MICROFINANZA RATING

April 2006

WV AzerCredit – Azerbaijan

Final Rating	BB
First rating	Validity: 1 year if no relevant changes in operations or within the operation context will happen.. The final rating grade does not consider the political and economic context.

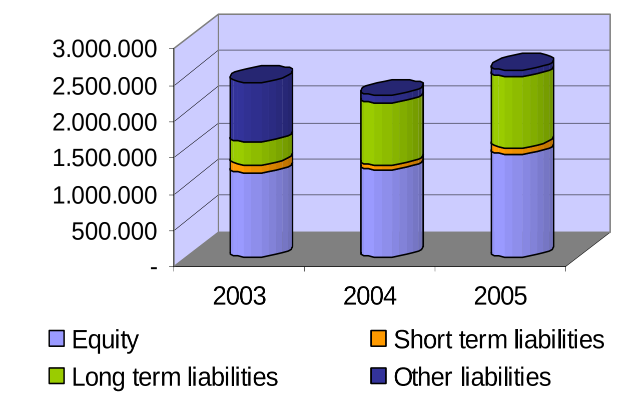
World Vision AzerCredit LLC is a non-banking credit organization founded by World Vision International (WVI). The original project started in 1995 with the aim of providing sustainable lending services to those entrepreneurs excluded from the formal financial sector. The lending operations are carried out both in rural and in urban areas, include individual and group loans and target agriculture and trade in particular.

To date, AzerCredit has been funded by the donations and concessional loans from the network of the founder and other international development agencies. However, the shortage of funds faced by the institution in the last years has limited its growth. Since the end of 2005, the funding strategy has become more effective, aiming also at commercial investors. AzerCredit is member of AMFA, the Azerbaijan Microfinance Association.

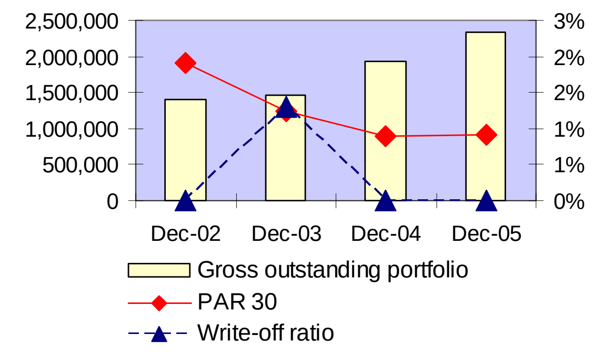
Legal Form	Limited liability company
Inception year	1995
Area of intervention	Urban and rural
Credit methodology	Group and individual

Number	Dec03	Dec04	Dec05
Active borrowers	4,410	5,387	5,830
Branches (hubs)	5	5	5
Satellites	0	0	2
Total staff	61	80	75
Loan officers	19	27	27

Liabilities and equity - USD



Loan portfolio evolution (USD)



Financial Indicators	Dec03	Dec04	Dec05
PAR 30	1.2%	0.9%	0.9%
Write-off ratio	1.3%	0.0%	0.0%
Restructured loans	0.0%	0.0%	0.0%
ROE	4.2%	-1.4%	4.6%
AROE	2.0%	-8.2%	-10.6%
Oper. Self-sufficiency (OSS)	107.2%	97.8%	105.0%
Fin. Self-sufficiency (FSS)	103.4%	88.8%	96.0%
Staff productivity (borrow.)	63	68	73
LO productivity (borrow.)	206	208	209
Operating expense ratio	39.6%	44.1%	32.7%
Funding expense ratio	1.8%	3.3%	1.4%
Provision expense ratio	0.9%	0.5%	0.1%
Portfolio yield - accrual	44.2%	45.4%	41.9%
Risk coverage ratio	107.1%	92.1%	82.6%
Cost of funds ratio	5.4%	8.1%	3.2%
Debt/Equity ratio	1.1	0.9	0.8

USD	Dec05
Average disbursed loan size	585
Gross outstanding portfolio	2,330,146
Total assets	2,580,925

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AREA	Risk factors	Relevance*
External environment	Uncertainties in the legal framework	Medium-low
	Ineffective credit bureau	Medium-low
	Growing competition in Baku and Ganja	Medium
Governance, management and operations	Inadequate composition and dimension of the Supervisory Council	High
	Top management deeply involved in operations, not focused enough on strategic development	Medium
	Sensible staff turnover	Medium
	Lack of internal audit position and manual	Medium
	Partial implementation of a new loan tracking system, poor reporting and lack of integration with the accounting system	High
	Improvable back-up and security procedures	Medium
Financial products and asset quality	Rigidities in loan product	Medium-low
	Lack of marketing and product development functions	Medium
Financial structure and ALM	Portfolio concentration in agriculture	Medium-low
	Lack of experience in commercial borrowing	Medium-low
	Foreign currency risk	Medium-low
Financial and operational results	Thin profit margins, under the pressure of future increase of funding expenses and decline of portfolio yield	Medium-high
Strategic objectives	Limited growth during the past years	Medium

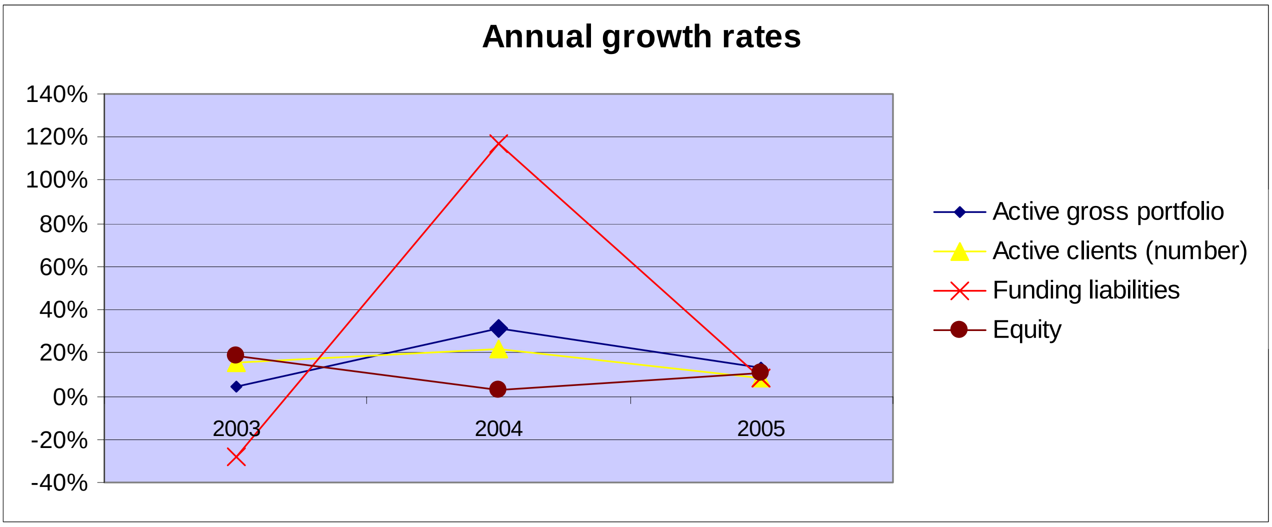
*** Relevance refers to the damage/loss brought about by negative events (associated to each risk factor) and to the probability that damage/loss eventually occurs.**

Strengths	Opportunities
→ Excellent portfolio quality → Experienced staff → Top management has a deep knowledge of operations	→ Large unmet demand → Member of AMFA → New CEO, very active in fundraising

Headquarters:
Baku

Branches:
Ganja
Mingechevir
Imishli
Horadiz

Sub-branches:
Gazakh
Goranboy



Final opinion

The consolidated credit methodology is reflected in the very good portfolio quality of AzerCredit.
On the other hand, due to the limited fund raising activities carried out in the past, growth has been low in the last years. Thanks to the active promotion of AzerCredit by the new appointed CEO, the organization has recently started to access commercial funds.
The governance and the management information system represent key challenges for the consolidation of the organization.
Profit margin is thin and subject to expected downward pressures due to the increasing competition in the Azerbaijan microfinance industry.

Benchmarking

All figures are referred to the MicroBanking Bulletin (MBB) database updated as of December 2004. AzerCredit (AC) financial ratios indicated here not fully correspond to the ratios presented in the report as they are calculated according to the *MicroBanking Bullettin* (MBB) methodology[1].

Financial ratios, USD	AzerCredit, Azerbaijan Dec05	ECA Medium broad	Non Banks (FSS MFIs)	Individual Solidarity	Viator, Azerbaijan Sep05	Findev, Azerbaijan Dec05
Gross Loan Portfolio gross loan portfolio adj for standardised write-offs (US$)	2,315,672	4,154,152	15,717,164	13,656,826	2,086,517	830,849
Average Loan Balance per Borrower on per capita GNI Average loan balance per borrower/ GNI per capita(%)	43%	52%	76%	68%	39%	31%
Portfolio at Risk> 30 Days oustanding balance of loans overdue> 30days/gross loan portfolio (%)	0.9%	3.1%	3.5%	4.5%	2.2%	1.5%
Adjusted Return on Equity AROE adj net operating income after taxes/avg tot equity (%)	-11%	-4%	51%	4%	0.1%	8.8%
Portfolio yield Financial Revenue from Portfolio/ Adjusted Average Gross Portfolio	41.9%	41.3%	35.5%	37.1%	37.7%	45.0%
Debt/ Equity Ratio adj.tot.liabilities/adj.tot.equity	0.8	11.2	2.4	4.2	0.1	0.4
Operating Expense/ Loan Portfolio (operating expense + In-Kind donations)/avg gross loan portfolio (%)	33%	28%	26%	29%	22%	29%
Borrowers per Loan Officer n. of active borrowers/n. of loan officers	216	164	280	269	337	575

ECA Medium broad, Eastern Europe and Central Asia, Gross Loan Portfolio (US$) 2 to 8 million, Avg. Balance per Borrower/ GNI per Capita ≥ 20% and ≤ 150%
All figures are referred to the MicroBanking Bulletin database updated as of December 2004

Important matters of the *benchmarking*

AC is compared to two sets of peer groups: the first considers the MFIs operating in ECA countries with medium broad outreach, the non-banking MFIs and the MFIs using both individual and solidarity methodology; the second one considers two MFIs already rated by *Microfinanza Rating* in Azerbaijan.

