MicroFinanza Rating

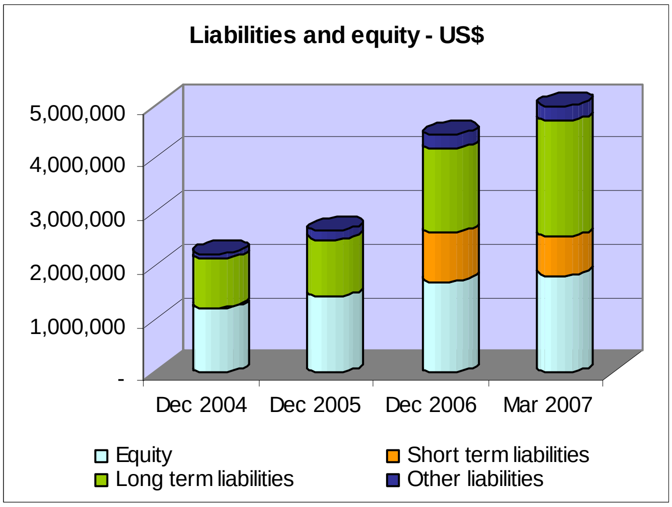
June 2007

WV AZERCREDIT – Azerbaijan

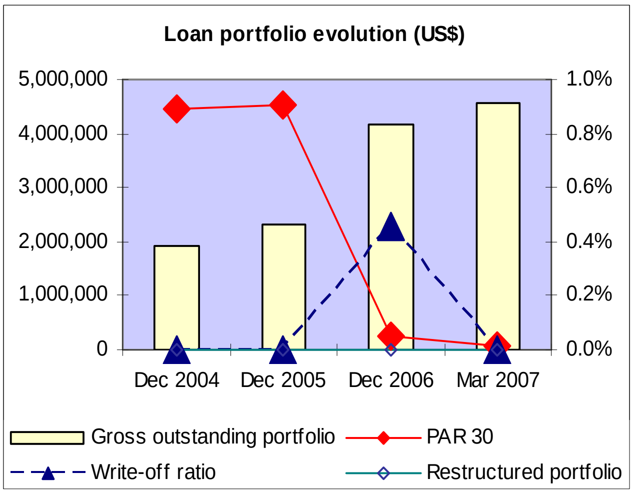
Final rating	BBB-
Second rating	Validity: 1 year if no relevant changes in operations or within the operation context will happen.
Previous rating: **BB**	April 2006

WV AzerCredit (AC) was founded in 1995 as a program of World Vision International, a relief and development organization, to provide sustainable lending services to those entrepreneurs who are not able to access credit facilities through the conventional banking system. Lending operations are carried out both in rural and urban areas and include individual and group loans, mainly targeting agriculture and the trade sector.
AzerCredit has been mainly financed by donations and concessional loans from the network of the founder and other international development agencies. Since the end of 2005, however, AC also started to access commercial sources of funding from international investors. During 2007 the ownership of AC will transfer entirely from WVI to Vision Fund, a US-based corporation owning over 40 MFIs worldwide.

Number	Dec 2005	Dec 2006	Mar 2007
Active borrowers	5,830	8,331	8,951
Branches (hubs)	5	6	6
Satellites	2	1	2
Total staff	75	91	95
Loan officers	27	31	35



Legal form	Limited Liability Company
Inception year	1995
Network of reference	World Vision International
Area of activity	Urban and rural
Credit methodology	Group and individual



US$	Mar 2007
Average disbursed loan size	749
Gross outstanding portfolio	4,564,419
Total assets	4,993,905

Financial Indicators	Dec 2005	Dec 2006	Mar 2007
PAR 30	0.9%	0.1%	0.01%
Write-off ratio	0.0%	0.5%	0.00%
Restructured loans	0.0%	0.0%	0.00%
ROE	4.6%	12.7%	16.5%
AROE	-11.0%	-0.9%	-3.0%
Oper. Self-sufficiency (OSS)	105.0%	126.0%	132.5%
Fin. Self-sufficiency (FSS)	95.8%	104.6%	103.3%
Staff productivity (borrow.)	78	92	94
LO productivity (borrow.)	216	269	256
Operating expense ratio	32.7%	27.4%	26.4%
Funding expense ratio	1.4%	2.7%	3.6%
Provision expense ratio	0.0%	-0.1%	-0.1%
Portfolio yield	41.9%	40.0%	41.4%
Risk coverage ratio	82.6%	146.9%	420.5%
Cost of funds ratio	2.9%	4.9%	6.0%
Debt/Equity ratio	0.9	1.6	1.7

As of March 2007 figures are annual

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AREA	Risk factors	Relevance*
External environment	Uncertainties in the legal framework	Medium-low
	Ineffective credit bureau	Medium-low
	Growing competition also from banks	Medium
Governance, management and operations	Supervisory Council lacks of a specific performance standard evaluation model/methodology for the assessment of the CEO	Medium-low
	Lack of risk management and internal control policies and of independent internal audit position	Medium-high
	Partial implementation of the new loan tracking system	Medium-high
	Improvable reporting on portfolio	Medium
	Improvable MIS back-up procedures	Medium
	Improvable salary level as perceived by some staff at branch level	Medium-low
	Client drop-out analysis not systematic	Medium
Financial products and asset quality	Portfolio concentration in agriculture	Medium
Financial structure and ALM	Lack of ALM policies and tools	Medium
	Maturity risk	Medium-low
	Currency risk	Medium
Financial and operational results	Negative adjusted profitability ratios and full sustainability to be consolidated	Medium
Strategic objectives and future evolutions	Lack of scenario and sensitivity analysis	Medium-low

*** 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.**

<u>Strengths</u>:	**<u>Opportunities</u>:**
➢ Excellent portfolio quality ➢ Market positioning ➢ Ownership ➢ Good growth rate in the last year and a half	➢ Operations expansion ➢ Introduction of regional managers ➢ Full implementation of the loan tracking system

Final opinion

AzerCredit is proceeding along its institutional development path and has evolved, since the last rating, with a continuous process of consolidation of its market positioning also enhanced by a diversified credit product offer. Outstanding portfolio has grown at an important rate of 70% in 2006, and portfolio quality has been maintained at excellent levels, while performances in profitability and efficiency, though clearly improved, have not yet avoided negative adjusted profitability ratios (mainly due to inflationary pressures in 2006 and beginning of 2007). Corporate governance has been strengthened in terms of Supervisory Council composition and of functioning policies. Ownership will soon transit from a relief and development NGO (World Vision) towards a regulated financial institution (Vision Fund).

The main risk factors of AzerCredit stand with the current lack of a dedicated internal audit position and, more in general, of a more structured risk management function, with the still partial implementation of the new loan tracking system, and with an improvable business and financial planning. These represent relevant issues to be faced by the institution, given the perspectives of operational scaling up and further commercialization of sources of funds.

Relevant changes respect to the previous rating

AREA	Relevant changes and comments	Trend
External Environment	Legal framework is still uncertain, as the proposed microfinance law has not been approved yet and the efficiency of the existing credit bureau has not improved. Competition in the microfinance sector is gradually growing, with the fast expansion of the main MFIs and with some commercial banks becoming more active in microfinance.	**Stable**
Governance, management and operations	During 2007, AzerCredit ownership will be transferred from World Vision International to Vision Fund International, a US-based corporation. This represents an enhancement of the institutional ownership as it will pass from a relief and development NGO to a regulated financial institution. Furthermore it opens the opportunity for multiple shareholders and enhances the fundraising capacities of the institution. AzerCredit's governance has been enhanced by the integration of three new members, among whom is the WV MED Regional Director, all of them with strong economic and financial professional background and attention to social impact. Furthermore, one of the new SC members has specific professional skills in auditing and internal control. A written SC Policy Manual has also been drafted and will be approved and officially introduced in few months. At the management level, a new marketing officer position has been created. The Marketing Officer is in charge of conducting market research, client retention analysis and developing new products. The SC has been trying to recruit an internal auditor but has not found the appropriate person even after a number of interviews. A contingency plan has been defined through the outsourcing of the function to a specialized international audit firm (Moore Stephens) until an appropriate IA profile will be identified. The MIS still has to be implemented in two branches and its reporting potential has not been fully developed. The MIS manager received specific training on the use of the E-merge and will contribute to develop its functions. A staff incentive system has been implemented and contributed to reduce staff turnover.	**Slightly positive**
Financial products and asset quality	Diversification in credit products is improving, as a new household loan product is going to be launched in one of the branches, for pilot testing, before extending it to all the branches. In 2006, AzerCredit's outstanding portfolio has grown compared to the previous year at an important rate of almost 70%, further improving its already excellent portfolio quality (PAR 30 improved from 0.91% to 0.05% during 2006) .	**Positive**
Financial structure and ALM	As of December 2006, AzerCredit has increased its Debt/Equity ratio (from 0.88 to 1.71), starting to leverage its capital. During 2007 AzerCredit is planning to increase its funding liabilities and receive commercial loans from Vision Fund, as well as from international commercial investors. A US$ 315,000 World Vision loan will most likely become equity, before the end of 2007. AzerCredit still lacks effective ALM policies and tools and is still exposed to currency risk (open position in US$ representing 23% of total equity). It also presents maturity mismatch in the aging category 31-90 days, representing about 14% of total equity.	**Slightly positive**

