio members of the governing body. However, the governance structure of the organisation is in the process of transition, and the board composition is likely to change after February 2002. The proposed board composition would include – apart from the General Director of KCLF – a banker, a lawyer, a NGO representative and one member each from the Business Women's Association and the Entrepreneur's Forum. Both the Business Women's Association and the Entrepreneur's Forum are well known representatives of small and micro-enterprises in the country.

The country representative of ACDI/VOCA presently has complete powers to overrule any decision taken by the board. This power is being reviewed as a part of the withdrawal policy of ACDI/VOCA. It is now proposed that in the restructured board, the country representative would enjoy observer status, without voting rights.

2 Microfinance operations

2.1 Background of microfinance operations

KCLF started its microfinance operations in Taldykorgan, which is one of the poorest regions in the southeast of Kazakhstan. The program started providing small loans to traders and other micro-entrepreneurs in the open markets and the trade houses of Taldykorgan. In 1999, KCLF expanded operations to Shymkent, another city in the southern part of Kazakhstan. Operations were also initiated recently in Almaty – the third branch office of the organisation. The headquarters of KCLF have also been moved from Taldykorgan to Almaty, on account of the latter's greater locational advantage.

At the KCLF headquarters, a General Director takes overall responsibility for KCLF activities, and is aided by Directors of Communications and Operations. Two more positions – for Directors of Finance and Internal Audit – are likely to be operationalised in the near future.

The branch operations of KCLF are handled by the Systems, Operations, Finance and Administration Departments, with a Branch Manager taking overall responsibility. The Operations Department handles all operational aspects through its loan officers (Enterprise Agents – EAs – and Credit Experts) and a Coordinator, EA manages the staff in the department. The Systems Department, through an MIS specialist and support staff handles the computerised information systems of the organisation, whereas all accounts and finance related work, including loan disbursements and repayments are handled by the Finance Department. The Finance Department is headed by a Chief Accountant who is supported by 2-3 accountants. The Administrative Department, in addition to providing overall logistic support, also handles other important aspects like legal issues and human resource development.

At present, KCLF has a total staff of 61, with the Director of Operations also working as the Branch Manager of Almaty. The organisation has a total of 21 loan officers (EAs and Credit Experts) at the three branches. On 31 December 2001, the three branches had a total clientele of 3,118 in 648 groups, in addition to a few individual clients (15).

Sources of loan and grant funds

Till date, KCLF has mainly operated with donor grants for both its onlending and operational requirements. A list of the main donors to KCLF are presented below

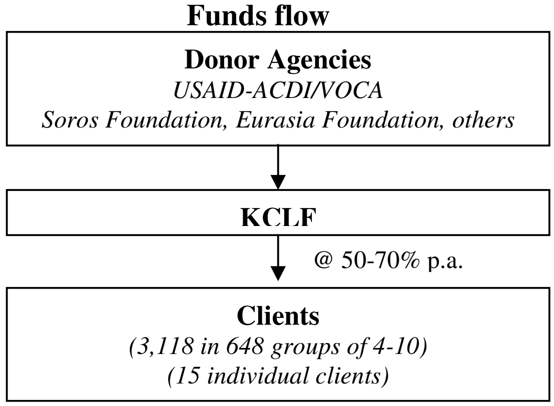
Donor	Grants received	
	Tenge (in millions)	US$ (Historical rates)*
USAID	148.1	1,250,000
Soros Foundation	8.0	100,000
Eurasia Foundation	30.4	203,000
Mercy Corps International	37.1	250,000
US Religious Organisation	1.4	10,000
Hivos	1.3	10,000
Total	**226.4**	**1,823,000**

*Historical rates refer to the rate at which the grant was received.

USAID – through ACDI/VOCA – has been the main support institution for the program. In addition to the donors indicated above, KCLF has also obtained a dollar denominated loan of US$ 160,000 from the Kazkommerts Bank (a commercial bank of Kazakhstan) for purchase of its Almaty office building. The loan carries an interest of 16% p.a. and is payable in 30 equated monthly instalments.

The flow of funds for on-lending is depicted in the following diagram.

Funds flow



2.2 Microfinance policies

KCLF operations are well streamlined and clear policies exist for area identification and launch of operations. Identification of a new area takes place through an annual strategic planning exercise, where all staff members participate. This is preceded by an informal survey of the area, including background/secondary information and preliminary visits by staff.

KCLF operations are concentrated in market places and the organisation considers women entrepreneurs as its main clients. Operations in a new area begin with the promotion of KCLF products and services. The organisation initially promoted its programme through advertisements on television and in the print media, and the word of mouth publicity further helped in creating awareness about operations. However, based on its experience that formal advertisements are not cost efficient and direct contact with clients is more effective in promoting its products, promotion activity is mainly undertaken through word of mouth and direct contact with the clients. Simultaneously, local staff are recruited and trained and are involved in a general review of the operational area, including an informal demand estimation. Main markets are identified as a result of this process and the program is initiated in the identified markets.