Compared with the first set of peer groups, AzerCredit shows better results in terms of portfolio quality but at the same time it appears less efficient. The higher operating expenses, partly due to the limited scale of AC and to the deeper outreach, are reflected in a poorer profitability performance. On the other hand, due to the limited competitive pressure, AC is still able to maintain a portfolio yield higher than the group of FSS MFIs (non banks) and of the mixed methodology group (Individual/Solidarity). AC's productivity is higher than the one of the MFI in ECA with medium broad outreach, but is lower than the one reached by the other two peer groups.

The second benchmark analysis confirms some aspects of the picture described above: in comparative terms, AC has a better portfolio quality but is less efficient. The operating expense ratio registered by Viator is significantly lower also due to the prevalent individual methodology used, while Findev presents a higher productivity also thanks to the group methodology and to the very deep outreach. The resulting profitability is considerably lower for AC than for Findev and, to a minor extent, for Viator. Leverage is low for AC, but the debt to equity ratio registered by the other two Azeri MFIs is even lower; Findev's portfolio yield is slightly higher, while the one of Viator is slightly lower than AC's.

[1] The MBB adjusts the financial data to produce a common treatment for the effect of: a) inflation, b)subsidies, and c)loan loss provisioning and write-off (see *MBB* , Appendix I: Notes to Adjustments and Statistical Issues).

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1. External Environment and AzerCredit positioning

Institutional background

AzerCredit was founded as a project by **World Vision International** in **1995** and it was one of the micro-finance **pioneers** in Azerbaijan. WVI fed its initial growth with funds coming from **UNDP**, **USAID** and **Mercy Corps International**; more recently, donations came from **WV Canada**, **CIDA** and **WVI** among others. AC's operations are partly financed by concessional loans mainly borrowed from the network of the founder.

In 2002 Word Vision AzerCredit registered as a **non-banking credit organization**, and in October 2003 it obtained the **licence by the National Bank of Azerbaijan**. The MFI was then transformed into a Limited Liability Company in April 2004.

AC works in both urban and rural areas, providing micro and small loans mainly for trade and agriculture; both **individual** and **group** methodologies are used and the average loan size is around **USD 600**.

Political and macroeconomic context

After its independence from the Soviet Union in 1991, Azerbaijan suffered a period of political instability and economic dislocation, due to the break-up of the Soviet economy and the conflict with the neighbour country Armenia. Nowadays politic is more stable and the president, Ilham Aliyev, will most likely continue to consolidate his authority and remain in power over the forecast period.

Sovereign risk[2]

Azerbaijan	Foreign currency		Domestic currency	Rating
	Short term	Long term	Long term	Outlook
MOODY'S	na	na	na	na
S&P	na	na	na	na
Fitch	B	BB	BB	STA

Since 1994, with the normalization of the economic situation and of the relationship with Armenia, the country has attracted growing international interest and foreign direct investments because of its rich oil and natural gas reserves in the Caspian Sea basin. **Azerbaijan has enjoyed in recent years strong growth and a stable macroeconomic environment**. Since 2000, the Gross Domestic Product has grown on average by 10.6% per year, reaching 21% in 2005 due to the oil boom and gas production. A surge in hydrocarbons output is supposed to support Azerbaijan's economic expansion in 2006-07, with the most of production exported to Western markets. Real GDP growth is therefore expected to accelerate from an estimated 24% in 2005 to 27.5% in 2006.

Azerbaijan

Macroeconomic Indicators	Dec02	Dec03	Dec04	Dec05
Exchange rate in US$ (end of period)	4,893	4,923	4,903	4,593
Exchange rate variation	na	0.6%	-0.4%	-6.3%
Inflation rate (average for the period)	2.8%	2.2%	6.7%	11.8%
Inflation rate (end of period)	3.3%	3.6%	10.4%	7.4%
Deposit rate	8.7%	9.5%	9.2%	8.5%
Lending rate	17.4%	15.5%	15.7%	17.1%
Real GDP growth	10.6%	11.2%	10.2%	24%*
GDP per head (US$)	754	877	1,023	1,532

Source: International Finance Statistics, EIU. * Estimate.

The average annual **inflation** in the period 2000-2003 stands at a modest 3% in the period 2000-2003, while it increased in 2004 (10.4%). In 2005, the significant hard-currency inflows provoked a sharp rise of the prices. Annual average consumer price inflation is expected to decelerate from an

[2] **Scales used: MOODY'S:** Long term - AAA, AA1, AA2, AA3, A1, A2, A3, Baa1, Baa2, Baa3 (Investment grade), Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C (Speculative grade); Short term - Prime-1, Prime-2, Prime-3 (Investment grade); Not Prime (Speculative grade); **S&P**: Long term - AAA, AA, A, BBB (Investment Grade); BB, B, CCC, CC (Speculative grade); SD (Selective Default); D (Default) - Rating from AA to CCC may be modified by a + or -; Short term - A-1(+), A-2, A-3 (Investment Grade); B, C (Speculative Grade); SD (Selective Default); D (Default) **Fitch:** Long term - AAA, AA, A, BBB (Investment Grade); BB, B, CCC, CC, C (Speculative grade); DDD, DD, D (Default) - Rating from AA to CCC may be modified by a + or -; Short term: F1, F2, F3 (Investment grade); B, C (Speculative grade); D (Default).

estimated 11.6% in 2005 to just over 7% in 2006, before further slowing down to about 5% in 2007.The inflationary pressures will be maintained under control by allowing a nominal appreciation of the local currency. A new currency, the New Manat, corresponding to 5.000 old Manat, was introduced at the beginning of 2006. While affirming itself as oil and gas exporter, its non-oil economy is national market-oriented and is characterized by a low competitiveness (compared to neighbour countries). Based on an absolute poverty line of about USD 25 per capita per month, **almost 49% of the population is poor**.

<u>Microfinance sector</u>

The market coverage of Azeri MFIs is still very low, as microfinance reaches only 7% of an estimated 670,000 rural households; however, the microfinance sector is rapidly growing. The leading actor is the **Microfinance Bank of Azerbaijan (MFBA),** recently established and financed by the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC/WB), among others. As of December 2005 this fast-growing bank presents an outstanding loan portfolio worth more than US$ 17.5m and 5,724 clients. **AgrarCredit** with an outstanding portfolio worth almost USD 12m and 3,627 clients is the second MFI. The third one is **FINCA,** which serves more than 27,000 active clients and has an outstanding portfolio almost worth USD 10.5m The remaining MFIs, largely managed by international humanitarian organizations, have a smaller portfolio and a lower number of branches. Those MFIs often present a considerable outreach in depth, while the upper segment of the market is served by the MFBA, AgrarCredit and CredAgro.

The Azerbaijan Microfinance Association (AMFA), which performs an active role in lobbying, training and benchmarking, includes 20 members: the majority if them are MFIs operating in microlending, 2 members are devoted to SMEs lending and one is a second tier MFI. The total outstanding portfolio of the members of the Association is worth about US$ 60m, on the overall, they are able to reach almost 65,000 clients.

The role of the 30 **Credit Unions** operating in the country is limited in terms of total number of clients and active portfolio. Moreover, their development as effective financial intermediaries is unlikely unless the legislation changes allowing them to collect deposits.

<u>Regulation and supervision</u>

A **specific law for microfinance** is **lacking** at the moment, but the Parliament and the National Bank are currently working on a **draft of Microfinance Law**. AMFA and the Asian Development Bank are actively lobbying the National Bank to obtain a suitable regulatory framework. The present draft includes some important advantages: the possibility for the employees of Credit Organizations (COs) to participate in the Supervisory Council (SC) of other COs, the option for private citizens to establish MFIs, the choice between establishing a registered or a licensed entity with different capital requirements, the possibility to acquire a full for-profit status and the future development of prudential norms. On the other hand some concerns arise with respect to the setting of a loan ceiling of USD 5,000, and to the impossibility to use the compulsory and voluntary savings that the MFIs will be allowed to collect for on-lending. Moreover, some degree of uncertainty remains about tax exemption. The draft Law may be approved by the end of September 2006.

The regulatory provision currently in force is an addenda to the “Rules for licensing of credit organisations, their branch offices (issue of permit for banking transactions) and for organisation of their activity” of the National Bank of Azerbaijan, dated November 1996. **Supervision** is being performed by the **National Bank** through quarterly reports (financial statements and portfolio classification).

According to the current regulation, **all MFIs are legally registered as limited liability companies** (LLC), owned by national or international NGOs. MFIs registered as limited liability companies are **not allowed to collect savings**, unless they transform themselves into banks. In order to operate, MFIs need to register with the Ministry of Justice and to receive a licence from the Central Bank for each branch office. MFIs, as commercial companies, should pay **profit and social security taxes;** however, at the end of 2005, thanks to their non-profit status, they were **exempted by decree from paying social taxes**. At the same time, despite the fact that MFIs had received in the past a special allowance, the tax authority recently announced that they have to **pay profit taxes**. The possibility to be called to pay profit taxes also retroactively is not a risk for AzerCredit since no profits were registered for tax purposes in 2004, and it just transformed into a LLC in April 2004. On the other hand, the risk related to the **uncertainty about future social tax payment** is still present.

The National Bank established in June 2005 a **Credit Register** to which all credit organizations report loans bigger than USD 1,000. Despite the poor effectiveness of this credit bureau, the **informal exchange of information** among MFIs working in the same areas is widespread, thus limiting the potential risk of over-indebtedness of clients.