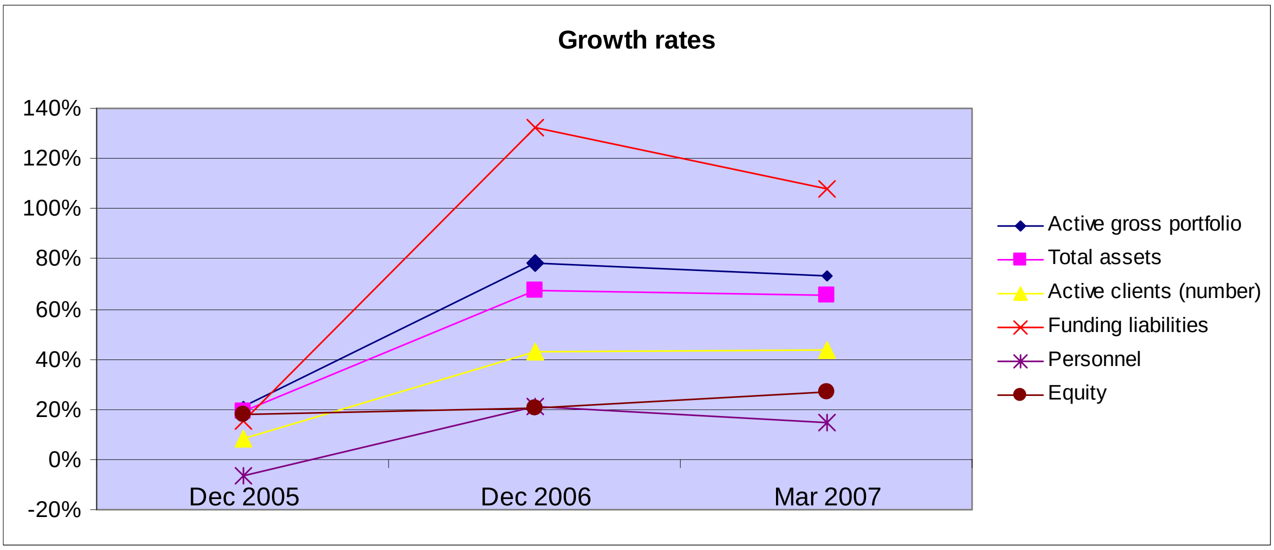
Financial and operational results	All indicators of financial and operational performance have improved in comparison to the last rating. Adjusted indicators (AROA and AROE) have greatly improved even if they remain slightly negative, because of inflation, as well as FSS is now over 100%. Profit margin increased from 4.7% to 20.7%. The loan officer productivity ratio has improved during 2006 (from 216 active borrowers per loan officer as of December 2005 to 269 as of December 2006). This seems to be an effect of the introduction of the staff incentive system. Staff productivity has improved as well. Efficiency has improved in comparison with the last rating: operating expense ratio (over average portfolio) has decreased from 32% to 27%. Both for productivity and efficiency there is still room for further improvements, contributing to the consolidation of the full self-sufficiency of the institution.	**Positive**

Strategic objectives and future evolutions	AzerCredit's financial projections have been produced for the period 2006-2010. Nevertheless the projections and the business plan document could be further up-dated. Scenario and sensitivity analysis are missing.	**Stable**

Headquarters:
Baku

Branches:
Ganja
Mingechevir
Imishli
Horadiz
Goranboy

Sub-branches:
Gazakh
Agjebadi



Benchmarking

The benchmarking exercise includes a comparison of crucial indicators with selected peer groups. The figures stem both from MicroFinanza Rating studies and from the MicroBanking Bulletin (MBB) database updated as of December 2005. AzerCredit and CREDO financial ratios indicated here do not fully correspond to the ratios presented in the report as they are calculated according to the *MicroBanking Bulletin* (MBB) methodology.[1].

Financial ratios	MicroFinanza Rating		MBB 2005		
	AzerCredit (March 07)	CREDO, Georgia (March 07)	ECA Medium Low Broad	ECA Medium High SME	Individual/ Solidarity
Gross Loan Portfolio gross loan portfolio adj for standardised write-offs (US$)	4,564,419	4,935,078	3,714,018	3,356,375	5,222,817
Average Loan Balance per Borrower on per capita GNI Average loan balance per borrower/ GNI per capita(%)	14.2%	56.5%	48.8%	336.2%	45.5%
Portfolio at Risk> 30 Days oustanding balance of loans overdue> 30days/gross loan portfolio (%)	0.01%	0.10%	1.2%	1.0%	2.3%
Adjusted Return on Equity AROE adj net operating income after taxes/avg tot equity (%)	-5.3%	-5.0%	0.8%	-0.6%	1.9%
Portfolio yield Financial Revenue from Portfolio/ Adjusted Average Gross Portfolio	41.4%	34.6%	38.9%	25.3%	31.9%
Debt/ Equity Ratio adj.tot.liabilities/adj.tot.equity	1.7	2.4	0.7	1.7	1.9
Operating Expense/ Loan Portfolio (operating expense + In-Kind donations)/avg gross loan portfolio (%)	26.4%	25.8%	25.5%	15.7%	23.3%
Borrowers per Loan Officer n. of active borrowers/n. of loan officers	256	159	182	65	223
Borrowers per Staff n. of active borrowers/n. of staff	94	74	84	32	117

All figures are referred to the MicroBanking Bulletin database updated as of December 2005
CREDO's figures refer to MicroFinanza Rating rating, as of March 2007.

Important matters of the *benchmarking*

- AC presents a deeper outreach compared to all the compared peer groups
- AC presents the lowest (almost inexistent) portfolio at risk bigger than 30 days
- Profitability, after financial adjustments, is still lower at AC compared to all the peer groups, despite the higher portfolio yield ratio. Among the main reasons there is the tough adjustment to inflation which has substantially raised in Azerbaijan in 2007
- AC has started leveraging its capital and is substantially in line with the peer groups.
- AC's operating expense ratio is the highest among the compared groups. However the trend in AC efficiency has been positive in the last years
- AC shows the best performance in terms of loan officer productivity and a good level of staff productivity. In the last indicator AC still has margins for improvement, as indicated by the performance obtained by the "individual/solidarity lending" peer group.

[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 (AC) **started its operations in 1995, as a World Vision International (WVI) project**, providing micro and small loans mostly to people working in trade and agriculture that are excluded from the formal financial sector. In 2002 WV AzerCredit registered as a non-banking credit organization and in October 2003 it obtained a licence from the National Bank of Azerbaijan. In **April 2004, the MFI was then transformed into a Limited Liability Company**, entirely owned by World Vision International. During 2007, AzerCredit ownership will be transferred to Vision Fund International, a US-based microfinance corporation fully owned by WVI. This will open the possibility for multiple shareholders and institutional growth will benefit from the access to funds on the international market.

AC's operations are partly financed by concessional loans borrowed from World Vision network, but the MFI has also recently accessed international commercial sources of funds, receiving loans from investors such as BlueOrchard, Incofin and Oikocredit.

Political and macroeconomic context

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

The independence of Azerbaijan, gained as a result of the collapse of the Soviet Union in 1991, logically grew to an unstable political and economic situation in the country, worsened by the conflict with the neighbour country Armenia. Nowadays, although there is little prospect of a resolution of the tensions with Armenia in the next few years and peace negotiations are likely to stall at least until elections in both countries are over (during 2008), **the domestic political situation is more stable** and the president is likely to consolidate its authority during the following years, ensuring himself a strong position for the next electoral competition.

The macro-economic environment is positive and economic growth is fast, mainly due to the booming oil sector and the development of the hydrocarbons industry, which have attracted huge foreign direct investment lasting recent years. This resulted in a **steady acceleration in real GDP growth** from 10.2% in 2004 to 26.5% in 2005 and 34.5% in 2006. GDP per head has more than doubled from 2005 to 2006.

Azerbaijan

Macroeconomic Indicators	Dec 2004	Dec 2005	Dec 2006	Mar 2007
Exchange rate in US$ (end of period)	0.98	0.92	0.87	0.87
Exchange rate variation	-0.4%	-6.3%	-5.1%	-0.5%
Inflation rate (average for the period)	6.7%	11.8%	9.4%	16.4%**
Deposit rate	9.2%	8.5%	10.6%	10.8%
Lending rate	15.7%	17.0%	17.9%	18.3%
Real GDP growth	10.2%	26.5%	34.5%*	na
GDP per head (US$)	1,023	1,532	3,507	na

Source: International Finance Statistics, EIU. *Estimate. na = not available
**the figure refers to the average for the period April 2006-March 2007

Rising budget expenditure and a large increase in foreign-currency inflows from oil exports are leading to a quick rise in monetary aggregates and the authorities will struggle to contain inflationary pressures. In fact, the average annual inflation sharply increased in 2005 (11.8%), while it started to decrease the following year (9.4%), thanks to a tight monetary policy and the appreciation of the local currency. However, **in January-April 2007, the inflation rate in Azerbaijan increased by 16.4%** in comparison with the same period of last year (9.6%) and the current tendency is heading for 20% for the full year of 2007. Such a sudden raise of the inflation mainly stems from Several factors ramped up prices, including the surge in petrodollars and the limited ability of the National Bank of Azerbaijan (NBA) to sterilize much of the inflow.

The agricultural sector, which represents Azerbaijan's larger employer – with around 40% of the total labour force – registered positive growth rates since 1998, but its contribution to the overall output has considerably decreased (from around 30% in the early 90s to 13% in 2002-05), both because of structural inefficiencies in the sector and the rapid development of the oil sector.

Microfinance Sector

As of March 2007, the **AMFA (Azerbaijan Micro-Finance Association) recognizes 28 microfinance institutions** (20 of whom are members of the association) operating in Azerbaijan, with a combined portfolio worth of more than 200 million USD, reaching almost 167,000 clients. These figures, compared to the data of December 2005 – total portfolio of US$ 73 millions and 70,000 active clients - demonstrate the **rapid growth of the sector** and how it is becoming **increasingly competitive**.

The leading actor - with an outstanding portfolio worth of US$ 60 million - remains the **Microfinance Bank of Azerbaijan (MFBA)**, which has shown considerable growth during the last year, especially in terms of client outreach (from 5,724 active clients as of the end of 2005 to and 23,036 clients as of March 2007). The second actor, but the first in terms of number of clients reached, with 54,627 active clients as of March 2007, is **FINCA** and the third is **AgrarCredit**.

The remaining market share is divided among smaller **MFIs, largely managed by international humanitarian organizations**, targeting micro and smaller enterprises in multiple regions of Azerbaijan.

Although the target market remains different for certain aspects, competition with commercial banks is rapidly increasing, especially in certain regions. Among the main banks offering microcredit services are **Bank of Baku**, **International Bank**, **Ata Bank** and **Bank Respublika**. Some are partner-banks of the GAF (German Azerbaijan Fund), a fund established in 2000 by German Bank of Development KfW, for the support of Azeri small and medium sized enterprises.

AzerCredit is a member of the Azerbaijan Microfinance Association (AMFA), which performs an active role in lobbying, training and benchmarking. The total outstanding portfolio of the members of the Association, as of March 2007, is worth about US$ 150 millions, and overall members are able to reach almost 125,000 clients.