Actual operations begin with introductory information meetings convened by the EAs in the markets. The information meetings serve to introduce KCLF to potential clients and also inform them about the lending policies and eligibility criteria for products offered. Group formation takes place after the information meetings.

Between 4-10 entrepreneurs in a market locality come together in a single group. Group formation and membership criteria stipulate that permanent residents of the area who are not related and are involved in a diverse set of businesses can be part of a group, with a maximum of one start-up enterprise allowed in each group. In addition, borrowers of other banks are not permitted in a group. New groups select a Coordinator, Secretary and a bookkeeper for managing their activities.

Orientation meetings with EAs follow group formation, and are aimed at reviewing businesses of the members and to help the group in formulating its by-laws. By-laws and membership are approved by the EA prior to the loan application meeting.

A loan application meeting is held to decide on the individual loan applications. In the presence of the EA, groups debate and decide on the merits of each loan application. An approval by the group is followed by a similar approval of loan applications by the concerned EA. At this stage, the EA scrutinises each application and compares it with the available business information for each potential client.

Approved application forms are then submitted at the KCLF office, and pass through the MIS personnel before being presented to the KCLF Credit committee. The MIS personnel check each application form for previous credit history and past business performance before submitting the applications to the Credit Committee.

The Credit Committee of KCLF comprises the Branch Manager, the MIS specialist, a Senior EA (or EA Coordinator) and an EA. The Credit Committee examines the loan applications and, on finding them in order, sanctions the loan. Individual loan contracts are then prepared – specifying lending conditions, repayment schedule and other policies – and provided to the applicant. Simultaneously, group and individual repayment schedules are also provided to clients. Disbursement of the loan takes place from the office, within a week of the submission of the loan application. Disbursements and loan repayments are done in bulk for each group, but are tracked individually.

Loan products

KCLF offers a range of flexible loan products to its clients. Its main product is the Group Loan, and it has recently launched a larger, individual loan for its clients in one branch. The product characteristics are as follows

Product	Amounts (US$)	Term, interest rate (months, % pa)	Other characteristics
1 Group loan – stepped			
Cycle 1	1-100	2-4, 50%	Loan repayments through fortnightly instalments, 1% of the loan amount is charged up-front as administrative fee
2	100-250	4-6, 60%	- do -
3	250-500	4-8, 60%	- do -
4	500-700	6-10, 65%	- do -
5 and above	700-3,000	6-12, 70%	Monthly instalments, rest as above
2 Individual loan	1,000-5,000	12-24, 55%	- do -

Savings mobilisation

While KCLF cannot mobilise savings due to legal restrictions, it has attempted to encourage a 'buffer fund' at the group level to mitigate some delinquency risks. The groups are motivated to include a clause on creation of buffer fund through saving mobilisation among group members in their by-laws. KCLF informally stipulates maintenance of a fund of at least one month's instalment of the biggest individual client from the group. The groups maintain the buffer fund with the accountant and use it to meet occasional delays in repayment by members.

3 Observations

3.1 Governance aspects

KCLF shows good performance on governance with a grade of α. While overall performance and strategy is strong, there are some areas for improvement also – all these aspects are discussed in detail below.

- Strategy for microfinance operations and governance structure

  KCLF exhibits a clear, focused approach to provision of m-f in Kazakhstan. In this regard, its strategy for expansion and creation of new products is well thought out. Overall policies are well laid out in the organisation and adherence to policies and norms is good. The organisation is ahead of other MFIs in the country and already has a strong presence in Taldykorgan and Shymkent. Its strategy of linking up with banks to identify and eliminate difficult and/or common clients is also praiseworthy.

  In terms of outreach, the organisation has done well to cover almost all major markets and trade houses in Taldykorgan and a fair proportion in Shymkent. There is, however some scope for consolidating its presence within these markets – in terms of clientele within the existing markets. In Almaty, the organisation has recently begun operations and has considerable scope for expansion, both horizontally as well as vertically.

  The interest structure on loans offered by KCLF is decided and reviewed keeping in mind the overall sustainability of operations. While the interest structure is adequate for the sustainability concern of the organisation, it is not competitive with other banks in the country, whose lending rates could be between 16-24% (collateralised, in dollar terms) and can potentially isolate bigger clients who have some access to the banking system. The biggest roadblock faced by clients in dealing with banks is that of collateral. The bigger clients of KCLF, who might not be constrained by collateral requirements might move away from KCLF in the future.

  The organisation should review its interest structure in relation to the likely competition in the future and also the possibility of maintaining its spread by minimising operating costs (discussed later).