AzerCredit's market positioning

AzerCredit operates mainly in **rural areas**, targeting micro agricultural and trade businesses both through **group** and **individual micro loan** products. The branches of Imishli and Horadiz are especially focused on rural microfinance. The **urban segment** of micro **traders** is also served, especially from Baku, Ganja and Mingechevir branches. **SME** are marginally financed through small and medium term loans. AC is facing the growth of competition on two sides: on one hand the presence of MFIs is becoming deeper and deeper in the urban areas of Baku and Ganja; on the other hand MFIs, and especially the more commercially oriented ones, are boosting the credit supply to the high end segment of the market. To cope with this, AzerCredit will base its future **growth** on the large unmet demand coming from the rural micro entrepreneurs.

After the growth of the first years of operations, the **stagnation of AzerCredit size** of the last years resulted in the loss of a part of the market share previously held by the organization. The most relevant **competitor** of AzerCredit is **FINCA**; the **Microfinance Bank of Azerbaijan (MFBA)**, **Viator**, **Azeristar** and **Normicro** are also active in some of the areas of operations of AzerCredit. The competition is especially present in the **urban centres**: the MFBA is particularly focussed on the **high end of the market**. The other competitors have the same target of AzerCredit, but the demand is large enough for the industry to grow, without producing high competition in the short run.

Main competitors

Institution	Gross portfolio (USD)	Products	Loan size (USD)	Loan maturity	Interest rate	Active clients
Azer Credit	2,330,146	group and individual	90 - 9,200	3 - 18 months	3% - 4% declining	5,830
Finca	10,452,339	group and individual	10,000 - 50,000	4 - 12 months	2.5% - 3.5% declining	27,288
MFBA	17,544,427	individual	10,000 - 125,000	3 - 36 months	2.5% - 3.5% declining	5,724
Viator	2,481,307	group and individual	100 - 5,000	2 - 24 months	2.75% - 3% declining	6,484
Azeristar	6,214	group and individual	140 - 2,000	4 - 12 months	3.5% flat - 4% declining	3,815
Normicro	15,902,236	group and individual	150 - 5,000	4 - 16 months	3% declining	4,613

The main **competitive advantages** of AzerCredit are:

- Good reputation in the areas of operation, generating trust in potential clients
- Client-friendly approach of the experienced LOs

The main **competitive disadvantages** are the following:

- Slightly higher cost of loan products
- Higher collateral requirements
- Lower product diversification
- Lower maximum loan amount, which do not satisfy the needs of upgrading clients.

2. Governance and operational structure

Ownership and Governance

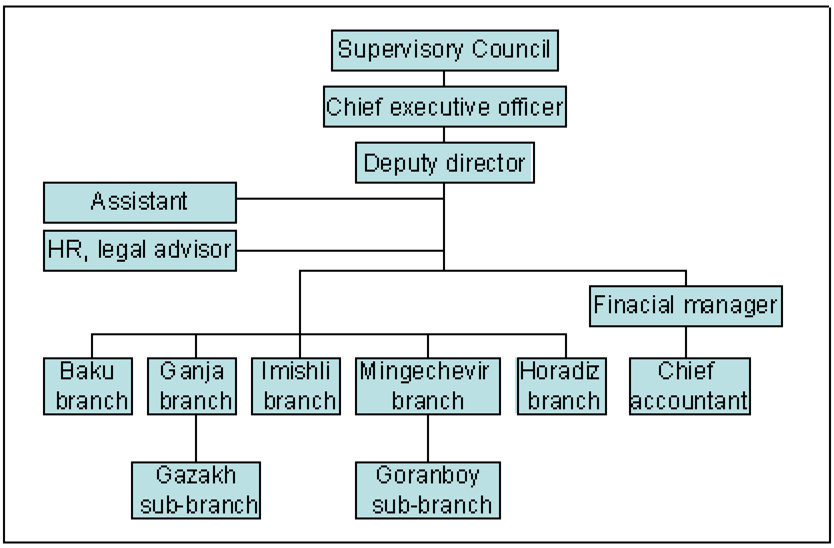
Supervisory Council

Members	Charge	Background and current profession
Mr. Seifu Tirfie	chairman	He has a PhD in Engineering. He has over 11 years experience in managerial positions in relief and development and is currently Program Director of World Vision Azerbaijan.
Ms. Marina Yoveva	member	She has a large experience in microfinance: she worked as director of an MFI, as technical advisor and later as Acting Regional Director for World Vision's MFI network in Eastern Europe. She is also in the supervisory board of the MicroFinance Center (MFC) in Poland.
Mr. Chris Pitt	member	He has managed MFIs in various Eastern European countries for World Vision and Opportunity International, holding relevant positions in relief and development. Dr. Pitt is currently Project Director at World Vision

AzerCredit was transformed from a World Vision program to a registered limited liability company in April 2004. AC is **100% owned by World Vision International** (WVI), which is represented in the Supervisory Council (SC) by three members of the World Vision's network.
Due to the fact that a balanced Board development plan was missing in the past, the current **SC** presents some **weaknesses**: **none of the members is Azeri**, all members belong to the **WV network** and the profiles of local experts of the **banking, legal and fiscal environment** is currently **missing**. Moreover, the **small dimension** of the Board and the time constraints of one of the members[3] are somehow limiting the capacity to guide AC's strategic development. Lastly, the fact that two members are not resident in Azerbaijan doesn't facilitate the organization of physical meetings. However, the fact that now meetings are held quarterly represents a positive evolution with respect to the past.
Both the top management and the SC members are aware that the Board development is an institutional priority: the **CEO**, with the support of WVI, is in charge of **inviting** at least **two local experts with experience in the legal, fiscal and banking sectors**.

Organisation and structure

AC's headquarters (HQs) are based in **Baku**, in the same premises of the branch. The other **four branches** are located in Ganja, Mingechevir, Imishli and Horadiz; the sub-branches of Gazakh and Goranboy operate under the respective supervision of Ganja and Mingechevir branches.
The structure of each branch is composed of a manager, an accountant, a cashier, loan officers and support staff.
The level of **decentralization** of the operations is **adequate**:



[3] Chris Pitt is taking part to the SC of several MFIs of the WV network; he may resign from AC's SC as soon as a suitable replacement will be identified.

depending on the branch, the branch credit committee[4] has the right to approve loans up to USD 5,000; amounts larger than USD 5,000[5] require the additional approval of the deputy director at the HQs. At **branch level** the managers are in charge of preparing the yearly budget and financial projections, which are discussed ex ante before the consolidation and compared ex post with the actual results together with the financial manager. The communication flow between the HQs and the branches is good: meetings are held in Baku for managers and accountants with an adequate frequency.
It is worth noting that the operations in Goranboy, given the relatively large dimension of its portfolio (9% of the total portfolio of AC), are slowed down by the fact that the information about credit process must be entered in the loan tracking system in Mingechevir.

Human Resources

Personnel	Dec03	Dec04	Dec05
Total	**61**	**80**	**75**
Loan officers	19	27	27
Other staff	42	53	48

At the end of 2005, AC personnel are composed of **75 employees**, out of which 27 loan officers; the improvable staff allocation ratio, **36%**, is partly due to the large share of support staff[6].
After the position had remained vacant for eight months[7], a **new CEO** was appointed in November 2005. **The current CEO is also managing a Georgian MFI** belonging to the WV network (CREDO VisionFund), and took part of the WV assessment team for AC starting from 2004. The CEO is in charge of fundraising, strategic planning, HR development and SC development. Both advantages and disadvantages may be generated by this management scheme, which is uncommon in the microfinance industry.
The top management is also composed of the **deputy CEO** and the **financial manager**. Thanks to the fact that their professional growth took place inside the organization, they have a deep knowledge of operations. However, the lack of an internal auditor and a certain degree of work overload of the financial department[8] is forcing them and the branch managers to be **deeply involved in operations**, limiting their capacity to concentrate on the strategic development of AC. The **deputy CEO** acts as a credit manager, as internal auditor for credit operations and represents the organization when the CEO is absent. The **financial manager** can also cover the representation role, but his main tasks are cash planning, reporting to investors, preparing the yearly financial projections, and conducting the internal financial audit (including the analysis of the variance of the actual incomes and expenditures from the budget).
Besides these two key figures, the chief accountant is in charge of the consolidation of the data and supervision of the accounting of branches and the human resource/legal advisor deals with the staff administration, recruitment and with the legal issues of the organization.
Due to the limited growth perspectives in the last years, the **marketing function** on the overall **has not been developed**. However the organization is aware that efforts will need to be spent to strengthen the marketing function: a more dynamic approach to market research and products development will be needed to grow in future, including training and the creation of a position dedicated to marketing[9].
Based on the annual appraisal of staff performance and training needs, some **trainings** are offered to the personnel (mainly through AMFA and MFC, and internally), but the opportunities provided are still limited. Even if a bonus system may be introduced in future, currently there is **no incentive scheme in place**. This, coupled with the limited growth registered by the organization in the last years, helps in explaining the rather **high turnover rate** (17.3%) registered in 2005. Moreover, the level of salaries in AC is lower than the average salary offered by the financial sector.

[4] The branch credit committee is composed of the branch manager and the senior loan officers.
[5] As of December 2005 the number of active loans larger than USD 5,000 is less than a dozen.
[6] Drivers, cooks, cleaners and guards are 16 as of December 2005.
[7] The previous CEO performance was not judged satisfactory, the fundraising being particularly poor.
[8] The former accountant in HQs recently left and the process to replace him has already started.
[9] A marketing position may be created in 2007 and covered by a person inside the organization.

Internal Control and operational risk management

The organization is currently lacking an internal auditor position and an internal audit manual. The audit function of credit operations is currently performed by the **deputy CEO**, while the **financial manager** is in charge of the audit of financial operations. The control of the compliance with procedures is carried out as well by the **branch managers** but the internal supervision of the sub-branches is not adequate to the current degree of decentralization of operations.
The risk of having a fragmented audit function is just partly mitigated by the periodic assessments conducted by the **regional WV department**[10].