Regulation and Supervision

No considerable changes have occurred in the legal framework since the last rating. The **draft of Microfinance Law submitted by the National Bank to the Parliament is still under discussion,** but is likely to be approved within the end of 2007. The next important step is to improve the regulatory and supervisory framework. This will entail drafting implementing regulations, establishing reporting requirements, and training NBA staff for effective on-site and off-site supervision of MFIs.

The approval of the Microfinance Law will bring to a more specifically defined legal framework, to the introduction ofdedicated prudential norms, and to a closer supervision from the National Bank of the organizations that will be allowed to collect savings (subject to specific requirements).

Supervision is performed by the National Bank through reports (financial statements and portfolio classification) that the MFIs are asked to submit quarterly.

According to the current regulation, all MFIs have to be legally registered as limited liability companies (LLC) and are required to pay profit taxes since 2005. However, thanks to their social orientation, they are currently **exempted by decree from paying social taxes**. Microfinance Institutions are not allowed to collect savings, unless they transform into banks.

AzerCredit does not currently participate in the Credit Register (credit bureau set up by the National Bank of Azerbaijan in 2005), which still presents inefficiencies and limited involvement of financial institutions, and given the increasing competition, this could represent a risk for potential clients' over-indebtedness. However, the risk is mitigated through the frequent informal exchange of information among MFIs operating in the same areas.

AzerCredit's market positioning

AzerCredit operates **both in rural and urban areas**, **but the emphasis is placed on providing credit to micro agricultural and trade businesses** excluded form the formal financial sector, both through group and individual lending. SME are also financed through small and medium terms loans.

AzerCredit is facing the **growth of competition** on two sides, both from existing MFIs which are rapidly expanding and from some commercial banks which are starting to penetrate the microfinance sector. In particular, a relatively **high level of dropout rate has been registered in the Mingachevir branch**, mainly due to the strong presence of the International Bank of Azerbaijan and Atabank.

Main competitors

Institution	Gross Portfolio (US$)	Products	Loan size (US$)	Loan maturity	Interest rate	Active Clients
AzerCredit	4,564,419	Group and individual	$150 - $10,000	3-18 months	3% - 5% declining	8,951
Finca	21,166,970	Group and Individual	$50 - $30,000	4-24 months	2.5% - 3.7% declining	54,627
MFBA	59,899,510	Individual	$100 - $200,000	3 - 36 months	2% - 3.5% declining	23,036
Normicro	3,318,871	Group and Individual	$200- $7,500	4-18 months	3% declining	5,049
Viator	2,784,880	Group and Individual	$100 - $5,000	3-24 months	2.75% - 3% declining	8,234
Findev	2,605,850	Group and Individual	$100 - $3,000	4-18 months	2.5% - 3.75% declining	4,098

To cope with this, AzerCredit is **systematically monitoring competition trends** in the different branches to be able to adapt its products and develop new ones in order to meet current and potential client **needs.** **AzerCredit's main countrywide competitor still remains Finca**, which operates in the same areas and has similar target clients. The MFBA, Normicro, Viator and Findev are also active in some of the areas of operations of AzerCredit. However, there is still a huge unmet demand, especially in the rural areas and among the lower segments of the population.

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

- Good relationships between clients and loan officers
- Good reputation and long experience resulting in high loyalty and trust from clients

The main **competitive disadvantages** are:

- Low product diversification
- Low flexibility of products conditions and slow reaction to changes in the market

2. Governance and operational structure

<u>Ownership and governance</u>

WV AzerCredit is a Limited Liability Company, 100% owned by World Vision International, a US-based NGO acting worldwide as a relief and development agency. However, **during 2007 its ownership will transfer to Vison Fund International,** a WV subsidiary corporation which is in the process of centralizing the ownership of all the microfinance institutions founded by World Vision International. This change in ownership represents a crucial step in AC institutional development, as it marks the **transition from a relief and development NGO towards a regulated financial institution**. Moreover, it opens up the possibility for AC to start raising both debt and equity and strengthen its fundraising capacities and growth prospects.

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 vast 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. Neil Cuthbert	**member**	He has a strong background in microfinance, having served as the global operations director of Opportunity International and director for economic recovery on World Vision's Tsunami Response Team. Mr. Cuthbert is currently Regional Director for Micro Enterprise Development at WV.
Mr. Hikmet Allahverdiyev	**member**	Mr. Allahberdiyev has a considerable experience in audits of international and local banks and development of internal control systems. Currently he is senior audit manager at Moore Stephens.
Ms. Laura Grant	**member**	Ms. Grant is president and founder of Woolykids, an easycare children clothing brand. Before starting her company Ms. Grant worked as Financial Analyst at British Petroleum and as consultant. Ms. Grant holds an MBA from Wharton.

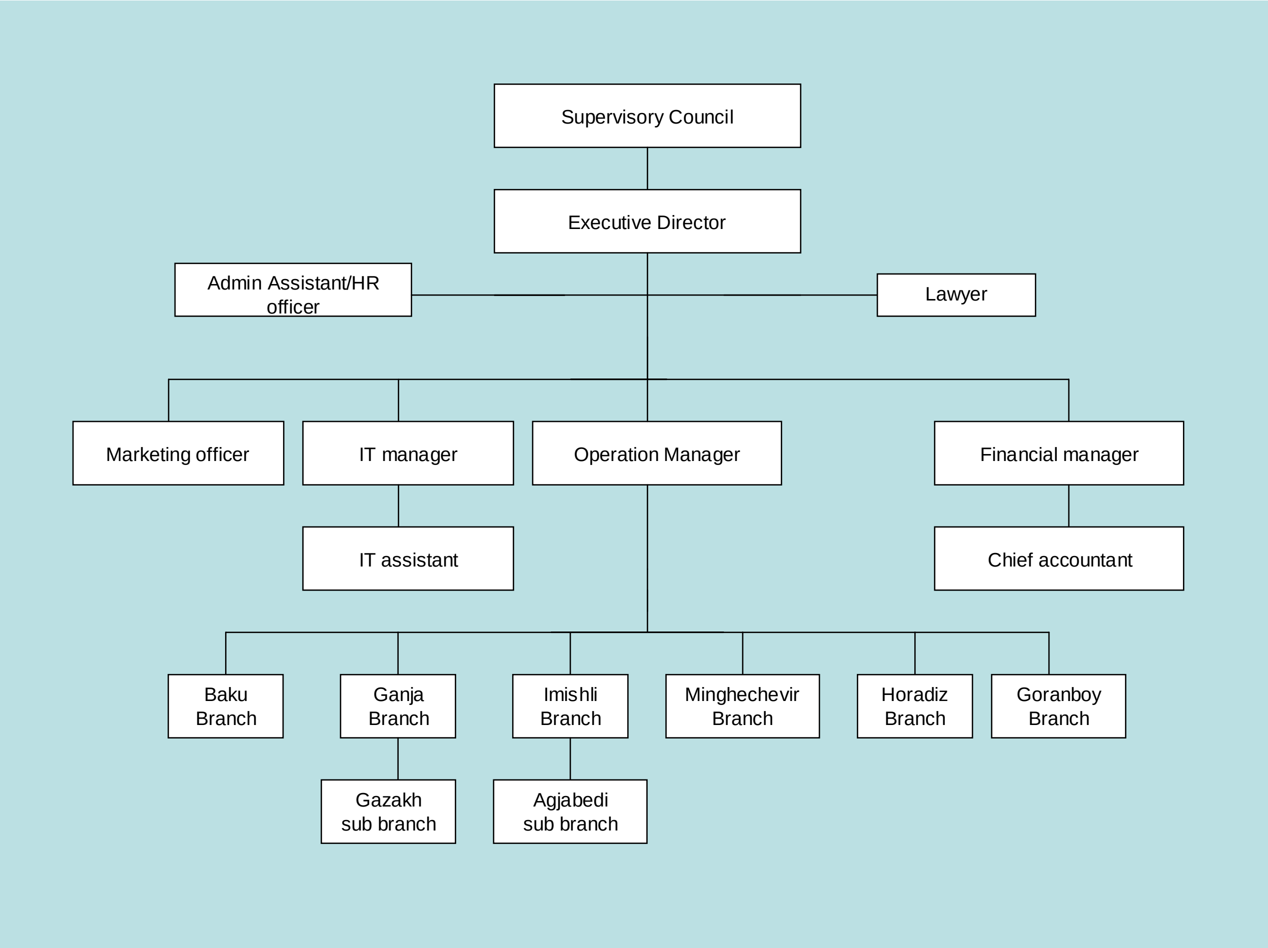
AzerCredit's governance structure and functioning have been **substantially enhanced** since the last rating. New members have been appointed to the Supervisory Council, which is now composed of 5 members, 3 of whom are WV representatives. **All the new members present strong economic and financial professional background**, as well as particular attention to social issues. One of the new SC members has specific professional **skills in internal control** and a good knowledge of the local context and he is likely to give a significant contribution to the development of the missing internal auditor position. Moreover, by the end of 2007, **AzerCredit is planning to further increase the number of SC members by identifying two local experts with legal and economic background**. A written SC Policy Manual has also been drafted and will be approved and officially introduced in few months.

Even if the responsibility to evaluate the CEO is now clearly on the SC, the same (SC) **lacks of a specific performance standard evaluation model or methodology for the periodic assessment of the CEO**.

The SC meets at least quarterly plus extraordinary meetings. Overall the **communication with the management is good** and the strategic support of the SC seems to be adequate and effective.

Organisation and structure

Since the last rating visit, AzerCredit has established **a new satellite office** (in Agjabedi, managed by the existing branch in Imishli) and the Goranboy sub-branch has been transformed into a new branch, thus deepening its outreach in the current areas of operation. Therefore, as of March 2007, AC's network consists of **6 branches and a satellite office**, and by the end of the year 2 more outlets will be created.



A higher level of decentralization will be reached through the creation of **regional manager positions, who will supervise 2 or 3 branches and the satellites**, reducing top managers' involvement in operations and enabling them to concentrate more on strategic issues.

The organizational structure has been enhanced through the creation of a **new marketing position** at management level. The newly appointed marketing officer is in charge of elaborating and managing information coming from the field in order to monitor clients satisfaction, track competition in the different branches and develop new products. A written marketing plan is still missing, but will be ready in few months. Such an evolution (i.e. the introduction of a full-time marketing position) represents an important positive improvement in the management structure of AC, considering the growing competition and the opportunity to timely penetrate and develop new market segments, and to proceed to operational expansion with a more rational approach.