  The governance structure of the organisation is also in a stage of transition, with a new board constitution underway. ACDI/VOCA has been the main promoter of KCLF, and through USAID, its biggest contributor. As such, it retains complete control over the operations of the organisation, and can supersede the board.

- Experience in microfinance

  The organisation has a reasonable level of m-f experience - over 3 years. It has done well to learn from its experience and has built upon the important lessons from the past years of implementation. However, with expanding operations, it is logistically difficult for KCLF board members – most of whom belong to its previous headquarters (Taldykorgan) – to guide the organisation's policies. The new board, it is expected, would play a more proactive role in guiding the program.

3.2 Managerial factors

KCLF exhibits strong performance on managerial factors with a grade of α though it still needs to formalise some financial and operational control functions in the institution.

- Human resource quality and management

KCLF has a well-qualified young managerial cadre led by the General Director and supported by the Directors of Communication and Operations. Both the management and field staff are qualified and possess good understanding of operations and management.

A clearly laid out process for staff induction and training is followed. Recruitment of new staff is undertaken in a phased manner, with initial shortlisting, orientation, and selection followed by an internal training on aspects like group formation, financial analysis and business assessment. In addition, senior staff is also imparted external training on critical aspects like business planning, delinquency management and financial analysis.

Staff retention rates have been satisfactory at KCLF, though the organisation has faced some drop-outs (and termination) among EAs in the past (5 EAs have either been terminated or have dropped out over the last two years.) It hopes that with a more rigorous and detailed induction and training regime, staff performance and stability would improve, as has happened during 2001.

Staff incentive systems have also been introduced for EAs. Performance incentives are mainly linked to portfolio quality and group formation (in the immediate neighbourhood of EAs), in addition to specific bonus payments for identifying clients in the manufacturing sector. The incentive system has been revised a few times in the past and is under review at present.

KCLF can consider bringing other branch staff under the incentive system as well, as this would maintain overall staff morale at the branches. While incentives for Branch Managers and other operations staff (EA Coordinator) could be linked to portfolio quality and branch profitability, incentive payments for other staff members (MIS, Finance and Administration) could be linked – at the first level – to overall branch profitability. Further links to specific parameters (like number of accounts handled by the MIS personnel) could be used as the second level of indicators for incentive determination. Further, incentive systems for new EAs should be linked more closely to productivity parameters than at present.

In terms of productivity of field staff (EAs and Credit Experts), there is scope for further improvement (average clients per EA on 31 December 2001 is 131). This is likely to improve over time, with expanding operations in Almaty and Shymkent.

- Accounting and MIS

KCLF has clearly separate, though closely interlinked accounting and information systems. Both the systems result in systematic, accurate flow of information.

The accounting system primarily consists of a Russian accounts software for enterprises, called 'One-C'. The software prepares daily trial balances and cash-flows from subsidiary ledgers which are linked to the credit and debit receipts and vouchers, but does not result in financial statements, which need to be typed in Excel. This is because the software firm has been closed down and KCLF has not managed to upgrade the system.

It is now planned that the accounts software would be upgraded to provide financial statements in the required formats. This should be accorded high priority and should be undertaken in the near future. KCLF has already initiated steps in this direction.

Clear loan loss provisioning and reserve policies, as laid down by the National Bank of Kazakhstan (NBK), are followed. Similarly, the organisation follows a prudent write off policy for loan losses, which is also specified by NBK.

The organisation uses a detailed, customised MIS – Information System for Credit Administration (ISCRA) – for its operations. KCLF holds the copyright for the MIS, which covers a wide range of operational as well as impact parameters. Basic client data is fed in at the time of group formation, on aspects including business profiles and profitability, previous credit history (with KCLF as well as banks) and family profiles. Prior to sanction, all loan applications are cross-checked with the MIS to assess the eligibility of the applicant. Loan disbursement dates are entered in advance and detailed loan repayment schedules are generated and provided to the borrowers in advance.

Further, all borrowers are classified as active, passive, registered without a loan date, waiting, blacklisted or drop-outs depending on initial details fed in. A client is classified as passive if she temporarily quits taking loans. KCLF allows passive members for a maximum period of six months.

ISCRA has been designed with a lot of in-built flexibility, and allows a wide range of analysis options. Thus portfolio as well as operational details may be analysed with the help of simple queries. The MIS can be used to generate information on disbursement, repayments, amounts due, portfolio quality (PAR at different age categories, by activities, loan cycles, EAs), restructured/rescheduled loans, write-offs and the like.

At the same time, the MIS has adequate protection features built-in and does not allow alteration in previous data without authorisation, and is only accessible to the MIS personnel and the Branch Managers. It is currently consolidated at Taldykorgan, the previous headquarters of KCLF.

The accounts and the MIS division work in close coordination and transaction related data entries in ISCRA are supported with cross-checks with the finance department. Similarly, the finance department relies on the MIS personnel to arrive at amounts due at the time of loan repayments.