To comply with Azeri law, AzerCredit has an **Audit Committee** which should perform the internal audit. Two out of three Committee members have audit experience but none of them is Azeri[11]; all of them come from the WV network. The Committee, which has not actually performed any effective audit operation so far, should develop an audit manual and recruit an internal auditor. The recruitment process has already started and, given the cash and gold operations, the planned growth and the shortcomings in the MIS, it is crucial for AzerCredit to complete it as soon as possible.
Moreover, in order to undertake a sound growth path, the necessity arises for the top management to delegate the internal audit function and concentrate on the strategic risk management.

The **formalization of procedures** is at a satisfactory stage for credit operations (including the cash and gold handling) and HR management, while a financial manual is still lacking[12].

Accounting policy and procedures

AzerCredit's financial statements are audited by a local company which works according to the requirements of the **National Bank**, but not fully compliant with the International Accounting Standards. Even if now they are close to CGAP standards, AC may need in future to show to international stakeholders its financial statements in compliance with IFRS. Due to the fact that the transformation into a LLC was completed in April 2004, the audit for 2004 covers the period May – December, while the previous audited period goes from October 2001 to November 2003. During 2004 the **functional currency** of AC shifted from USD to AZM; moreover, until the end of 2003 the **closing date of the year** was September the 30th; these factors represent some difficulties for external actors willing to make financial trend analysis.

Management Information System

The MIS represents one of the main **areas of improvement** of AC. Currently there are **two loan tracking systems** in place: "**EMerge**" is used in three branches (Baku, Mingechevir and Horadiz) and the **home-built system based on excel** that was in place before the implementation of EMerge is still in place in the two remaining branches (Imishli and Ganja). The implementation of EMerge was initiated in 2004 but then it was interrupted because of the poor quality of the work of the company in charge of the implementation. The two branches left are expected to have the system installed by October 2006. These two loan tracking systems are **not integrated** with the accounting one (**SunSystem**) and some errors are produced[13] which are manually corrected. SunSystem is centralized in the headquarters, where the chief accountant consolidates the financial statements prepared by the branch accountants (branches are profit/loss centres). The chief accountant is also in charge of consolidating the portfolio information from EMerge with the information coming from the branches where the system is not installed.

All branches are connected through a network: for the ones where EMerge is in place, the information is automatically available at the HQs, while for the others the data are sent by e-mail. In any case, the infrastructural weaknesses of the internet connection in the Country may cause some temporary malfunctioning.

[10] Two assessments of the organization were conducted during 2005.
[11] One member of the Audit Committee may be replaced in future with a local person.
[12] The financial manager will develop in future a complete manual including international accounting procedures and liquidity policies.
[13] The original information on the principal amount contained in e-merge is correct, but problems arise once it migrates to SunSystem.

The recently appointed MIS manager currently lacks the skills necessary to realize the potential of the loan tracking system, but he will soon participate to a specific training on e-merge. The current **portfolio reporting capacity** of EMerge used by the organization is **limited**, and the manual preparation of several reports[14] may be too slow to answer to operational and management needs.

The security is outsourced to a local company, which currently assures an acceptable level of protection in the offices; however, a more limited service will be selected in the near future. The current cash and gold limits identified in the procedures do not fully comply with NB requirements and the back-up procedures may be improved: the back-up of the EMerge and SunSystem information is done at the HQs and the copies are all stored in the office, while in the branches without e-merge there is no procedure to assure that back-up is done systematically.

[14] Among which: clients per LO, disbursements and repayments, portfolio breakdown by type of loan and loan cycles.

3. Lending operations

Financial products

Azercredit offers the three loan products illustrated in the table beside: **group** loans and **individual** loans (for **micro** and **small enterprises)**. Even if most of the portfolio consists of individual loans, the growth strategy of Azercredit may probably focus on the **rural underserved** areas of the Country, where group lending is the most suitable methodology to meet clients' needs. Having received a fund from ARRA to target IDPs[15], the loans issued by the Horadiz branch have specific characteristics: they are in **AZM**, carry 2% flat monthly interest rate and 2% up-front fee; they can be both individual and group loans and represent about 20% of the total portfolio of AC. Start-up businesses are not financed; **livestock breeding**, **agriculture** and **trade** are the main financed sectors.

No significant changes in the current products design are foreseen in the short term. The **limited degree of products diversification** is the result of the **lack of funds** which has characterized AC operations in the past years.

Credit methodology

Credit products	Group	Micro	Small
Credit methodologies	Group	Individual	Individual
Currency of the credit	USD	USD	USD
Type of interest	Declining	Declining	Declining
Min. interest rate (%)	3	3	3
Max. interest rate (%)	4	4	3
Average interest rate (%)	3.5	3.5	3
Commissions	1-2 up front fee	1-2 up front fee	2 up front fee
Min. credit amount (US$)	92	92	2,300
Max. credit amount (US$)	1,380	2,300	9,200
Max credit amount for the first loan (US$)	1,380	2,300	9,200
Average credit amount (US$)*	486	629	629
Min. loan maturity	3 months	3 months	3 months
Max. loan maturity	12 months	12 months	18 months
Average loan maturity	na	na	na
Periodicity of interests payments	monthly	monthly	monthly
Periodicity of principal payments	monthly	monthly	montlhy
Grace period (months)	6 months for agriculture	6 months for agriculture	up to 9 months
Collaterals / guarantees	Group solidarity, home assets, livestock, personal guarantee, jewels	Home assets, personal guarantee, jewels	Real estate, personal guarantee, jewels

* Average loan amount disbursed during 2005.

Lending procedures

The **credit procedures are sound** and well established: the assessment of the clients' capacity of repayment[16] as well as their monitoring are adequate.

The loan disbursement generally takes **one week**, in line with competitors. However, being the **week days** to apply (Monday) and to disburse the loans (Friday) **fixed**, in some cases the process may take longer. Moreover, due to the fact that the information regarding the loans disbursed by the Goranboy sub-branch must be input in Mingechevir e-merge system, for those clients the credit

[15] ARRA (Agency for Reconstruction and Rehabilitation of Azerbaijan) is a UNDP and WB funded project. The area served by Horadiz branch is close to the border of the occupied territory of Nagorno-Karabakh, where the resettlement of Azeri people is encouraged by the government.

[16] A proper cash-flow is prepared for all loans larger than AZM 700.

delivery can take considerably more. The loan amount can increase with the progressive cycles, but due to the chronic shortage of funds suffered during the past years, AC has **not been able to answer to the demand for larger amounts** coming from the up-grading clients. In future, the loan conditions may become more flexible along with the progressive cycles: with the aim of limiting drop-out, AC is planning to disburse larger amounts to good clients with longer maturity and through a shorter process. Moreover, in order to improve the service for urban clients, AzerCredit is considering the possibility to issue loans and receive repayments through banks.

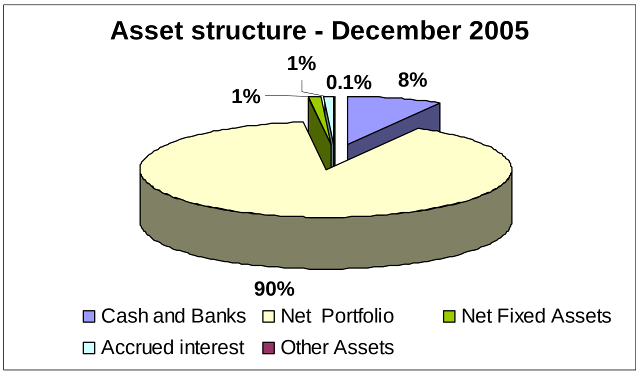
Collaterals and accessibility

The minimum value of **collateral** must represent at least 100% of the loan amount. Even if now there is a large unmet demand for microcredit and gold seems to be a widespread households' assets in Azerbaijan, the higher collateral requirements compared to competitors may become an obstacle to attract new individual clients in the medium term.

4. Assets structure and quality

Assets structure

The **concentration of resources in the core business** of AC is increasing over time and is currently **good**: as shown in the graph beside, as of December 2005, the net portfolio represents 90% of the total assets. The good concentration is confirmed considering the average value of net portfolio and total assets for 2005, worth of 85%. **Liquidity** at the end of the period is also **adequate**, cash and banks accounting for 8%; the average amount of liquidity over total assets for 2005 is also appropriate, equal to 6.4%. Net fixed assets and accrued interest both represent 1% of total assets.



Portfolio structure

As of December 2005 AC's gross portfolio is equal to USD 2,330,146: about 30% of it has been issued through the group methodology (representing 35% of active clients), while the remaining 70% is composed of individual loans. Due to the strategic focus on rural areas, the portion of group loans portfolio may slightly increase during 2006.

Portfolio features	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05
Gross outstanding portfolio (US$)	**1,463,073**	**1,926,976**	**2,330,146**
Group	437,555	579,304	685,646
Individual	1,025,518	1,347,672	1,644,502
Gross outstanding portfolio (AZM)	**7,202,708,379**	**9,447,964,017**	**10,702,359,700**
Growth of active gross portfolio	4.4%	31.2%	13.3%
Average disbursed loan amount (US$)	494	522	585
Av. disbursed loan size on per capita GDP	56%	51%	38%
Average maturity (months)	12	12	12
Number of active borrowers	4,410	5,387	5,830
% of active borrowers women	32.9%	33.4%	35.6%
Drop-out ratio	41.2%	33.7%	40.8%

After the expansion registered during 2004, in 2005 the **growth of AC portfolio** decreased to **13.3%**. The main reason is to be identified in the increasingly severe **shortage of funds** that AC has been facing during the last years. The progressive increase in the average disbursed loan amount has not been strong enough to compensate the huge growth of per capita GDP in the last years, the result being a **decreasing relative loan size**. Considering the inflationary environment on one hand and the lack of funds on the other hand, the fact that the real value of the average disbursed loans was not increased over the past three years shows AC's will to satisfy a broad number of clients. The **outreach has been very good** along the years, and a positive trend is visible both in terms of growth of the total number of clients and of women clients' involvement.