Human resources

As of March 2007, AzerCredit's counts **95 employees**, out of which 35 are loan officers. The staff allocation ratio (36.8%) has not increased much since the previous rating (36% as of December 2005).

Personnel	Dec 2005	Dec 2006	Mar 2007
Total	**75**	**91**	**95**
Loan officers	27	31	35
Other staff	48	60	60

AC shows a **solid management team,** mostly coming from internal staff graduation and strongly committed to the institution. Some changes have occurred in the managerial structure: the former chief accountant has been recently upgraded to the position of Financial Manager, as the former one left the institution in November 2006. A new administrative assistant has been recruited and assigned with additional duties and responsibilities, dealing with general administrative issues and Human Resource administration, previously carried out by the legal advisor. A new part time lawyer has been appointed as well.

The top management is composed of the **CEO who is also at the head of a Georgian MFI**, belonging to Vision Fund network (CREDO VisionFund), the deputy CEO and the Financial Manager. The deputy director acts as operational manager, HR manager and performs tasks related to the internal audit for credit operations, as long as the auditor position is vacant. During the absence of the CEO, he also performs the institutional representation. The institution is aware of the **work overload for the deputy CEO** and is acting to reduce it through the recruitment for vacant positions and the creation of the regional managers.

The **training opportunities** offered to the staff are based on a systematic personnel appraisal, performed at the end of the year by each branch manager and include internal courses as well as external training mainly provided by AMFA, MFC and World Vision. Overall, the level of training is satisfactory. Furthermore, a new incentive scheme for loan officers and branch managers has been introduced since last year. The bonus applied depends on the performance in terms of output and portfolio quality, according to targets fixed in advance. The **new incentive scheme** soundly contributed to reduce the staff turnover from 17.3% as of December 2005 to 9.9% at the end of 2006 and enhanced staff productivity. Although the introduction of the bonus system has raised staff remuneration level, **salaries are still perceived to be improvable** by a part of the personnel, especially at branch level, also because of the strong inflationary pressures. However, the institution seems to be aware of this.

<u>Internal control and operational risk management</u>

The **lack of an internal audit position** and of an internal control written policy still represents an important risk for the institution. Internal control activities are currently performed by the deputy CEO and by the Financial Manager, with a consequent work overload for both positions. The control of the compliance with procedures is also carried out by the branch managers. Nevertheless, the institution is aware of the weaknesses of its internal control function and of the risks connected with the fragmentation of the audit activities and is actively dealing with these issues. The Supervisory Council is currently trying to recruit an internal auditor, but none of the persons interviewed up to now has been considered appropriate to fill the vacancy.

However, to cope with this risk, the SC has defined a **contingency plan, consisting of outsourcing the internal audit functions to a specialized audit firm** (Moore and Stephens) until an adequate auditor has been identified. The proposal has been drafted and will be discussed during the next SC meeting. Moreover, the presence in the supervisory council of an expert in internal auditing will probably facilitate the recruitment of an experienced internal auditor and the creation of an independent internal audit body reporting to the SC.

<u>Accounting policy and procedures</u>

AC's financial statements for 2006 have been audited by a local consulting and audit company (TID Consulting), which works in accordance with International Standards on Auditing. AzerCredit's internal financial statements are prepared according to Azerbaijan law in compliance with procedures and instructions of the National Bank, which in majority comply with the International Financial Reporting Standards (IFRS). Audited financial statements have been prepared based on the accrual accounting principle and the currency used is the Azeri Manat (AZM).

<u>Management Information System</u>

The loan tracking system "E-Merge" has still to be implemented in two branches (Imishli and Ganja), where a home-built system based on excel is used. One of the reasons for this delay is connected with the fact that a test of transferring disbursements and repayments operations to a bank, which has proved to be incompatible with "E-Merge", is going to be performed in these two branches. However, the installation of the system will be completed by the end of 2007, according to a **written MIS Action Plan**.

AC uses SunSystem as **accounting software, which is not integrated with E-merge**, and some errors can be produced during the data migration from E-Merge to SunSystem.
The **reporting capacity of the software has not been fully developed** yet and many portfolio reports - among which the portfolio breakdown by product - are still manually prepared. However, the IT manager has received specific training on the use of E-merge system, and should be able to customize the software and increase its reporting potential.
Back up procedures should be improved, as no copies of E-merge and SunSystem back up data are stored in a safe place outside the office and in the branches without E-merge back up is not systematically assured.

3. Lending operations

Financial products

AzerCredit provides **individual and group loans** to urban and rural micro and small enterprises with the mission of supporting them in strengthening their business and creating employment. The characteristics of the different credit products offered are summarized in the table beside.

Nearly **75% of the total gross portfolio consists of individual loans** and only 5% are loans provided to small and medium enterprises. AC's future strategy will be to strengthen agricultural lending, which today accounts for nearly 50% of the total outstanding portfolio.

Although most of the loans are in US$, some branches also provide credits in local currency, in order to satisfy clients' repeated requests to receive funds in Manat.

Credit methodology

Credit products	Group	Micro	Small
Credit methodologies	Group	Individual	Individual
Currency of the credit	AZN/USD	AZN/USD	AZN/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
Description of 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$)	1,380	2,300	9,200
*Average credit amount (US$)**	447	697	697
Min. loan maturity (months)	3 months	3 months	3 months
Max. loan maturity (months)	12 months	12 months	18 months
Average loan maturity (months)	na	na	na
Periodicity of interests payments	Monthly	Monthly	Monthly
Periodicity of principal payments	Monthly	Monthly	Monthly
Grace period (months)	6 months for agriculture	6 months for agriculture	up to 9 months
Collaterals / guarantees	Group solidarity, home assets, livestock, personal guarantee, jewellery	Home assets, personal guarantee, jewellery	Real estate, personal guarantee, jewellery

*Average loan amount disbursed during 2006

AzerCredit is going to diversify its products range, both by increasing existing products' flexibility (in terms of maximum loan size, interest rate and loan maturity) and through the introduction of new services, according to the demand characteristics in the different areas of operation. In particular, **a new household loan product** is going to be tested in the Imishli branch within the next few months, before being launched in all the branches. According to the new products procedures, a client wishing to buy an item in a specific shop (which previously signed an agreement with AC) might benefit from a loan carrying 3% declining monthly interest rate, for a maximum maturity of 12 months, giving the purchased good as a pledge.

Lending procedures

The assessment of client capacity of repayment (made through cash-flow analysis of its business and household) and the monitoring of clients are **adequate and effective**.

The loan processing and disbursement time has been reduced and is now comprised between 3 and 5 days for first loans, mainly thanks to the fact that in some branches the application day is no longer fixed. Overall, **loan processing time** is in line with competitors.

Branch Managers can approve (without notification to Head Office) loans up to US$ 10,000. However, for loans exceeding US$ 5,000, the Branch Manager needs to inform the Deputy Director and provide loan documents if required. The Credit committees usually meet once a week. Loans disbursements and repayment are still done at AC branches, but the institution is considering the possibility to externalize these operations to banks.

Collateral and accessibility

A wide range of collaterals are accepted, such as home assets, livestock, personal guarantee, jewelry and real estate. **The minimum value of collateral must represent at least 100%** of the loan amount, which is higher in comparison to some competitors.

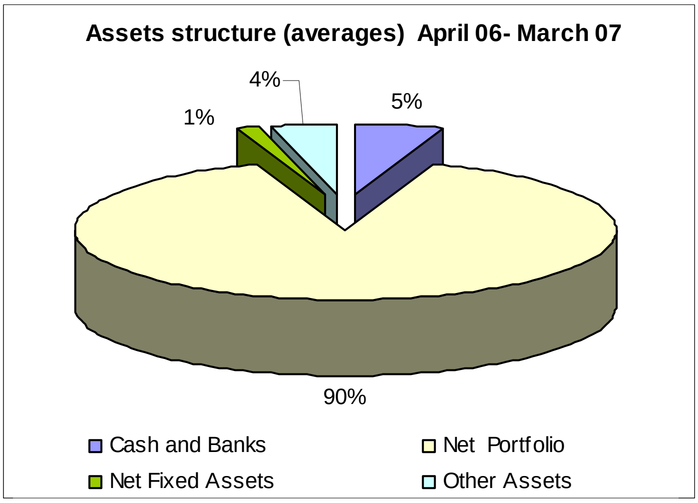
4. Assets structure and quality

Assets structure

As for the period April 2006-March 2007, AC's average net portfolio represents 90% of the total assets maintaining a very **good level of concentration of resources** in the core business..

Liquid assets in cash and banks are kept low, standing, on average, around 5%, decreasing from previous values of 8% (as of December 2005). Such a low level of liquidity can be explained by the fact that AC is not collecting savings and consequently does not need to keep large amounts of liquid assets.

Average net fixed assets represent 1% of total assets.



Portfolio structure

As of March 2007, AC's outstanding portfolio stands at 3,961,459 AZN (around US$ 4,5 million). The biggest share of the portfolio is constituted by individual loans (including micro and small loans), while the remaining 25% is represented by group loans.

Portfolio features	2004	2005	2006	Apr 2006- Mar 2007
Gross outstanding portfolio (US$)	**1,926,976**	**2,330,146**	**4,161,029**	**4,564,419**
Group methodology	579,304	685,646	1,013,507	1,122,803
Individual methodology	1,347,672	1,644,502	3,147,522	3,441,616
Gross outstanding portfolio (AZN)	**1,889,593**	**2,140,472**	**3,628,001**	**3,961,459**
Growth of active gross portfolio	31.7%	20.9%	78.6%	73.1%
Average disbursed loan amount (US$)	515	615	716	749
Av. disbursed loan size on per capita GDP	50.3%	40.2%	20.4%	na
Average maturity (months)	11	12	11	11
Number of active borrowers	5,387	5,830	8,331	8,951
% of active borrowers women	33.4%	35.6%	38.1%	38.1%
Drop-out ratio	33.7%	40.8%	30.3%	25.2%

After the limited growth registered during 2005 (20.9%), AC's **portfolio growth rate returned to an important level during 2006** (78.6% during 2006), fuelled by the access to new external borrowing. The average disbursed loan amount has been increasing during the years, but has not been high enough to compensate the huge growth of per capita GDP. This resulted in a decreasing relative loan size (from 50.3% at the end of 2004 to 20.4% as of December 2006).