- Tracking system for overdues

Tracking of overdues is prompt and follow-up action clear. A daily portfolio report from the MIS is submitted to the Branch Manager, which identifies all overdues by EAs. Therefore, identification of overdues from the system is immediate.

KCLF also undertakes an analysis of reasons for delinquency to identify measures to tackle such situations effectively. A clear process for follow-up action on such loans is in place. This involves visits to the client by the EA Coordinator and, if needed, by the Branch Manager. In cases of accident or personal contingency, a loan may be forwarded to the Credit Committee for restructuring. Otherwise, the EA, the EA Coordinator and the Branch Managers impress upon the client (and the other group members) the need for prompt repayment.

While the tracking and follow-up system for overdues is rigorous and largely effective though this process of due diligence is not recorded. It is recommended that the Branch Managers/EA Coordinators prepare a brief summary report for follow-up visits and their outcome, and also comment on the likely reasons for late payment – this would strengthen the process of loan approval and would also minimise dependence on individuals within the organisation.

- Financial planning and control systems

The overall financial planning systems are comprehensive. However, financial control functions, especially the internal audit mechanism at the organisation need to be strengthened as discussed below. KCLF has already initiated some steps to strengthen its financial control systems and is in the process of establishing a separate internal audit department.

The planning structure of KCLF involves an annual exercise for strategic planning and a semi-annual review of the interest rate structure. Financial planning has been carried out in detail using 'Microfin' (CGAP's business planning software) and staff members have also attended training on the use of Microfin.

It is recommended that the financial planning exercise should be reviewed to show realistic allocation of assets and costs to the three branches. At present, the organisation is in a phase of transition, and headquarter's costs and assets are shown on the books of Almaty Branch. This would create difficulties in branch level analysis of performance in the future and should be rectified promptly.

Although a separate internal audit department is yet to be established (planned over the next few months), some field audit functions are in place and are shared by the branch and the head office management. The EA Coordinator (and the Senior EAs) are responsible for monitoring operations and undertake surprise visits to groups and clients to cross-check the information provided by EAs.

However, a system of random checks and visits of field operations is not in place, and depends on the understanding of the EA Coordinator. Further, a report on such visits and their findings is not prepared. Most importantly, an internal audit of financial information is not carried out, though the Branch Manager checks overall compliance as part of routine functions.

Constitution of a formalised internal audit division – as planned by KCLF – should be accorded the highest priority. At the same time, a detailed manual for internal auditors needs to be prepared and staff trained accordingly. The internal audit should cover both financial as well as operational compliance issues, and should ensure a representative coverage of clients.

The high volume of cash presently with the organisation raises some possibility of potential fraud and arbitrage. There could be a serious risk if any senior staff member of KCLF is able to lend the cash available to clients while not showing it in KCLF accounts. The staff member could make significant profits in this manner. While this is a potential risk due to the financial sector variances in Kazakhstan – low bank deposit rates and high lending rates of KCLF – the organisation's control systems are quite elaborate and, in the assessment of the rating team, are adequate to guard against such an occurrence.

- <u>Decision making</u>

The decision-making processes at KCLF are effective. Functional responsibilities are clearly laid out and a strong organisational culture to adhere to respective responsibilities exists. Flow of information is fast and adherence to policies prompt.

- <u>Quality of clients/member groups</u>

Groups and individual clients supported by KCLF show a high awareness of policies and products of the organisation. All group meetings are supervised by KCLF's EAs and the process – especially of loan approvals and repayment collection – is comprehensive. *Member attendance in group meetings and the maintenance of the buffer fund are areas that the institution can further emphasise to its EAs.*

- <u>Infrastructure</u>

KCLF has a substantial infrastructure base, at around 31% of its total assets as on 31 December 2001. Fixed assets are comprised of land and building, vehicles, computers and office furniture and equipment. While the infrastructure level at Taldykorgan and Shymkent are comfortable, some reinforcement at Almaty is needed for the ensuing expansion of operations. It should be possible for the institution to undertake the desired expansion of operations with the present infrastructure support at Taldykorgan and Shymkent.

Additional asset creation at Almaty is planned and should help in rapid expansion of operations in the branch.

3.3 Financial performance

The financial performance grade of KCLF is very good at α. The performance, especially on critical portfolio quality and sustainability parameters is very good. However, there is some scope for improving the cost structure of the organisation over the next 1-2 years.

- Credit performance and asset quality

  KCLF's credit performance is quite good, and the institution has been able to overcome delinquency problems encountered during 2000 and early 2001 through rigorous staff training and follow-up. High levels of credit discipline and procedures for preventing and controlling delinquency have shown good results.