Dec-05

By sector	outstanding portfolio (US$)	% of outst. portfolio	% number of borrowers
Trade	671,509	28.8%	25.0%
Service	201,326	8.6%	7.8%
Production	129,474	5.6%	4.7%
Agriculture	1,327,836	57.0%	62.5%
TOTAL	**2,330,146**	**100%**	**100%**

The **drop-out ratio is quite high** in the periods under analysis: after a sensible improvement in 2004, the ratio grew again up to 40.8% in 2005.The phenomenon is concentrated in the individual methodology and is mainly related to the inability of AC to satisfy the clients asking for **larger amounts**. In the first half of 2005, the shortage of funds also led the Baku branch to draw waiting

lists for clients, thus probably making some of the clients shift to competitors.
However, the clients' retention rate is **systematically monitored** by the management.

AzerCredit's portfolio mainly finances **agriculture** (57%) and **trade** (28.8%). No specific policy exists on the portfolio structure. The control of the risk related to the agricultural concentration will be necessary also in view of the expansion in rural areas.

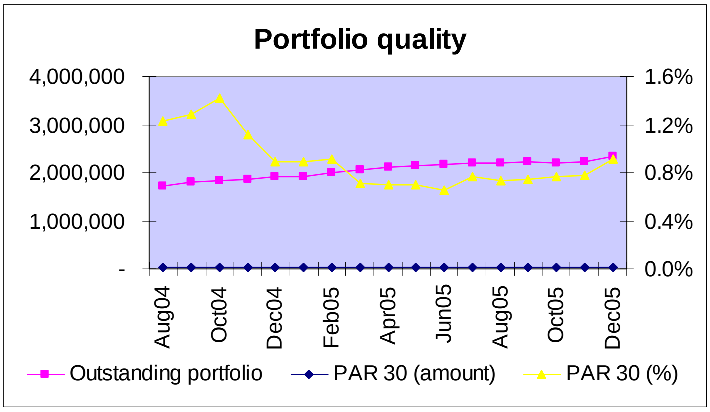
Dec-05

Branch	outstanding portfolio (US$)	% of outst. portfolio	% number of borrowers	PAR > 30 days	PAR > 30 weighted
Baku	436,491	18.7%	13.3%	0.5%	0.1%
Ganja	507,756	21.8%	22.2%	1.0%	0.2%
Mingechevir	439,718	18.9%	22.7%	1.1%	0.2%
Imishli	462,500	19.8%	18.4%	0.0%	0.0%
Horadiz	483,681	20.8%	23.4%	1.8%	0.4%
TOTAL	**2,330,146**	**100%**	**100%**		**0.9%**

On the other hand, the **geographical diversification of the operations** is assured by the even distribution of the portfolio among the 5 branches, located in different areas of the Country.

Loan portfolio quality

As of December 2005, AC presents an excellent portfolio quality with a portfolio at risk > 30 days worth of **0.9%**.



The bulk of it is represented by loans late more than 180 days; the write-off operation foreseen for February 2006 will further improve the picture. AC does not restructure loans.

The **trend** of portfolio quality is very **positive**, especially starting from October 2004, and didn't suffer any shocks during the period when AC operated without CEO[17], confirming the soundness of credit operations. On the other hand the risk coverage ratio (PAR30) has been decreasing over years, down to 82.6% at the end of 2005. However this doesn't represent a serious risk since a large part (about 50%) of AC portfolio is backed by gold.

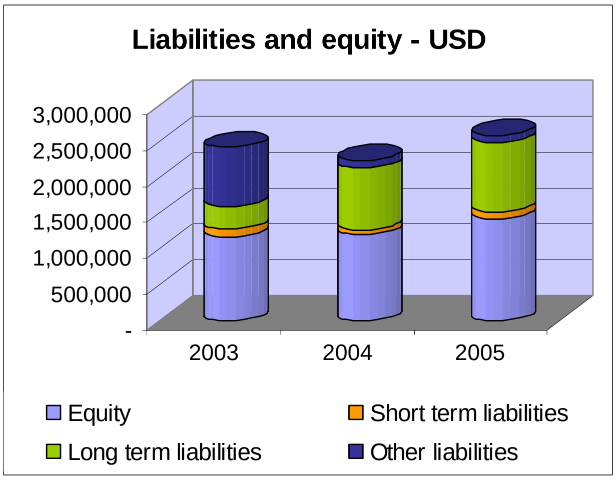
The table above shows that delinquency is concentrated in the Horadiz branch (PAR30 equal to 1.8%, accounting for almost half the total PAR30 of AC), due to the particular vulnerability of the economic context of that area and of the relevant portion of people without permanent residence.

Portfolio Quality Indicators	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05
Consolidated PAR30	**1.2%**	**0.9%**	**0.9%**
31-60	0.2%	0.1%	0.2%
61-90	0.2%	0.1%	0.0%
91-180	0.4%	0.1%	0.1%
181-365	0.5%	0.7%	0.6%
>365	0.0%	0.0%	0.0%
Arrears rate (> 1 day)	1.1%	0.8%	0.7%
Restructured portfolio	0.0%	0.0%	0.0%
Provision expense ratio	0.9%	0.5%	0.1%
Loan loss reserve ratio	1.3%	0.8%	0.8%
Risk coverage ratio (30 days)	107.1%	92.1%	82.6%
Write off ratio	1.3%	0.0%	0.0%

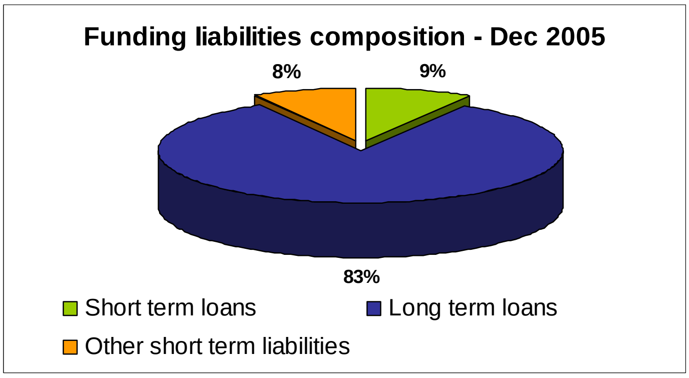
[17] From April to November 2005.

5. Financial structure and ALM

To date AC has mainly **based its growth on the equity donated** by WV[18], maintaining in the past two years a low debt to equity ratio (0.82 as of December 2005). The high portion of other liabilities in 2003 is due to the fact that at the end of that year the **gold collateral** of clients was still in balance sheet, while subsequently it was put off balance.
Up to now, AC has been cooperating with international agencies for development, but the current funding strategy is now opened to **equity and loan investments also from commercial international actors**.



Liabilities and equity structure
The bulk of AC's liabilities (83%) has a **long term maturity**, 9% of obligations are due in the short term, while the other liabilities are mainly represented by clients' prepayments.
The current investors are mainly **WV**, **SFDI** (Social Fund for Development of IDPs), funded by the World Bank and **SCRI** (State Committee on Refugees and IDPs), financed by ADB; they all apply concessional and semi-commercial conditions.



Nobody has been significantly promoting AC for a long time: as a result, in the past years the organization has been suffering a **shortage of funds** that drastically limited its growth. However, thanks to the contribution of the **newly appointed CEO**, AC is now exploring several funding opportunities. AC **does not currently have experience with commercial borrowings**, but the strategy is to strengthen the cooperation with WV and to **build a commercial credit history** by attracting different international commercial investors such as Blue Orchard and Symbiotics.
The organization may also feed its growth through **equity investors:** the possibility that AC may obtain a fully for-profit status in the future would help attracting potential shareholders.

The satisfaction of AC financial needs for 2006 (about USD 1.3m, corresponding to a planned growth of about 35%) will not be jeopardized as long as the funds received from **ARRA** (representing 18% of AC total assets) will not need to be returned. The ARRA multilateral contract, between AC, the WB, the UNDP and the Government, was a **grant** agreement that restricted the use of the funds for AC to financing IDPs in the Horadiz area. However, the Government has been recently claiming the **loan** nature of the contract, and given that it may be willing to redirect the resources in other directions, a risk exists that this will become a **legal issue**, with the subsequent **uncertainties about the funding of AC**.

As of December 2005 **total equity** is worth of about **USD 1,414,600**, out of which 90% is **donated and paid in capital**, 9% is represented by the net income generated in 2005 and 1% is retained earnings from the previous periods. It is worth mentioning that in 2004 an operation was conducted on AC equity structure: the donation from ARRA was reduced and the cumulated losses together with the losses from revaluation included in other equity accounts were cut as well. The operation is worth of about USD 90,000 and was conducted to compensate AC for the exchange rate

[18] WV International channeled the funds received from WB, UNDP, CIDA, USAID and BP.

losses[19] suffered in relation to the loans disbursed in AZM through the ARRA fund. Indeed, at the moment of the agreement, being the issue of loans in local currency a required condition, ARRA committed itself to cover part of the exchange rate losses that would have been generated in future lending operations.

The **capitalization strategy** of AC for the future will be based both of external contributions and on generating net income: **WV** is considering the **transformation** of one of the **loans to AC (USD 315,000) into equity**: the stage of negotiation is advanced.

<u>Assets and Liabilities Management</u>

As of December 2005, AC presents a very high current ratio (13), increasing over time. Given the fact that 83% of AC's liabilities have a long term maturity and almost 100% of its portfolio is short term and considering the very low leverage, AC is not currently subject to any maturity mismatch risk. On the other hand, AC is **exposed** to **currency risk**: given the positive net currency position in USD worth of 44% of total assets, AC may keep on suffering relevant exchange rate losses (worth of USD 71,000 in 2005). Moreover, since the course of the exchange rate between the USD and the AZM is expected to be favorable to the latter, a more prudent approach would require some measures to mitigate the risk.