The number of active borrowers has grown soundly over the years (especially during 2006, when they increased by 42.9%) and the share of female clients increased as well (38.1% as of March 2007).

Looking at the breakdown of the total portfolio by sector, **the share of agricultural portfolio** has decreased form the previous rating (from 57% as of December 2005 to 49.7% as of March 2007), in favour of a growth of the portfolio financing trade activities (from 28.8% to 34.9%). However, there is still a **portfolio concentration in agricultural lending**,

March 2007

By sector	outstanding portfolio (US$)	% of outst. portfolio	% number of borrowers
Trade	1,592,516	34.9%	28.6%
Service	554,140	12.1%	11.4%
Production	147,356	3.2%	3.4%
Agriculture	2,270,407	49.7%	56.6%
TOTAL	4,564,419	100%	100%

which is not regulated by a specific internal policy.
The clients **drop out ratio**, after the significant growth registered during 2005 (up to 40.8%), shows a reduction in the following periods analysed, reaching about 25% in the period April '06-March '07. This positive tendency is likely to continue in the future, as a more systematic analysis of dropout reasons will be conducted by the newly appointed marketing officer, through specific exit surveys and customer satisfaction focus groups.

The biggest branch, as of March 2007, is Ganja with a share of 26.3% over the total value of portfolio. Goranboy, which manages only 6.8% of the total outstanding and 9.4% of the total borrowers, is the smallest, due to the fact that it has only recently been transformed from sub-branch to branch. However, overall, **AzerCredit presents a good diversification of credit risk among different branches** and different geographical areas.

March 2007

Branch	outstanding portfolio (US$)	% of outst. portfolio	% number of borrowers	PAR > 30 days
Baku	881,952	19.3%	12.7%	0.00%
Ganja	1,199,458	26.3%	26.0%	0.04%
Mingechavir	453,695	9.9%	11.3%	0.00%
Goranboy	309,555	6.8%	9.4%	0.00%
Imishli	911,304	20.0%	19.3%	0.00%
Horadiz	808,454	17.7%	21.3%	0.02%
TOTAL	4,564,419	100%	100%	

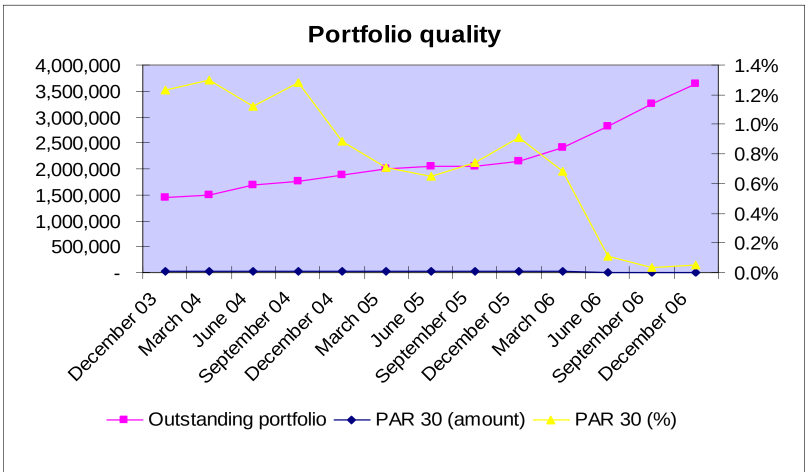
Analysing the **portfolio breakdown by amount,** 35.4% of total outstanding portfolio is concentrated in the bracket AZN 500 – 1,000, with more than 90% out of the total number of issued loans smaller than AZN 1,000. The share of bigger loans (over 1,000 AZN), which as of March 2007 represent 9,2% of total outstanding portfolio, has not much increased since March 2006 (when it accounted for 7.9%).

March 2007

By amount (AZN)	outstanding portfolio (US$)	% of outst. portfolio	% number of credits	PAR > 30 days
below 100 AZN	81,606	2.1%	9.3%	0.02%
101-500 AZN	1,347,292	34.0%	51.6%	0.16%
501-1,000 AZN	1,400,772	35.4%	29.9%	0.0%
1,001 - 3,000 AZN	1,012,549	25.6%	7.4%	0.0%
3,001-5,000 AZN	119,240	3.0%	1.8%	0.0%
over 5,000 AZN	0	0.0%	0.0%	0.0%
TOTAL	3,961,459	100%	100%	

<u>Loan portfolio quality</u>

AzerCredit portfolio quality is excellent with a consolidated PAR30 of 0,01% and a PAR1 of 0,2% as of March 2007.



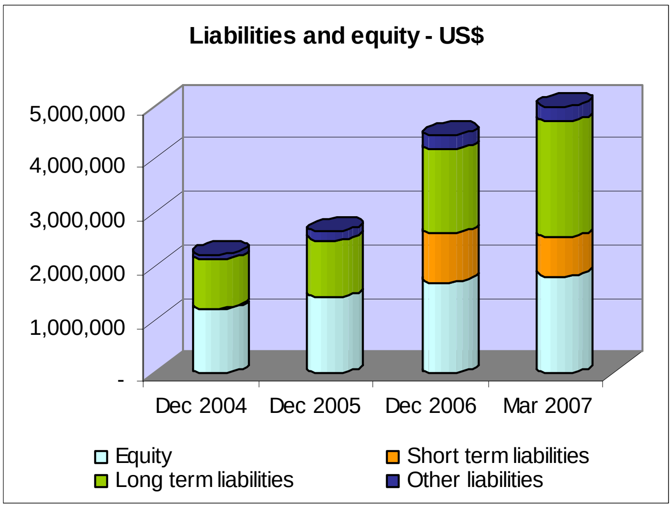
It is worth noting that, since December 2005, the trend of portfolio quality (which was already very good, with a PAR30 of 0.9%) has been very positive, partly enhanced by a write-off operation implemented during 2006.

The **risk coverage ratio (>30 days) has soundly increased** over the years of analysis. Moreover, considering that a significant part of the portfolio is backed by gold, the risk of loan losses is well managed.

Portfolio Quality Indicators	2004	2005	2006	Apr 2006- Mar 2007
Consolidated PAR30	**0.89%**	**0.91%**	**0.05%**	**0.01%**
31-60	0.07%	0.19%	0.03%	0.01%
61-90	0.07%	0.03%	0.02%	0.00%
91-180	0.06%	0.07%	0.00%	0.00%
181-365	0.69%	0.62%	0.01%	0.00%
>365	0.00%	0.00%	0.00%	0.00%
Arrears rate (> 1 day)	1.6%	1.4%	0.1%	0.0%
Restructured portfolio	0.0%	0.0%	0.0%	0.0%
Provision expense ratio	0.5%	0.0%	-0.1%	-0.1%
Loan loss reserve ratio	0.8%	0.8%	0.1%	0.1%
Risk coverage ratio (30 days)	92.1%	82.6%	146.9%	420.5%
Write off ratio	0.0%	0.0%	0.5%	0.0%

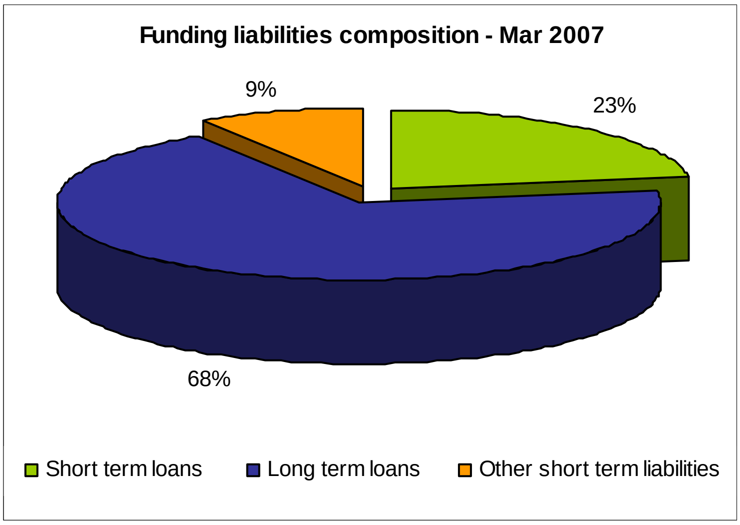
5. Financial structure and ALM

AzerCredit's financial structure presents a gradually growing financial leverage of the capital since 2004 with the introduction of short and long term commercial liabilities (WV, Vision Fund, BlueOrchard, among others). In particular between 2005 and 2006 the **debt to equity ratio** has doubled from 0.88 to 1.61, reaching up to 1.72 as of March 2007.
Nevertheless there is still room to for the institution to financially leverage its capital in order to feed the growth of credit portfolio.



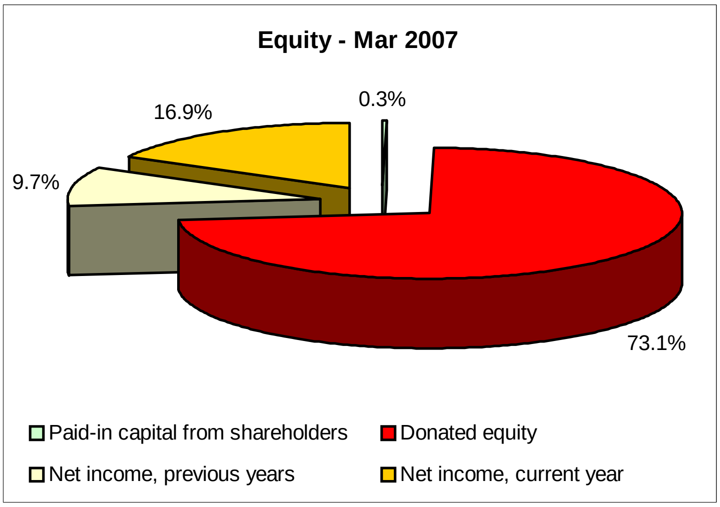
Liabilities and equity structure
As of March 2007, the total value of AzerCredit funding liabilities is worth of US$ 2.9 million, of which the majority are long term loans (almost 70% of total), which are mainly coming from Vision Fund and from local development funds (SFDI and SCRI).

The **short term funding liabilities** are represented by other two loans from Vision Fund and by a loan from BlueOrchard.