  KCLF has a cumulative repayment rate of 99.6% and a $PAR3_{30}$ of 0.9% (after loan write offs) on 31 December 2001. Its PAR_{30} before write offs is 7.7%, mainly on account of previous delinquency (during 2000-early 2001) in one branch.

  The main target market for KCLF products are the small businesswomen in tradehouses and markets of its areas of operation. As such, KCLF loan portfolio is skewed towards small trade (an estimated 40% of the loan portfolio is in the trade of food products, whereas an estimated 50% of the loan portfolio is in the trade of other consumer goods). The remaining portfolio is invested in service enterprises (6%), manufacture (4%) and other trade (2%).

- Mobilisation of funds

  KCLF has operated only through donor grants till date. Apart from its promoter, ACDI/VOCA, it has mobilised grants from a few other institutions like the Eurasia Foundation, Soros Foundation, MCI and the US Religious Organisation. The contribution of USAID-ACDI/VOCA in KCLF's equity is quite high at around 65%.

  The institution is mindful of the need for a diversified sources of funds and is actively exploring diverse sources of both equity and debt capital.

- Asset, liability and equity composition

  The asset composition of the institution is poor, with only about 43% of its total assets deployed as loans. The organisation has high idle balances and a high fixed asset base as well. *Fast expansion of portfolio during 2002, leading to a better utilisation of idle cash is likely to result in higher returns for KCLF.*

The organisation has very limited liabilities as of date, with one loan obtained for a building purchase. As its operations have mainly been financed through donated equity, it has a comfortable capital adequacy position, with a risk weighted capital adequacy ratio of almost 200%. This would enable KCLF to leverage debt funds for operations in the future in accordance with its expansion plans.

- <u>Sustainability and profitability</u>

The organisation's financial sustainability in terms of its independence from subsidies is good, with a Subsidy Dependence Index of 64.3%, Financial Self-Sufficiency of 86.5% and Operational Self-Sufficiency of 110.0%.

In terms of profitability, KCLF's microfinance programme shows a reasonable return on average assets of 2.9%. The yield (55.5%) to Annual Percentage Rate (63.5%) ratio is good at 87% - this has resulted from the excellent portfolio quality that KCLF has managed to maintain after some initial problems.

However, its operating cost ratio of 51.6% needs to be reduced over the next 2-3 years. *While the costs of operating in Kazakhstan are somewhat high, the organisation should undertake a detailed review of its cost structure and identify areas for cost control. This would also enable it to bring down its interest structure and be more competitive with other MFIs and banks in the country. However, the operating cost ratio for KCLF is likely to be higher in 2002 than the previous year, on account of higher administrative and salary costs for the new head office and Almaty branch, both of which have been started recently. Consequently, KCLF is projected to incur a loss in the year 2002.*

The organisation is likely to regain profitability of operations from the year 2003 through sustained portfolio quality, expansion of portfolio and increased cost control. KCLF's current investment in infrastructure and high maintenance costs would impact its efficiency indicators in the short-term. However, a large proportion of the operating costs are fixed in nature and are likely to result in medium and long-term growth without significant increments.

4 Conclusions

Strengths	Weaknesses/Areas for improvements
Governance/organisational	Governance/organisational
✓ Clear focus and strategy for microfinance ✓ Clear expansion strategy ✓ Strong emphasis on disciplined and efficient operations …	× Potential for further increasing the depth of coverage within existing markets × Governance structure in transition
Managerial	Managerial
✓ Secure, accurate computerised MIS ✓ Professionally trained management ✓ Committed management staff ✓ Detailed staff induction, training and incentive systems	× Low staff productivity × Internal audit yet to be established × Accounting system needs to be upgraded
Financial	Financial
✓ Good portfolio quality and credit performance ✓ Strong performance on profitability ✓ High capital adequacy	× Weak portfolio diversification × High operating costs × Limited equity and debt sources × High idle (and near idle) cash balances

5 Creditworthiness

KCLF has achieved an overall rating grade of ***alpha* (*α*)**.[2] In terms of creditworthiness this implies **high safety** and **good systems**. The institution performs consistently well on governance, management and financial parameters. Over the next year, it should concentrate on establishing an effective governance structure, increase its depth of concentration in existing markets, up-grade its accounting system and most importantly put in place a formal internal audit mechanism. Some degree of cost review and control should also be initiated, along with a review of its interest structure on loans, especially to the larger clients.

In M-CRIL's view, on account of KCLF's excellent systems, good portfolio quality, emphasis on strong groups and high demand for loans from its members, it can absorb – from all sources – loan funds of Tenge 30 million (around US$200,000) for the next one year for on-lending to its clients. However, projections show that KCLF's sustainability would depend on the mobilization of equity (donor grants) to the extent of Tenge 100 million (around US$650,000) by the institution.