Dec-05

USD	USD*	Local currency	Total
Assets	**2,017,115**	**563,811**	2,580,925
Cash and banks	164,348	52,975	217,323
Financial assets	0	0	-
Portfolio	1,836,805	475,850	2,312,655
Fixed assets	0	32,340	32,340
Other assets	15,962	2,647	18,608
Liabilities	**876,844**	**289,442**	1,166,287
Loans	849,990	219,443	1,069,433
Other liabilities	26,854	70,000	96,854
NET POSITION	**1,140,270**	**274,369**	

*Exchange rate AZM / USD= 4593

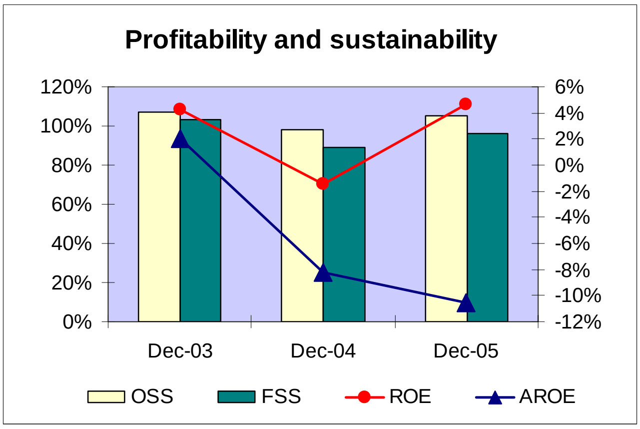
The fixed interest rates applied by current investors are excluding interest rate risk for the organization. However, the future access to commercial borrowings that may have variable interest rates could stress the financial margin of AC, whose portfolio has fixed interest rate.

The tools used for the **liquidity management** and the organization of the function are **adequate** to AC needs: projected cash flows are prepared by the branch managers and consolidated by the financial manager, who is in charge of compensating any liquidity unbalances. Due to the shortage of funds that marked AC's operations in the last years, the development of **treasury management** tool **was not a priority**; however, given the fact that deposits bear a rather low interest rate, AC may start identifying short term investment options to effectively face any future excess liquidity generated by the access to new funds.

[19] Both the losses included in the net result of the previous periods and the ones that didn't pass through the income statement (that is the reduction of portfolio produced but the AZM denominated loans in periods of appreciation of the USD against the AZM)

6. Financial and operational results

The analysis of the financial performance of AC is based on audited financial statements (FS) for 2005 and on non-audited FS for 2003; 2004 was analyzed combining the audited FS of the period May-December with the internal FS relative to January-April[20].



The **profitability** of AC in 2005 is **positive**, but is based on **thin margins**. The ROA is equal to 2.4%, while the ROE reaches 4.6% due to the low leverage (0.8). In 2005 the financial performance recovered from the drop registered in 2004, allowing AC to reach operational self sustainability again (105%).

The **impact of adjustments** on the profitability of AC is **relevant** and is mainly due to the **inflationary** economy of Azerbaijan: the inflation adjustment accounts for the 75% of the total variation of net income. Other adjustments are related to the subsidized cost of funds and to some in kind subsidies received. **AROE** is equal to **-10.6%** while **AROA** is **-5.75%**. The opposite trend of ROE and AROE in the last two years is due to the higher relative impact of adjustments on AC's results. AC was financially self sustainable in 2003, but the negative trend of 2004 was not fully recovered in 2005; **FSS** is now equal to **96%**.

Financial Indicators (USD)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05
Operating expenses ratio (aver. gross portf.)	**39.6%**	**44.1%**	**32.7%**
Staff allocation ratio	31.1%	33.8%	36.0%
Loan officer productivity (borrowers, average)	206	208	209
Loan officer productivity (amount, average)	72,061	70,342	81,261
Cost per loan lent	108	109	100
Cost per borrower	139	149	127
Funding expense ratio*	**1.8%**	**3.3%**	**1.4%**
Provision expense ratio	**0.9%**	**0.5%**	**0.1%**
Portfolio yield (gross portfolio)	**44.2%**	**45.4%**	**41.9%**

If the **productivity is satisfactory**, the **efficiency** of AC operations presents **room for improvements**. In both respects, the already mentioned trend of decreasing performance in 2004 and recovery in 2005 is confirmed.

Loan officers' productivity is good, but the rather low staff allocation ratio represents an obstacle to efficiency. In 2005, the **operating expense ratio is still high**, equal to **32.7%**, while the **provision expense ratio**, thanks to the excellent portfolio quality, is **very low** (**0.1%**). After the rise registered in 2004[21], the **funding expense ratio** decreased again down to **1.4%** in 2005. The portfolio yield is declining over time, but in 2005 it is high enough (41.9%) to cover the operating, provisioning and funding expenses. Nonetheless, the **7.8% margin** left is compensated by the **cost of inflation**[22] (7%), whose effect of capital erosion should be considered.

It is also worth mentioning that the significant **improvements of AC performance in 2005** with respect to 2004 is also due to the following factors: on one hand, 2004 presented a heavier cost structure due to the MIS investments and to the **more expensive sources of funds**; on the other hand, some expected expenses were not beared thanks to the decree that **exempted MFI from**

[20] See chapter 2, accounting policy and procedures, for explanations.

[21] The loan borrowed from Sandy River remained unused on AC bank account until AC was transformed into a LLC (April 2004). Then AC was able to start using the funds and the interest was paid starting from July 2004.

[22] Calculated as the portion of capital eroded by inflation in 2005 divided by the average gross portfolio.

paying social taxes and to the fact that during 9 months the **CEO position remained vacant**. Considering this, and given the expected growth of the cost of funds and the decline of the portfolio yield, it is crucial for AC to improve the cost effectiveness of the organizational structure.

7. Strategic objectives and financial needs

Strategic objectives and strategies

The CEO prepared a **business plan** for the period **2006-2008**, including market as well as institutional analysis; the **financial projections** are prepared with Microfin for the same period but have not been recently updated since they largely depend on funding opportunities. The preparation of different scenarios and the conduction of sensitivity analysis on the most crucial variables represent areas of further improvement.

As shown in the table below, AC plans to **increase its portfolio by 34% per year** in the period covered by the business plan. The moderate projected growth would be fed in the first year by a balanced **growth of equity**[23] **and borrowings**, while for thbe following periods it will be based on a slight increase of leverage. The planned access to commercial borrowings will make the **cost of funds increase** and competition will put **downward pressure on AC's portfolio yield**. However, according to the management plans, thanks to the economies of scale allowed by growth, the **operating expense ratio will decrease** down to 20.8% in 2008, with the result that **OSS will reach 134%** in three years. On the other hand, financial self sustainability will not be reached in the medium term.

Projected key financial indicators	Actual Dec2005	2006	2007	2008
Gross portfolio (US$)	2,330,146	3,123,610	4,199,917	5,653,458
Growth of portfolio (in US$)	13.3%*	34.1%	34.5%	34.6%
Number of active clients	5,830	8,065	10,264	13,375
Portfolio yield	41.9%	36.1%	33.7%	30.7%
Growth of equity	10.4%*	31.3%	13.8%	19.9%
Debt to equity ratio	0.8	0.8	1.2	1.3
FSS	96.0%	91.0%	87.0%	92.0%
OSS	105%	127%	124%	134%
Operating expense ratio	32.7%	29.3%	25.0%	20.8%

*Growth in AZM

In order to reach these objectives, AC strategy will focus on **growing in rural areas**, where the market demand and AC supply have more potential, establishing **new satellite offices** and **branches** to increase the outreach (including the transformation of the two sub-branches into branches). Investments in terms of credit staff and MIS will need to be carried out: the implementation of EMerge in the remaining branches and the integration between it and the accounting system will become a priority as soon as the human resources in the organization will be ready to manage the changes. Among the strategic objectives of AC there is also the development of the SC, of the marketing and of the internal audit function.

In the near future, **VisionFund International (VFI),** a micro-finance fund fully owned by WVI, **may acquire the share owned by WV International**, with the advantages for AC of benefiting from VF expertise in microfinance.

Financial needs

AC's financial needs for 2006 are worth of about **USD 1.3m**. Mainly thanks to the contacts established by the newly appointed CEO, the following funding opportunities are outlined:

- Long term loan from **VFI**, USD 1m – 1.5m, at maximum 7.5%;
- Short term loan from **BlueOrchard**, USD 200-300,000;
- Short term loan from **Symbiotics**, USD 500,000;

Like several MFIs in the country, AC is monitoring the evolution of the **Asian Development Bank**[24] **project**, which will include a long term investment worth of USD 25m in Azerbaijan at market interest rate. Moreover, the **SCRI** may agree on prolonging the USD 105,500 loan, half of which is to be repaid in 2006. Negotiations are also ongoing with **KFW** and **Novib**.

[23] The increase of equity will probably come from the transformation of the USD 315,000 loan from WV into capital, and from the capitalization of retained earnings.
[24] The overall project is worth US$25 million including both financing and technical assistance to MFIs.

8. Details of the risk factors

According to our analysis, the main **risk factors** of AzerCredit are the following ones:

AREA	Risk factors	Relevance*	Main measures implemented and/or to implement in the short term	Observations
External environment	Uncertainties in the legal framework	Medium-low	AC is lobbying the Parliament through AMFA.	A specific microfinance law is currently lacking and it is not clear when MFIs will start paying social taxes.
	Ineffective credit bureau	Medium-low	The informal exchange of information is widespread among MFIs operating in the same area.	The involvement of financial institutions is limited and members are only required to register loans larger than USD 1,000
	Growing competition in Baku and Ganja	Medium	Future growth will be based on the large rural demand.	The presence of MFIs in urban areas is increasing.
Governance, management and operations	Inadequate composition and dimension of the Supervisory Council	High	The CEO, supported by WVI, is in charge of identifying two local experts with legal/banking background.	None of the three members is Azeri, and none is expert of the local legal/fiscal environment. Just one member is resident in Azerbaijan.
	Top management deeply involved in operations, not focused enough on strategic development	Medium	A position of internal auditor will be created and the financial department will be enhanced.	The operating needs of AC are currently limiting the focus on strategic issues of the deputy CEO and of the financial manager.
	Sensible staff turnover	Medium	The financial department is developing a bonus system and a HR/legal advisor has been recently hired.	-
	Lack of internal audit position and manual	Medium	The Audit Committee is currently recruiting an internal auditor and is in charge of developing an audit manual.	The shortcomings in the MIS, cash handling and the necessity for the management to focus on strategic risk management call for a rapid recruitment of an internal auditor.
	Partial implementation of a new loan tracking system, poor reporting and lack of integration with the accounting system	High	EMerge will be implemented in the two remaining branches by October 2006. The MIS manager will participate to specific trainings.	The MIS department, partly unfamiliar with EMerge, is not expressing a large part of the reporting potential of the system.
	Improvable back-up and security procedures	Medium	AC is currently revising its cash and gold limits.	Cash and gold procedures not fully compliant with NB regulation. Non systematic approach to back-ups.