Most of the funding liabilities currently presented by AzerCredit are at market terms, showing that the institution is already experienced in the management of commercial and international sources of funds.

Total equity is about **US$ 1.8 million** as of March 2007, mainly resulting from the grants for loan capital received by WVI along the years and from the accumulated retained earnings.
The **capitalization strategy** in the medium run is mainly based on the accumulation of retained earnings and possible access to new equity funds (also enhanced by the new ownership of Vision Fund) and the institution is foreseeing to increase its total equity up to about US$ 2.5 million by 2008 and up to US$ 4 million by 2010.



Assets and Liabilities Management
The assets and liabilities management tools currently used by AzerCredit are still very simple and basic, despite the increasing commercial international funding liabilities that the institution has been contracting (Incofin, DWM, Oikocredit). **Financial risk analysis** has not been systematically performed so far while the access to commercial sources

of funds is being enhanced.

Liquidity management tools at AzerCredit are still quite basic and the institution could be exposed to financial risks and especially to liquidity risk. In fact, even if the current ratio maintains at adequate levels (3.77 as of December 2006 and 4.92 as of March 2007), the **maturity structure** of the organization as of March 2007 **presents a mismatch (cumulative negative net position)** for the aging category "31-90 days" (see table below, amounts expressed in US$), representing 13.8% of total equity.

AzerCredit **does not present, for the moment, a relevant exposure to interest rate risk** given that all the borrowed funds except one (BlueOrchard representing only 3% of total funding liabilities as of March 2007) bear fixed interest rates. The institution is liabilities-sensitive for aging category 31-90 days and assets-sensitive for all the remaining time brackets. If interest rates fall, this would have a negative impact on AzerCredit's Net Interest Income in all the assets-sensitive categories and a positive impact in the liabilities-sensitive categories.
A more detailed and systematic monitoring of the maturity structure by aging categories (gap analysis) would allow the institution to adopt measures to reduce its exposure to financial risks such as liquidity risk and interest rate risk.

March 07	30 days or less	31 to 90 days	91 to 180 days	181 to 365 days	1 to 5 years	Other	Total
Total assets	**374,722**	**263,169**	**901,485**	**3,054,437**	**388,083**	**0**	**4,981,897**
Cash and banks	103,868						103,868
Investments							0
Outstading portfolio	37,648	263,169	901,485	3,054,437	296,662		4,553,401
Net fixed assets					91,421		91,421
Other assets	233,207						233,207
Total liabilities	**98,958**	**826,277**	**9,387**	**59,226**	**2,174,473**	**0**	**3,168,321**
Deposits							0
Loans	98,958	548,230	9,387	59,226	2,174,473		2,890,274
Other liabilities		278,047					278,047
Net position	**275,764**	**-563,108**	**892,098**	**2,995,211**	**-1,786,390**	**0**	**1,813,576**
Cumulative liquidity risk	275,764	-287,343	604,755	3,599,965	1,813,576		

Concerning **foreign exchange risk**, AzerCredit presents, as of March 2007, a positive net position in US$ of US$ 420,000, that is 23% of total equity, which is much lower than December 2005 (when it was worth of US$ 1,14 million, being 80% of total equity) and has also been reduced since December 2006 (when it was worth of US$ 753,000, or 51% of total equity). This is because the institution has increased the liabilities denominated in US$ and has reduced the percentage of the loan portfolio denominated in US$, representing now 70% of the total outstanding portfolio against 78% in 2005.

March 2007

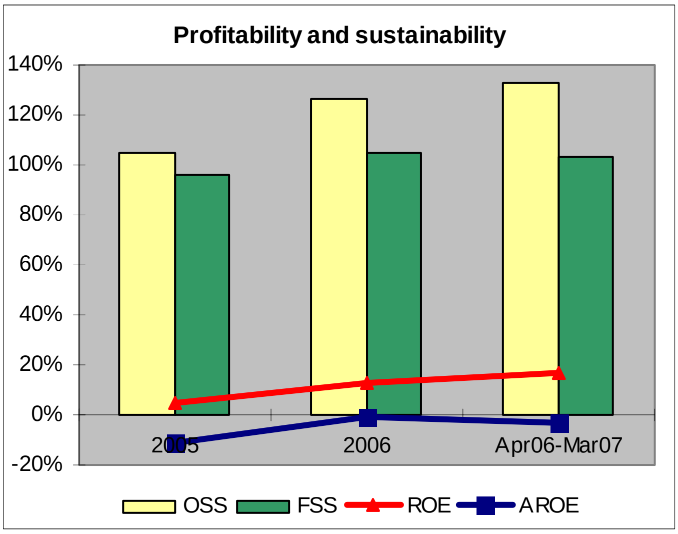
US$	US$*	Euro	Other currencies	Local currency	Total
Assets	**3,255,474**	**0**	**0**	**1,726,423**	4,981,897
Cash and banks	56,470	0	0	47,398	103,868
Financial assets	0	0	0	0	-
Portfolio	3,162,088	0	0	1,391,313	4,553,401
Fixed assets	0	0	0	91,421	91,421
Other assets	36,916	0	0	196,291	233,207
Liabilities	**2,834,851**	**0**	**0**	**333,470**	3,168,321
Deposits	0	0	0	0	-
Loans	2,776,027	0	0	114,247	2,890,274
Other liabilities	58,824	0	0	219,223	278,047
NET POSITION	**420,623**	**0**	**0**	**1,392,953**	**1,813,576**

*Exchange rate AZN / US$: 0.87

Nevertheless **AzerCredit is still clearly exposed to currency risk** and it has kept on suffering important exchange rate losses (worth US$ 65,800 as of December 2006), and **does not count**

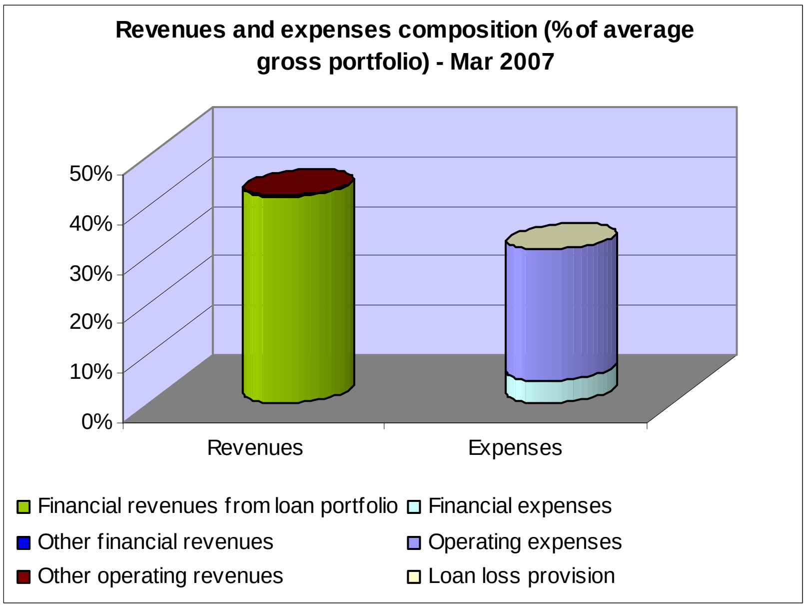
on defined policies and dedicated tools for the management of currency risk despite the increasing access to commercial international borrowed funds.

6. Financial and operational results



The analysis of the financial performance of AzerCredit is based on the audited financial statements of 2004, 2005, and 2006, and on the un-audited financial statements of March 2007.

AzerCredit shows a **positive trend of profitability and sustainability** if compared to FY 2005. As of March 2007, ROE has reached 16.5% up from 4.6% in 2005 and 12.7% in 2006. ROA, as of March 2007, is 6.8%, being 5.6% in December 2006 and 2.5% in 2005. OSS has raised from 105% in 2005 to 133% in March 2007.
Nevertheless **adjusted indicators, despite a positive trend if compared to 2005, still register negative values,** also due to the relevant raise of the inflation rate in 2007: AROE is -3% in March 2007, and it was -11% in 2005, AROA is -1.2% in March 2007 and it was – 5.9% in 2005. The reason why FSS is just over 100% (103.3% in March 2007 up from 95.8% in 2005) depends on the fact that AROE and AROA are calculated after taxes, while FSS is before taxes.



The **high inflation rate,** especially in 2007**,** and the consequent financial adjustment has determined such a difference between unadjusted and adjusted profitability indicators.

The main reason of the positive trend in profitability is the **improvement in terms of efficiency**, clearly reflected by the reduction of the operating expense ratio from 32.7% in 2005 to 26.4% as of March 2007. The institution has started benefiting from economies of scale as the size of its gross outstanding portfolio has almost doubled since December 2005.

Productivity has also clearly improved since 2005, especially in terms of number of active borrowers per loan officer while not so much in terms of cost per loan lent and cost per borrower.

Financial Indicators	2004	2005	2006	Apr 2006- Mar 2007
Operating expenses ratio (aver. gross portf.)	**42.0%**	**32.7%**	**27.4%**	**26.4%**
Staff allocation ratio	33.8%	36.0%	34.1%	36.8%
Loan officer productivity (borrowers)	200	216	269	256
Loan officer productivity (US$)	71,369	86,302	134,227	130,412
Branch productivity (US$)	385,395	466,029	693,505	760,736
Cost per loan lent (US$)	108	99	91	91
Cost per borrower (US$)	146	128	128	127
Funding expense ratio	**3.1%**	**1.4%**	**2.7%**	**3.6%**
Provision expense ratio	**0.5%**	**0.0%**	**-0.1%**	**-0.1%**
Portfolio yield (gross portfolio)	43.2%	41.9%	40.0%	41.4%

The increase of **funding expense** ratio, from 1.4% in 2005 to 3.6% for the period April 2006-March 2007, reflects the gradual commercialization of the financial sources of AzerCredit. Given the even wider future access to commercial funds by AzerCredit, the incidence of funding expenses will keep growing

AzerCredit needs to **consolidate its level of profitability and sustainability** through a further improvement of efficiency and productivity. This is in order to face, from a more stable and secure position, the main challenges along its evolution path, such as the volatility of macroeconomic conditions, like the level of inflation, the increasing competition with the consequent gradual reduction of yields on portfolio, and the gradual but constant raising of financial expenses linked to the commercialization of the sources of funds.