Provision of debt should be in tranches and contingent on simultaneous equity infusion. The first tranche of 50% of the recommended loan amount (US$100,000) should be provided after an equity inflow of at least US$300,000. The remaining debt should be provided after mobilisation of additional equity capital of US$350,000, as indicated above.

A rating update of the organisation after one year is suggested to reassess the absorptive potential and risk profile of this fast growing organisation. **This rating is valid, subject to no other substantial inflows of loan funds into the organisation beyond the limits specified here** and to no other significant changes in the organisational structure and external operating environment.

[2] The Rating Grade given measures performance on the rigorous standards established by M-CRIL. The assessment uses an instrument designed specifically for the conditions and nature of MFIs operating in South Asia and is comparable with other ratings done by M-CRIL in this region.

Financial statements for KCLF's microfinance operations

Balance Sheet - as on 31 December 2001

Assets	Tenge	Tenge	US$	US$
			(Tenge150/US$)	
Current assets				
Cash in hand and bank		55 618 050		370 787
Interest bearing deposits		14 252 400		95 016
Advances		484 500		3 230
Loans outstanding				
Gross loans outstanding	120 059 814		800 399	
(Loan loss reserve)	- 1 004 550		- 6 697	
Net loans outstanding		119 055 264		793 702
Total current assets		**189 410 214**		**1 262 735**
Long term assets				
Net property and equipment	83 710 500		558 070	
Total long term assets		**83 710 500**		**558 070**
Total Assets		**273 120 714**		**1 820 805**
Liabilities and Net Worth				
-				
Current liabilities				
Other current liabilities	1 562 850		10 419	
Total current liabilities		**1 562 850**		**10 419**
Long term liabilities				
Long term debt				
Kazkommerts Bank	20 823 000		138 820	
Total long term debt		20 823 000		138 820
Total long term liabilities		**20 823 000**		**138 820**
Net worth				
Donated equity	226 416 635		1 509 444	
Donated equity - ACDI/VOCA (in-kind)	26 244 500		174 963	
Retained net surplus/(deficit)	- 3 552 181		- 23 681	
Current net surplus/(deficit)	1 625 910		10 839	
Total net worth		**250 734 864**		**1 671 566**
Total Liabilities and Net Worth		**273 120 714**		**1 820 805**

Income Statement: Statement from 1 January – 31 December 2001

Income	Tenge	Tenge	US$	US$
Interest and fees on loans	63 954 298		426 362	
Interest on investments	2 688 660		17 924	
Other financial income (registration & fees)	4 928 252		32 855	
Total income		**71 571 210**		**477 141**
Financial costs				
Interest on borrowings	1 856 850		12 379	
Gross financial margin		**69 714 360**		**464 762**
Provision for loan losses	3 727 650		24 851	
Net financial margin		**65 986 710**		**439 911**
Operating costs				
Salaries	29 651 400		197 676	
Travel	2 003 400		13 356	
Depreciation	2 848 350		18 989	
Administrative/office expenses	24 996 750		166 645	
Total operating costs		**59 499 900**		**396 666**
Net Surplus/Deficit before taxes		**6 486 810**		**43 245**
Tax on profit		4 860 900		32 406
Net profit after taxes		**1 625 910**		**10 839**

Adjustments:

KCLF is supported by ACDI/VOCA staff in management and operations, though the involvement of ACDI/VOCA has reduced over time. The involvement of ACDI/VOCA staff, mainly the country representative has been adjusted as an in-kind contribution in the financial statements for KCLF. Other adjustments for inflation and subsidised debt have also been included, for which a market rate of 24% for borrowings in local currency has been taken.

The value of adjustments for in-kind donations for ACDI/VOCA staff thus computed is estimated at Tenge 4.8 million for the year ending 31 December 2001. On account of limited borrowings of KCLF, the adjustment for subsidised funds is only Tenge 0.8 million, whereas, the equity/inflation adjustment is higher (as the institution has a comfortable equity base) at Tenge 12 million. Thus, after all adjustments, the profit/(loss) for the period ending 31 December 2001 is Tenge (16) million and the adjusted return on average assets is –7.2%.

6 Financial projections

Financial projections have been drawn out for KCLF using *Microfin* (CGAP's business planning software). Projections have taken into account seasonal factors as well as specific KCLF plans on staffing and fixed asset acquisition. Some important assumptions for the financial projections are as follows

1 Expansion plans: the projections have been worked out for the existing branches of KCLF. Although there are plans to expand operations by starting new branches after a couple of years, these are quite tentative in nature at present and have not been considered in the projections.

2 Liquidity management: cash levels have been maintained at 50% of monthly disbursements plus fixed monthly operating expense levels. Any idle cash is invested in short-term deposits.

3 All future loans carry a cost of 24% pa. The existing loan from Kazkommerts Bank, that carries an interest of 16% pa, has been classified as a concessional loan.