Financial products and asset quality	*Rigidities in loan product*	**Medium-low**	Some degree of flexibility may be introduced to retain good clients.	Gold requirements, weekly cycles for the issue of credit and low maximum loan size may represent competitive disadvantages with individual clients.
	Lack of marketing and product development functions	**Medium**	A marketing manager position may be created in 2007.	The shortage of funds has been preventing AC from conducting systematic marketing research and from developing a diversified range of products.
Financial structure and ALM	*Portfolio concentration in agriculture*	**Medium-low**	-	No specific policy exists on portfolio concentration in agriculture. Agro-lending represents 57% of portfolio and its share may increase with the expansion of operations.
	Lack of experience in commercial borrowing	**Medium-low**	The current funding strategy includes the building of a commercial credit history.	-
	Foreign currency risk	**Medium-low**	-	AC presents a negative net position with respect to the USD worth of 5% of total assets.
Financial and operational results	*Thin profit margins, under the pressure of future increase of funding expenses and decline of portfolio yield*	**Medium-high**	The planned growth will produce economies of scale.	The operating expense ratio is still high and the staff allocation could be improved. The increasing competition and planned access to commercial funds may hamper AC sustainability.
Strategic objectives and future evolution	*Limited growth during the past years*	**Medium**	The newly appointed CEO is active in fundraising and some opportunities have already been identified.	The stagnation experienced in the last years due to the shortage of funds may have affected the internal and external image of the organization.

Annex 1 - Financial statements

Azer Credit				
	non audited	audited	audited	audited
Balance sheet (US$)	**Dec-03**	**Apr-04**	**Dec-04**	**Dec-05**
ASSETS				
Cash and bank deposits	190,554	69,128	268,754	217,323
Short term financial assets	-	-	-	-
Net outstanding portfolio	1,443,747	1,562,930	1,911,199	2,312,652
Gross outstanding portfolio	1,463,073	1,587,250	1,926,976	2,330,146
Performing portfolio	1,445,306	1,567,779	1,909,837	2,308,977
Portfolio at risk > 30 days	17,767	19,471	17,140	21,169
(Loan loss reserve)	19,326	24,320	15,777	17,494
Accrued interest	-	-	10,445	16,005
Other short term assets	731,731	734,661	4,746	2,605
Total short term assets	**2,366,032**	**2,366,719**	**2,195,143**	**2,548,586**
Long term financial assets	-	-	-	-
Net fixed assets	47,165	46,974	38,593	32,340
Other long term assets	-	-	-	-
Total long term assets	**47,165**	**46,974**	**38,593**	**32,340**
Total assets	**2,413,197**	**2,413,693**	**2,233,737**	**2,580,925**
LIABILITIES and EQUITY				
LIABILITIES				
Sight deposits	-	-	-	-
Short time deposits	-	-	-	-
Short term loans	110,000	85,000	65,574	99,160
Other short term liabilities	822,574	812,502	107,938	96,854
Total short term liabilities	**932,574**	**897,502**	**173,512**	**196,014**
Long term time deposits	-	-	-	-
Long term loans	315,000	315,000	859,989	970,272
Other long term liabilities	-	-	-	-
Restricted funds	-	-	-	-
Total Long term liabilities	**315,000**	**315,000**	**859,989**	**970,272**
Total liabilities	**1,247,574**	**1,212,502**	**1,033,501**	**1,166,287**
EQUITY				
Paid-in capital from shareholders	-	-	4,938	5,271
Donated equity	1,263,464	1,263,464	1,183,371	1,269,862
Quasi-capital	-	-	-	-
Reserves	-	-	-	-
Total retained earnings	- 41,246	- 4,076	19,662	139,506
Other equity accounts	- 56,595	- 58,108	- 7,735	-
Total equity	**1,165,623**	**1,201,280**	**1,200,236**	**1,414,639**
Total liabilities and equity	**2,413,197**	**2,413,782**	**2,233,737**	**2,580,925**

Annex 1

Azer Credit				
	non audited	non audited	audited	audited
Income Statement (US$)	**Jan03-Dec03**	**Jan04-Apr04**	**May04-Dec04**	**Jan05-Dec05**
Interest & commissions received on loans	652,245	219,956	513,180	919,873
Financial revenue from investment		-	-	
Other financial revenues	-	-	22,229	1,374,198
A) Financial revenue	**652,245**	**219,956**	**535,409**	**2,294,071**
Interest paid on borrowings	26,943	8,211	44,750	30,322
Interest paid on savings	-	-	-	-
Interest paid on mortgage	-	-	-	-
Other financial expenses	941	-	21,508	1,445,451
Inflation adjustment	-	-	-	-
B) Financial expenses	**27,885**	**8,211**	**66,258**	**1,475,773**
Gross financial margin (A - B)	**624,361**	**211,746**	**469,151**	**818,298**
Loan loss provision	12,686	4,971	2,765	1,729
Net financial margin	**611,675**	**206,775**	**466,387**	**816,569**
Other operating revenue	19,314	3,669	17,714	8,518
Personnel expenses	360,377	126,923	322,610	418,307
Administrative expenses	225,255	76,264	186,459	298,079
C) Operating expenses	**585,632**	**203,187**	**509,069**	**716,386**
Net operating income	**45,356**	**7,257**	**- 24,968**	**108,701**
Extraordinary revenue	-	-	-	-
Extraordinary expense	-	-	-	-
Net income before donations, before tax	**45,356**	**7,257**	**- 24,968**	**108,701**
Taxes	-	-	-	46,654
Net income before donations	**45,356**	**7,257**	**- 24,968**	**62,047**
Donations in cash	-	30,733	-	-
Revenue not from the operations	-	-	895	64,728
Expenses not from the operations	-	-	-	-
Net income	**45,356**	**37,990**	**- 24,074**	**126,774**

Annex 2 - Financial statements' adjustments

The financial statements in Annex 1 are the result of **standard reclassification**. They are based on audited financial statements according to international standards, except for the FS for the periods Jan-Dec03 and Jan-Apr04, which were not audited.

Financial statements have been then adjusted to allow a comparison with other institutions which use a different logic of presentation of the information and to evaluate the level of sustainability of the institution at market conditions and prices.
The main adjustments normally are:

- adjustment for the accrued interest on delinquent loans > 90 days
- elimination of subsidies (donations in kind[25] and soft loans[26])
- provisions are calculated with a standard formula[27]
- adjustments for inflation
- adjustments for write-offs

Adjustments (US$)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05
Subsidized cost of fund adjustment	-	-	**48,272**
- Interest rate used (national currency)	11.6%	11.8%	12.8%
- Interest rate used (foreign currency)	4.4%	5.1%	7.0%
Inflation adjustment	**23,080**	**79,890**	**154,486**
- Inflation rate used	2.2%	6.7%	11.8%
Loan loss provision adjustment	-	-	**379**
In-kind subsidy adjustment	-	-	**1,650**
Total variation of net income	23,080	79,890	204,787

AC does not accrue interests on loans late more than 90 days. The audited financial statements (Apr05-Dec05) do accrue interests but not on past due loans, thus related adjustments are not required. For the FY 2005, an adjustment for the subsidized cost of funds was made, to counterbalance the use of concessionary loans; moreover, a small cost was introduced to take into account the in-kind support received (training). The bulk of the adjustments to the FS is related to inflation: the relevant increase of the consumer price index, combined with the large role of equity in sustaining AC operations, makes this adjustment accounting for about 75% of the total variation of net income.

Write off adjustment	6,741	13,288	14,474

The write-off adjustment does not have a direct effect in terms of net income variation. However, the **write-off adjustment** represents the amount of loans past due more than 180 days which, according to the best standards in microfinance, should be written-off and so deducted from the outstanding portfolio.