7. Strategic objectives and financial needs

Strategic objectives and strategies

The main features of the projected institutional, operational and financial evolution of AzerCredit are shown in the Business Plan 2006-2010, prepared by the CEO in October 2005. Financial projections have been prepared using the CGAP Microfin model and are based on only one growth scenario. Different **scenario analysis** (conservative, likely and optimistic) **and sensitivity analysis on the main variables is missing**.

As it can be seen in the table below, forecasts have sometimes underestimated the actual results achieved. In particular portfolio growth during 2006 has been much bigger than expected, as well as the financial self sufficiency. The business plan and forecasts for years to 2007 to 2010 were partially reviewed at this point, except for FSS and OSS indicators.

Projected key financial indicators	Forecast 2006	Actual Dec2006	2007	2008	2009	2010
Gross portfolio (US$)	3,123,610	4,161,029	5,987,785	8,344,406	11,316,493	14,314,669
Growth of portfolio (in US$)	24.0%	78.6%	43.9%	39.4%	35.6%	26.5%
Number of active clients	8,065	8,331	10,644	13,712	17,309	20,893
Portfolio yield	38.0%	40.0%	36.0%	34.0%	31.0%	29.0%
Growth of equity	37.0%	14.5%	19.0%	20.0%	28.0%	30.0%
Debt to equity ratio	1.5	1.6	2.2	2.6	2.7	2.7
FSS	95.0%	104.7%	98.0%	112.0%	119.0%	120.0%
OSS	113%	126%	111.0%	119.0%	127.0%	130.0%
Operating expense ratio	33.0%	27.4%	28.0%	23.0%	19.0%	16.0%

AzerCredit's **main strategic objectives** are:

- Continue its geographic expansion, especially in the rural areas, through the creation of new sub branches and branches
- Widen the range of credit products, launching consumer loans and introduce non lending financial products, such as money transfer service and insurance products
- Increase productivity and efficiency of the operations, starting to benefit from economies of scale (operating expense ratio is expected to decrease to 16% by the end of 2010)
- Enhance governance, through the development of the Supervisory Council and strengthen the organizational structure, through the coverage of the vacant positions.

Portfolio yield is expected to decrease, because of growing competitive pressures, but AC plans to be able to retain sufficient margin to improve its operating margin and financial position. Moreover, the institution is planning to increase its borrowed funds in the following years, thus making the cost of funds grow.

Financial needs

According to the projections, the **financial needs for 2007** could be quantified as approximately US$ 2 miliion. AzerCredit has already secured enough funding agreements to cover the needs with traditional commercial investors such as Incofin, DWM, OikoCredit.
At the same time, AC is developing further contacts with new potential financial partners and is also going to receive a short term loan from its Georgian sister institution CREDO.
The World Vision loan worth of US$ 350,000 will most likely become equity, when the ownership transfer will be completed.
In general we can say that the **funding strategy of AzerCredit has been quite effective** so far and has been substantially improved with the arrival of the new CEO in November 2005.

8. Details of the risk factors

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

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 has still to be approved by the Parliament
	Ineffective credit bureau	Medium-low	An informal exchange of information on clients is widespread among MFIs operating in the same areas	Still low level of involvement of financial institutions. AzerCredit does not participate to the Credit Register
	Growing competition also from banks	Medium	Flexibility of the existing products will be improved and new lending products will be launched. Geographical expansion will continue in the rural areas, underseved by banks.	Some banks are implementing downscaling strategies, especially in some areas.
Governance, management and operations	*Supervisory Council lacks of a specific performance standard evaluation model/methodology for the assessment of the CEO*	Medium-low	–	The periodic evaluation of the CEO is one of the most important responsibility assigned to the Sup. Council. A dedicated standard evaluation methodology used systematically for that purpose would improve the quality and effectiveness of the governance function
	Lack of risk management and internal control policies and of independent internal audit position	Medium-high	The presence in the supervisory council of an expert in internal auditing will facilitate the recruitment of an experienced internal auditor. The actual possibility to outsource the internal audit activities partly mitigates the risk.	Since 2004, the internal audit position is vacant and internal control activities are performed by the Deputy CEO, with a consequent overload of his functions.
	Partial implementation of the new loan tracking system	Medium-high	E-merge will be implemented in the two remaining branches by the end of 2007, according to a written MIS implementation policy.	–
	Improvable reporting on portfolio	Medium	The MIS manager has received training and should be able to customize the software to produce more complete portfolio reports.	Portfolio reports by product are not automatically produced.
	Improvable MIS back-up procedures	Medium	AC is currently revising its back up procedures,especially as regards to the safe storage of the back up disks.	Back up data are not stored in a safe place outside the office.
	Improvable salary level as perceived by some staff at branch level	Medium-low	A staff incentive system has been introduced, which partly mitigated the inflation effects. A revision of salary levels is going to be realized.	Some branch manager and loan officer is perceiving that the current level of salaries could be improved if compared to other competitor MFIs and also because it has been strongly affected by the inflationary pressures.
	Client drop-out analysis not systematic	Medium	The newly appointed marketing officer will start a systematic analysis of drop out clients.	-

* 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.

AREA	Risk factors	Relevance*	Main measures implemented and/or to implement in the short term	Observations
Financial products and asset quality	*Portfolio concentration in agriculture*	Medium	-	Agricultural lending represents almost 60% of the total portfolio and is likely to increase in the future. No specific policy on agriculture concentration is in place.
Financial structure and ALM	*Lack of ALM policies and tools*	Medium	The adoption of an ALM policy manual is considered as a priority by the financial manager.	The assets and liabilities management tools currently used by AzerCredit are still very simple and basic, despite the increasing commercial international funding liabilities that the institution has been contracting
	Maturity risk	Medium-low	–	The maturity structure of the organization as of March 2007 presents a mismatch (cumulative negative net position) for the aging category "31-90 days" representing 13.8% of total equity.
	Currency risk	Medium	The trend in the last two years has seen a substantial reduction of the net position, due to the increase of US$ denominated liabilities (mainly borrowed funds) and to the increase of the portfolio share denominated in AZN	As of March 2007, AzerCredit presents a positive net position in US$ worth of 23% of total equity
Financial and operational results	*Negative adjusted profitability ratios and full sustainability to be consolidated*	Medium	Positive trend compared to FY 2005	Adjusted Return on Equity and Assets still register negative values mainly due to high inflation rate
Strategic objectives and future evolutions	*Lack of scenario and sensitivity analysis*	Medium-low	-	Projections for the period 2006-2010 have been produced using CGAP Microfin model, but no scenario analysis have been included in the business plan.

* 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.

Annex 1 - Financial statements

AzerCredit				
Balance sheet (US$)	**Dec 2004**	**Dec 2005**	**Dec 2006**	**Mar 2007**
ASSETS				
Cash and bank deposits	268,754	217,323	61,669	104,119
Short term financial assets	-	-	-	-
Net outstanding portfolio	1,911,199	2,312,652	4,157,870	4,562,069
Gross outstanding portfolio	1,926,976	2,330,146	4,161,029	4,564,419
Performing portfolio	1,909,837	2,308,977	4,158,878	4,563,860
Portfolio at risk > 30 days	17,140	21,169	2,150	559
(Loan loss reserve)	15,777	17,494	3,159	2,349
Accrued interest	10,445	16,005	33,951	-
Other short term assets	4,746	83,344	141,535	236,073
Total short term assets	**2,195,143**	**2,629,325**	**4,395,025**	**4,902,262**
Long term financial assets	-	-	-	-
Net fixed assets	38,593	32,340	56,650	91,643
Other long term assets	-	-	-	-
Total long term assets	**38,593**	**32,340**	**56,650**	**91,643**
Total assets	**2,233,737**	**2,661,665**	**4,451,675**	**4,993,905**
LIABILITIES and EQUITY				
LIABILITIES				
Sight deposits	-	-	-	-
Short time deposits	-	-	-	-
Short term loans	10,000	10,000	906,391	717,533
Other short term liabilities	107,938	177,593	258,362	278,675
Total short term liabilities	**117,938**	**187,593**	**1,164,753**	**996,208**
Long term time deposits	-	-	-	-
Long term loans	915,563	1,059,433	1,580,314	2,179,734
Other long term liabilities	-	-	-	-
Restricted funds	-	-	-	-
Total Long term liabilities	**915,563**	**1,059,433**	**1,580,314**	**2,179,734**
Total liabilities	**1,033,501**	**1,247,026**	**2,745,067**	**3,175,942**
EQUITY				
Paid-in capital from shareholders	4,938	5,271	5,553	5,579
Donated equity	1,183,371	1,269,862	1,342,977	1,349,167
Quasi-capital	-	-	-	-
Reserves	-	-	-	-
Total retained earnings	19,662	139,506	358,077	463,218
Other equity accounts	- 7,735			
Total equity	**1,200,236**	**1,414,639**	**1,706,607**	**1,817,964**
Total liabilities and equity	**2,233,737**	**2,661,665**	**4,451,675**	**4,993,906**

Annex 1

AzerCredit

Income Statement (US$)	2004	2005	2006	Apr 2006- Mar 2007
Interest & commissions received on loans	733,810	919,873	1,322,579	1,517,511
Financial revenue from investment	-	-	-	-
Other financial revenues	22,229	1,374,198	-	-
A) Financial revenue	**756,038**	**2,294,071**	**1,322,579**	**1,517,511**
Interest paid on borrowings	52,986	30,322	88,709	130,237
Interest paid on savings	-	-	-	-
Interest paid on mortgage	-	-	-	-
Other financial expenses	21,508	1,445,451	65,836	59,499
Inflation adjustment	-	-	-	-
B) Financial expenses	**74,494**	**1,475,773**	**154,544**	**189,736**
Gross financial margin (A - B)	**681,545**	**818,298**	**1,168,035**	**1,327,775**
Loan loss provision	7,751	651	-1,779	-2,802
Net financial margin	**673,794**	**817,647**	**1,169,814**	**1,330,577**
Other operating revenue	21,394	7,441	10,996	12,069
Personnel expenses	449,921	418,307	506,743	557,154
Administrative expenses	262,957	298,079	398,573	410,347
C) Operating expenses	**712,878**	**716,386**	**905,316**	**967,501**
Net operating income	**-17,690**	**108,701**	**275,494**	**375,146**
Extraordinary revenue	-	-	-	-
Extraordinary expense	-	-	-	-
Net income before donations, before tax	**-17,690**	**108,701**	**275,494**	**375,146**
Taxes	-	46,654	71,772	98,289
Net income before donations	**-17,690**	**62,047**	**203,722**	**276,857**
Donations in cash	30,828	-	7,377	7,411
Revenue not from the operations	895	64,728	-	-
Expenses not from the operations	-	-	-	-
Net income	**14,033**	**126,775**	**211,099**	**284,268**

Annex 2 - Financial statements adjustments

The financial statements in Annex 1 are the result of **standard reclassification**. They are expressed in US$, using the exchange rates published by IFS (International Financial Statistics). The figures are based on audited financial statements except for the last period (March 2007), for which internal financial statements have been used.