4 The average lending rate for group loan has been taken at 56% pa on declining balance for year 2, 54% for year 3, 50% for year 4, 45% for year 5 and 40% for year 6.

5 The operating costs of the organisation are shown to increase during 2002 from present levels, especially as a result of new staff recruitment for Almaty and the headquarters. This is offset through an appropriate increase in the loan portfolio only towards the second half of the year, when better credit demand is anticipated from traders. This is also augmented through greater staff productivity levels towards the second half of 2002.

6 Paid-up equity (shareholding) has not been considered for projections as not-for-profit NBFCs in Kazakhstan (like KCLF) are not permitted to issue shares.

7 All currency figures are in **Tenge**, the local currency of Kazakhstan unless specified otherwise.

A summary of financial projections is presented below

Balance Sheet	***FY01 2001***	**FY02 2002**	**FY03 2003**	**FY04 2004**	**FY05 2005**	**FY06 2006**
Cash in Bank and Near Cash	55,618,050	51,070,053	60,545,868	66,063,145	79,667,150	94,558,297
Net Portfolio Outstanding	119,055,264	223,183,968	320,392,365	479,997,657	612,863,685	779,191,607
Short-term Inv. & other curr ass	14,736,900	12,041,900	484,500	484,500	484,500	484,500
Net Fixed Assets	83,710,500	78,998,974	70,680,123	61,873,338	57,629,632	50,331,804
TOTAL ASSETS	**273,120,714**	**365,294,895**	**452,102,856**	**608,418,640**	**750,644,967**	**924,566,209**
LIABILITIES *						
Concessional Loans	*20,823,000*	20,823,000	11,734,469	1,056,870	0	0
Commercial Loans	*0*	0	30,333,606	13,554,622	49,552,743	65,482,861
Other liabilities	*1,562,850*	1,562,850	1,628,850	1,698,850	1,778,850	1,878,850
TOTAL LIABILITIES	**22,385,850**	**43,696,924**	**16,310,342**	**51,331,593**	**67,361,711**	**78,472,329**
EQUITY *						
Accum.Donated equity, prev periods	150,528,995	226,416,695	322,592,097	417,573,609	471,570,791	495,465,967
Donated equity, current period	75,887,700	96,175,402	94,981,513	53,997,181	23,895,176	20,771,323
Accumulated net surplus	24,318,169	(994,126)	18,218,905	85,516,257	187,817,290	329,856,590
TOTAL EQUITY	**250,734,864**	**321,597,971**	**435,792,514**	**557,087,047**	**683,283,257**	**846,093,880**
TOTAL LIABILITIES AND EQUITY	**273,120,714**	**365,294,895**	**452,102,856**	**608,418,640**	**750,644,968**	**924,566,209**

KCLF Assessment

Income Statement	*FY01 2001*	FY02 2002	FY03 2003	FY04 2004	FY05 2005	FY06 2006
Total Financial Income	*71,571,150*	88,202,190	155,307,949	233,199,058	296,479,135	365,492,402
Total Financial Costs	*1,856,850*	381,730	2,776,109	7,533,671	13,643,472	17,827,568
Gross Financial Margin	*69,714,300*	87,820,460	152,531,840	225,665,388	282,835,663	347,664,834
Provision for loan losses	*3,727,650*	1,145,166	3,167,537	4,751,325	5,406,712	6,719,687
Net Financial Margin	*65,986,650*	86,675,294	149,364,303	220,914,063	277,428,950	340,945,147
Program Operating Exp	*53,549,910*	60,056,434	77,092,213	94,965,688	111,871,263	130,519,169
Administrative Operating Exp	*5,949,990*	51,928,019	52,555,801	53,194,481	54,961,976	56,869,978
Amount of taxes paid	*4,860,900*	3,136	503,258	5,456,542	8,294,678	11,516,700
Net income from operations (after taxes)	***1,625,850***	**(25,312,295)**	**19,213,031**	**67,297,352**	**102,301,033**	**142,039,300**
Grant Income	*75,887,700*	96,175,402	94,981,513	53,997,181	23,895,176	20,771,323
Excess of Income over Expenses	***77,513,550***	**70,863,107**	**114,194,544**	**121,294,533**	**126,196,210**	**162,810,623**

Cashflow Projections	FY02 2002	FY03 2003	FY04 2004	FY05 2005	FY06 2006
Cash flow from Operations	(12,946,047)	33,996,728	84,122,082	119,742,991	161,108,967
Total Other Sources	794,943,500	1,053,832,754	1,292,757,100	1,602,064,239	1,907,915,489
Total Other Uses	882,720,852	1,173,335,179	1,425,359,086	1,732,098,401	2,074,904,631
Plus grant income	96,175,402	94,981,513	53,997,181	23,895,176	20,771,323
Ending Balance	51,070,053	60,545,868	66,063,145	79,667,150	94,558,297