[25] Donations in kind are valorized and added to operational expenses.
[26] In the income statement it is registered the value of the difference between financial costs of the institutions and financial cost evaluated at the market rate. In particular, in the case of loans in local currency, it is considered 75% of the average lending rate in the national market (IFS Line 60P). In the case of loans denominated in foreign currencies (US$ and Euro), it is considered the average value of LIBOR 1 year plus 3%.
[27] Provisions are calculated according to the following formula:

Portfolio:	1-30 days	10%	Restructured loans	1-30 days	50%
	31-60 days	30%		> 1 day	100%
	61-90 days	50%			
	>90 days	100%			

Annex 3 - Financial ratios

AzerCredit (USD)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05
PROFITABILITY			
Return on Equity (ROE)	4.2%	-1.4%	4.6%
Adjusted Return on Equity (AROE)	2.1%	-8.2%	-10.6%
Return on Assets (ROA)	2.0%	-0.6%	2.4%
Adjusted Return on Assets (AROA)	1.2%	-4.2%	-5.7%
Operational self-sufficiency (OSS)	107.2%	97.8%	105.0%
Financial self-sufficiency (FSS)	103.4%	88.8%	96.0%
Profit Margin	6.8%	-2.3%	4.7%
LOAN PORTFOLIO QUALITY			
Portfolio at risk (PAR30)	1.2%	0.9%	0.9%
Arrears rate (> 1 day)	1.1%	0.8%	0.7%
Restructured loans	0.0%	0.0%	0.0%
Provision expense ratio	0.9%	0.5%	0.1%
Loan loss reserve ratio	1.3%	0.8%	0.8%
Risk coverage ratio (30 days)	107.1%	92.1%	82.6%
Write-off ratio	1.3%	0.0%	0.0%
Adjusted write-off ratio	1.8%	0.8%	0.7%
EFFICIENCY AND PRODUCTIVITY			
Staff allocation ratio	31.1%	33.8%	36.0%
Loan officer productivity (borrowers)	232	200	216
Loan officer productivity (amount)	77,004	71,369	86,302
Staff productivity (borrowers)	72	67	78
Staff productivity (amount)	23,985	24,087	31,069
Operating expenses ratio (average gross portf.)	39.6%	44.1%	32.7%
Cost per loan lent	108	109	100
Cost per borrower	139	149	127
Personnel expenses ratio (average gross portf.)	24.4%	27.8%	19.1%
Admin. expenses ratio (average gross portfolio)	15.2%	16.3%	13.6%
ASSETS/LIABILITIES MANAGEMENT			
Portfolio yield (gross portfolio)	44.2%	45.4%	41.9%
Funding expense ratio*	1.8%	3.3%	1.4%
Cost of funds ratio*	5.4%	8.1%	3.2%
Provision for inflation (average gross portfolio)	0.0%	0.0%	0.0%
Adjusted provision for inflation (av. gross port.)	1.6%	4.9%	7.0%
Current ratio	2.54	12.65	13.00
Liquidity over total assets	7.9%	12.0%	8.4%
Debt/equity ratio	1.07	0.86	0.82
Equity multiplier	2.1	1.9	1.8
Capital adequacy ratio	48.3%	53.7%	54.8%
OUTREACH			
Average disbursed loan size	494	522	585
Average disbursed loan size on per-capita GDP	56.3%	51.0%	38.2%
Percentage of active borrowers women	32.9%	33.4%	35.6%
GROWTH (amount in US$)			
Growth of active gross portfolio	4.4%	31.2%	13.3%
Growth of active borrowers	15.6%	22.2%	8.2%
Growth of total assets	47.9%	-7.8%	8.2%
Growth of staff	-15.3%	31.1%	-6.3%
Growth of funding liabilities	-28.1%	116.9%	8.2%
Growth of operating expenses*	na	21.2%	-5.9%
Growth of equity	18.9%	2.6%	10.4%

na = non available; *exchange rate variations are not included in the calculation of the ratio

Annex 4 - Definitions

	Description of the ratio	Formula
Profitability	**Return on equity (ROE)**	Net income before donations / Average equity
	Adjusted return on equity (AROE)	Adjusted net income before donations / Average equity
	Return on assets (ROA)	Net income before donations / Average assets
	Adjusted return on assets (AROA)	Adjusted net income before donations / Average assets
	Operational self-sufficiency (OSS)	(Financial revenue + Other operating revenue) / (Financial expenses + Loan loss provision expenses + Operating expenses).
	Financial self-sufficiency (FSS)	(Adjusted financial revenue + Other operating revenue) / (Adjusted financial expenses + Adjusted loan loss provision expenses + Adjusted operating expenses)
	Profit margin	Net operating income / operating revenue
Portfolio quality	**Portfolio at Risk (PAR30)**	Portfolio at Risk > 30/ Gross outstanding portfolio
	Provision expense ratio	Loan loss provision expenses / Average gross portfolio
	Loan loss reserve ratio	Accumulated reserve / Gross portfolio
	Risk coverage ratio (>30 days)	Accumulated reserve / Portfolio at risk >30 days
	Write-off ratio	Write-off of loans / Average gross portfolio
Efficiency and productivity	**Staff allocation ratio**	Loan officers / Total staff
	Loan officer productivity – Borrowers	Number of active borrowers / Number of loan officer
	Loan officer productivity – Amount	Gross portfolio / Number of loan officer
	Staff productivity – Borrowers	Number of active borrowers/ Number of staff
	Staff productivity – Amount	Gross portfolio / Number of staff
	Operating expenses ratio	Operating expenses / Average gross portfolio
	Cost per borrower	Operating expenses / Average number of borrowers
	Administrative expenses ratio	Administrative expenses / Average gross portfolio
	Personnel expenses ratio	Personnel expenses / Average gross portfolio
Financial management	**Portfolio yield**	Interest income from portfolio / Average gross or net portfolio
	Funding expense ratio	Interests and fee expenses on funding liability / Average gross portfolio
	Cost of funds ratio	Interest expenses on funding liability / Period average funding liability
	Current ratio	Short term assets / Short term liability
	Debt/Equity ratio	Total liability / Equity
	Capital adequacy ratio	Total equity / Total assets
Outreach	**Average disbursed loan size**	Amount issued in the period / Number of issued loans
	Average disbursed loan size on per-capita GDP	Average disbursed loan size / Per-capita GDP

Other definitions:

Funding liability: Liability that finance the loan portfolio and the cash investments necessary to manage the loan portfolio

Operating expenses: Personnel expenses + Administrative expenses

Recovery from write-off ratio: Income from write-off (payments received from loan already written-off) / Average gross portfolio

Restructuring of delinquent loans: includes rescheduling loans (extending the term of the loan or relaxing the schedule of required payments) and refinancing loans (paying off a problem loan by issuing a new loan).

Drop-out ratio: calculated as follows: (number of active clients at the beginning of the period + number of new (first time) clients entering during the period – clients written off during the period – number of active clients at the end of the period) / (number of active clients at the beginning of the period).

Annex 5 - Guidelines of reporting and accounting

Financial statements

AC does not provide non-financial services, so its financial statements reflect exclusively the results of its financial activities. Financial statements are audited by a local auditor and sent to the National Bank.

Loan loss provision and write-offs

AC sets the loan loss reserve on monthly basis, calculating the cost of provision according fixed percentages calculated on ageing categories of the portfolio at risk (outstanding balance of past due loans). The calculation is made automatically by the MIS. The cost of the provision is recorded into the income statement and is cumulated into the loan loss reserve in the balance sheet. **AC writes-off bad loans when they are late > 180 days** after the approval of the SC. So far, AC has written off 1.3% of its portfolio in 2003 and is planning to write off some old late loans in February 2006 as well.

Aging portfolio in arrears	% provision
0 days	0%
1 - 60 days	30%
61 - 180 days	60%
> 180 days	100%

Insider loans

AC does not allow the disbursement of loans to the staff and SC members.

Donations

Donations both for loan capital are put in balance sheet (equity), while donations for operating expenses are registered in income statement. In-kind donations are presented only in adjusted financial statements. As shown in the table beside, during the past three years AC jut received one donation from WVI.

Donations received (USD)

Year	Amount	Destination	Source
May-04	33,626	Fixed assets	WVI
TOTAL	1,191,935		

Details of funding liability

Dec-05

Loans borrowed

Source	Currency (in which the loan is due)	Outstanding Balance (US$)	Outstanding Balance Short term (US$)	Outstanding Balance Long term (US$)	Agreement, kind of product and collateral
UMCOR	USD	10,000	0	10,000	no collateral
WV PO	USD	315,000	0	315,000	negotiating the tranfer of principal to equity, no collateral
WV USA SANDY RIVER	USD	299,995	0	299,995	no collateral
WV MEERO	USD	25,000	25,000	0	no collateral
SCRI (from ADB)	AZM	112,758	56,379	56,379	no collateral
VISION FUND	USD	199,995	0	199,995	no collateral
SFDI(from WB)	AZM	106,684	17,781	88,903	no collateral
TOTAL		1,069,433	99,160	970,272	

Annex 5

Funding liabilities features

Source	Loan amount (USD)	Disbursement date	Maturity date	Principal repayments	Interest repayments	Interest rate
UMCOR	10,000	31/7/2001	-	-	-	0.00%
WV PO	315,000	1/12/2001	30/6/2007	-	annually	6.00%
WV USA SANDY RIVER	300,000	20/2/2004	30/6/2010	quarterly, starting 30/9/08	quarterly	4.50%
WV MEERO	25,000	10/2/2004	10/3/2006	quarterly, starting 10/12/05	quarterly	6.00%
SCRI (from ADB)	105,500	7/4/2004	7/4/2007	quarterly	-	0.00%
VISION FUND	200,000	9/12/2005	30/6/2007	baloon repayment	quarterly	6.80%
SFDI(from WB)	100,000	23/12/2003	30/4/2009	quarterly, starting 31/7/06	-	0.00%

Annex 6 - Rating Scale

Rating grade	Definition
AAA	Extremely strong capacity to meet its financial obligations. Excellent operations. Very stable and highly unlikely to be adversely affected by foreseeable events.
AA	Very strong capacity to meet its financial obligations. Very good operations. Stable and unlikely to be adversely affected by foreseeable events.
A	Strong capacity to meet its financial obligations. Very good operations. Stable even if it could be affected by major internal or external events.
BBB	Adequate capacity to meet its financial obligations. Good operations. Quite stable even if it could be affected by significant internal or external events.
BB	Limited vulnerable capacity to meet its financial obligations. Adequate operations. Quite stable even if it could be affected by internal or external events.
B	Partially vulnerable capacity to meet its financial obligations. Sufficient operations. Not completely stable and vulnerable to internal or external events.
CCC	Vulnerable capacity to meet its financial obligations. Basic operations. Potentially unstable and vulnerable to external or internal events.
CC	Highly vulnerable capacity to meet its financial obligations. Poor operations. Potentially unstable and vulnerable to external or internal events.
C	Very high vulnerable capacity to meet its financial obligations. Very poor operations. Unstable and very vulnerable to external or internal events.
D	Not able to meet its financial obligations. Insufficient operations. Very unstable and completely vulnerable to external or internal events.

The rating grade can be corrected with a + or – sign, which implies a slight positive or negative variation respect to the main grade.