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 with market conditions. The main adjustments normally are:

- adjustment for the accrued interest on delinquent loans
- elimination of subsidies (donations in kind[2] and soft loans[3])
- provisions are calculated with a standard formula[4]
- adjustments for inflation
- adjustments for write-off[5]

The financial adjustments applied to AzerCredit refer to **inflation** and **subsidized cost of funds**. Given the sudden raise of inflation in 2007, the relative adjustment for the last period is quite relevant, affecting the adjusted net income and therefore the adjusted profitability ratios and FSS ratio.
The cumulative effect of the adjustments reduces the net income in all the periods.

Adjustments (US$)	2004	2005	2006	Apr 2006- Mar 2007
Reversal of accrued interest on non-perf loans	-	-	-	-
Subsidized cost of fund adjustment	-	54,536	71,409	61,848
- Interest rate used (national currency)	11.8%	12.8%	13.4%	13.6%
- Interest rate used (foreign currency)	5.1%	7.0%	8.3%	8.4%
Inflation adjustment	76,408	155,097	145,996	264,374
- Inflation rate used	6.7%	11.8%	9.4%	16.4%
Loan loss provision adjustment	-	379	-	-
In-kind subsidy adjustment	-	-	-	-
Total variation of net income	76,408	210,012	217,405	326,222

[2] Donations in kind are valorized and added to operational expenses.
[3] 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 EUR), it is considered the average value of LIBOR 1 year plus 3%.
[4] Provisions are calculated according to the following formula:

Portfolio:	1-30 days	10%	Restructured loans	0-30 days	50%
	31-60 days	30%		> 30 days	100%
	61-90 days	50%			
	>90 days	100%			

[5] Loans past due more than 180 days are written-off.

Annex 3 - Financial ratios

AZERCREDIT (US$)	2004	2005	2006	Apr 2006- Mar 2007
PROFITABILITY				
Return on Equity (ROE)	-1.5%	4.6%	12.7%	16.5%
Adjusted Return on Equity (AROE)	na	-11.0%	-0.9%	-3.0%
Return on Assets (ROA)	-0.8%	2.5%	5.6%	6.8%
Adjusted Return on Assets (AROA)	na	-5.9%	-0.4%	-1.2%
Operational self-sufficiency (OSS)	97.8%	105.0%	126.0%	132.5%
Financial self-sufficiency (FSS)	na	95.8%	104.6%	103.3%
Profit Margin	-2.3%	4.7%	20.7%	24.5%
LOAN PORTFOLIO QUALITY				
Portfolio at risk (PAR30)	0.9%	0.9%	0.1%	0.01%
Arrears rate (> 1 day)	1.6%	1.4%	0.1%	0.00%
Restructured loans	0.0%	0.0%	0.0%	0.00%
Provision expense ratio	0.5%	0.0%	-0.1%	-0.08%
Loan loss reserve ratio	0.8%	0.8%	0.1%	0.05%
Risk coverage ratio (30 days)	92.1%	82.6%	146.9%	420.5%
Write-off ratio	0.0%	0.0%	0.5%	0.00%
Adjusted write-off ratio	0.8%	0.7%	0.5%	0.00%
EFFICIENCY AND PRODUCTIVITY				
Staff allocation ratio	33.8%	36.0%	34.1%	36.8%
Loan officer productivity (borrowers)	200	216	269	256
Loan officer productivity (amount)	71,369	86,302	134,227	130,412
Staff productivity (borrowers)	67	78	92	94
Staff productivity (amount)	24,087	31,069	45,726	48,047
Branch productivity (amount)	385,395	466,029	693,505	760,736
Operating expenses ratio (average gross portf.)	42.0%	32.7%	27.4%	26.4%
Operating expenses ratio (average assets)	30.6%	28.4%	25.0%	23.7%
Cost per loan lent	108	99	91	91
Cost per borrower	146	128	128	127
Personnel expenses ratio (average gross portf.)	26.5%	19.1%	15.3%	15.2%
Admin. expenses ratio (average gross portfolio)	15.5%	13.6%	12.0%	11.2%
ASSETS/LIABILITIES MANAGEMENT				
Portfolio yield (gross portfolio)	43.2%	41.9%	40.0%	41.4%
Funding expense ratio*	3.1%	1.4%	2.7%	3.6%
Cost of funds ratio*	7.8%	2.9%	4.9%	6.0%
Provision for inflation (average gross portfolio)	0.00%	0.00%	0.00%	0.00%
Adjusted provision for inflation (av. gross port.)	4.5%	7.1%	4.4%	7.2%
Current ratio	18.61	14.02	3.77	4.92
Liquidity over total assets	12.0%	8.2%	1.4%	2.1%
Debt/equity ratio	0.86	0.88	1.61	1.75
Equity multiplier	1.9	1.9	2.6	2.7
Capital adequacy ratio	53.7%	53.1%	38.3%	36.4%

* exchange rate variations are not included in the calculation of the ratio

Annex 3

OUTREACH				
Average disbursed loan size	515	615	716	749
Average outstanding balance	358	400	499	510
Average disbursed loan size on per-capita GDP	50.3%	40.2%	20.4%	na
Average outstanding balance on per-capita GDP	35.0%	12.0%	14.2%	na
Percentage of active borrowers women	33.4%	35.6%	38.1%	38.1%

GROWTH (amount in national currency)				
Growth of active gross portfolio	31.2%	13.3%	69.5%	64.9%
Growth of active borrowers	na	8.2%	42.9%	43.3%
Growth of active loans	na	8.2%	42.9%	43.3%
Growth of total assets	-7.8%	11.6%	58.7%	57.6%
Growth of staff	na	-6.3%	21.3%	14.5%
Growth of funding liabilities	116.9%	8.2%	120.7%	98.1%
Growth of operating expenses*	na	-5.9%	19.9%	395.5%
Growth of equity	2.6%	10.4%	14.5%	18.9%

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 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 / Number of borrowers
	Administrative expenses ratio	Administrative expenses / Average gross portfolio
	Personnel expenses ratio	Personnel expenses / Average gross portfolio
Financial management	**Portfolio Yield (gross portfolio)**	Interest income from portfolio / Average gross or net portfolio
	Cost of fund ratio	Interest expenses on funding liabilities / Period average funding liabilities
	Funding expense ratio	Interests and fee expenses on funding liabilities / Average gross portfolio
	Current ratio	Short term assets / Short term liabilities
	Debt/Equity ratio	Liabilities / 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 liabilities: Liabilities 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).

Annex 5 - Guidelines of reporting and accounting

Financial statements

AzerCredit does not provide non-financial services. Its financial statements reflect only 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-off

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 0.43% of its portfolio in 2006.

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, AC only received donations from World Vision International during 2004.

Donations received (US$)

Year	Amount	Destination	Source
2004	44,952	Grant loan capital	WVI from BP
	82,650	Grant loan capital	WVI from WV US
	181,184	Grant loan capital	WVI from USAD\MCI
	183,333	Grant loan capital	WVI from WV Canada
	212,037	Grant loan capital	WVI from SIDA
	433,468	Grant loan capital	WVI from ARRA
	18,323	Grant loan capital	WVI from UNDP
TOTAL	**1,155,947**		

Details of funding liabilities

The debt position of the AC, as of March 2007, is detailed in the following tables.

March 2007

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
World Vision PO	USD	315,000	0	315,000	Negotiating the transfer of principal to equity, no
WV USA Sandy River	USD	299,995	0	299,995	No collateral
UMCOR	USD	10,000	10,000	0	No collateral
SCRI	AZN	29,860	29,860	0	No collateral
SFDI	AZN	84,756	28,252	56,504	No collateral
Vision Fund	USD	200,000	200,000	0	No collateral
Blue Orchard	USD	100,000	100,000	0	No collateral
Vision Fund	USD	350,000	350,000	0	No collateral
Vision Fund	USD	659,995	0	659,995	No collateral
Vision Fund	USD	250,000	0	250,000	No collateral
Vision Fund	USD	250,000	0	250,000	No collateral
Vision Fund	USD	350,000	0	350,000	No collateral
TOTAL		2,899,606	718,112	2,181,494	

March 2007

Funding liabilities features

Source	Loan amount (US$)	Disbursement date	Maturity date	Principal repayments	Interest repayments	Interest rate
World Vision PO	315,000	1/12/2001	30/06/2007	End date	-	0.0%
WV USA Sandy River	300,000	20/02/2004	30/06/2010	Quarterly from 30/09/08	Quarterly	4.5%
UMCOR	10,000	1/9/2001	N/A	End date	-	0.0%
SCRI	105,500	7/4/2004	7/04/2007	Quarterly from third year	-	0.0%
SFDI	100,000	23/12/2003	30/4/2009	Quarterly from 31/07/06	-	0.0%
Vision Fund	200,000	9/9/2005	30/06/2007	End date	Quarterly	6.8%
Blue Orchard	100,000	20/10/2006	20/10/2007	Semi-annual (Apr'07 and Oct'07)	Semi-annual (Apr'07 and Oct'07)	6.25% + USD Libor
Vision Fund	350,000	8/3/2006	30/06/2007	End date	Quarterly	6.8%
Vision Fund	660,000	2/6/2006	30/06/2009	End date	Quarterly	8.8%
Vision Fund	250,000	19/09/2006	30/06/2009	End date	Quarterly	9.5%
Vision Fund	250,000	12/2/2007	30/06/2009	End date	Quarterly	9.5%
Vision Fund	350,000	15/02/2007	30/06/2009	End date	Quarterly	9.5%

<u>Other accounting policy</u>
The financial statements are prepared on an accrual basis. AzertCredit does not have an accounting policy which provides for the effects of inflation.

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.