Financing Sources	FY02 2002	FY03 2003	FY04 2004	FY05 2005	FY06 2006	Total
New Unrestricted Grants -- Not Identified	47,660,602	94,981,513	53,997,181	23,895,176	20,771,323	***241,305,795***
New restricted grants for operations	33,514,800	0	0	0	0	***33,514,800***
New restricted grants for portfolio	15,000,000	0	0	0	0	***15,000,000***
New Unrestricted Loans	30,333,606	0	35,998,121	15,930,118	10,990,618	***93,252,463***
Total – Tenge	126,509,007	94,981,513	89,995,302	39,825,294	31,761,941	***383,073,058***
Total - US$	**843,393**	**633,210**	**599,969**	**265,502**	**211,746**	***2,553,820***

Note:

1 Restricted grant sources refer to HIVOS and Eurasia Foundation with whom KCLF have had specific discussions on portfolio, operational and asset financing.

2 Financing sources from year 2003 onwards are only indicative of the total capital requirement of KCLF and do not constitute a recommendation by M-CRIL. The level of capital indicated during 2003–6 can be sourced through a mix of grant and loan funds, the composition of which can be assessed through annual rating updates.

Notes to the financial statements

1. The Financial Statements have been estimated for the microfinance operations and represent an approximate picture only. This has involved wherever merited, appropriate modifications to the existing financial statements using data gathered and assumptions made during the rating exercise and also allocations based on an estimation of the degree of use of overall fixed assets and the value of the total staff time on microfinance activities. Such modifications can result in differences between the income statement, balance sheet prepared by the organization itself and the statements presented above.
2. Income includes interest income, fees and earnings from other microfinance related services offered by the MFI rated. All loan portfolio related income is recognised only when it is actually received (**cash basis**). Grants allocated to the organisation's microfinance programme are treated as donated equity in the balance sheet (and not regarded as operational income).
3. Financial costs (interest on borrowings and savings) and operating costs are calculated on an **accrual basis**. Loan loss provisioning expense and the corresponding balance sheet entry (loan loss reserve) has been computed based on the quality of the portfolio.

Glossary

1. Cumulative repayment rate
   Ratio of cumulative principal recovered (net of pre-payments) to the cumulative principal due till the date of measurement.
2. Portfolio at risk (PAR_{30})
   Ratio of the principal balance outstanding on all loans with overdues greater than or equal to 30 days to the total loans outstanding on a given date.
3. Yield on portfolio
   The interest income on loans divided by the average loan portfolio for the year.
4. Other financial income to average portfolio
   Total financial income other than from the interest on loans divided by average portfolio.
5. Financial cost ratio
   Total interest expense for the year divided by the average portfolio.
6. Loan loss provisioning ratio
   Total loan loss provisioning expense for the year divided by the average portfolio.
7. Operating cost ratio
   Ratio of salaries, travel, administrative costs and depreciation expenses to the average loan portfolio.
8. Average loan portfolio
   This represents the average loan outstanding for the year computed on a monthly basis.
9. Subsidy Dependence Index
   The Subsidy Dependence Index broadly measures the net subsidies received as a proportion of the income of the organisation. A higher ratio indicates that there is a higher level of dependence on subsidies. Subsidies can be in the form of grants and savings deposits/ borrowings at a rate lower than market rate. Computation of subsidies is done with respect to the market rate of interest.
10. Average total assets
    This represents the average total assets for the year calculated on an annual basis.
11. Operational Self-Sufficiency
    Ratio of total income to total costs for the year.
12. Financial Self-Sufficiency
    Ratio of total income to total adjusted expenses for the year. Adjustments are made for subsidised cost of funds (w.r.t. the market interest rate), equity (w.r.t. inflation) and in-kind donations.
13. Risk weighted capital adequacy ratio
    Ratio of networth to risk weighted assets (Risk weights: 100% for all assets except the following: fixed assets & interest bearing deposits: 50%; cash 0%).

M-CRIL's Microfinance Rating Symbols

M-CRIL Grade	Description
α+++ alpha triple plus	Highest safety, excellent systems ➢ most highly recommended
α++ alpha double plus	Highest safety, very good systems ➢ most highly recommended
α+ alpha single plus	Very high safety, good systems ➢ highly recommended
α alpha	High safety, good systems ➢ highly recommended
α– alpha minus	Reasonable safety, good systems ➢ recommended
β+ beta plus	Reasonable safety, reasonable systems ➢ recommended, needs monitoring
β beta	Moderate safety, moderate systems ➢ acceptable, needs improvement to handle large volumes
β– beta minus	Significant risk, poor to moderate systems ➢ acceptable only after improvement
γ+ gamma plus	Substantial risk, poor systems ➢ needs considerable improvement
γ gamma	Highest risk, poor systems ➢ not worth considering