Strategy for setting and monitoring financial Covenants…

…for microfinance counterparties.

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The views expressed in this presentation are those of the authors and not necessary represent the views of the EIF or EIF policy

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Introduction

- Why is setting an appropriate level of covenants important?
  - Alert investors in case of decline of the counterparty's financial situation
  - Mitigate agency risks (in particular between creditors and shareholders) by increasing the discipline and respect of limits
  - Anticipate corrective actions by the investors or MFI management
  - Contributes to increasing transparency and management discipline
  - Increase chance of business continuing as a going concern within the predefined business plan and risk appetite
  - Helps Investors to take adequate actions before borrower's potential default (acceleration, restructuring, prepayment,…)

II- Identifying the most relevant financial covenants

Identifying the most relevant financial covenants

- How many financial covenants to be inserted in a Facility Agreement?
  - Best within control of the intermediary to cure
  - Enough covenants (5-8, typically) to ensure that the following risk areas are adequately covered:
    a) Liquidity and Asset/Liability management
    b) Capitalization
    c) Portfolio quality
    d) Profitability
  - The number of financial covenants to be inserted in the facility agreement will depend on:
    a) The risk of the underlying counterparty

    → *More financial covenants for riskier counterparties*

    b) The type of counterparty

    → *MFIs, Cooperative Banks, Banks, Leasing companies,..*

Identifying the most relevant financial covenants

- Which financial covenants to select? Examples:

Liquidity A/L Management	Capitalization -	Portfolio quality	Profitability
B/S Liquidity Ratio (Liquid assets + receivables from gross portfolio for next 30 days) / (Total assets)	D/E Ratio (Total debt) / (Total Equity)	PAR 30d (Portfolio at risk 30 days) / (gross loan portfolio)	Cost to Income Ratio (Operating Expense) / (Operating Income)
Current Ratio (Short term assets) / (Short term liabilities)	CAR Ratio (Tier I Capital + Tier II Capital) / (Risk weighted assets)	PAR 90d (NPL Ratio) (Portfolio at risk 90 days) / (gross loan portfolio)	Operating Expenses Ratio (Operating Expense) / (Average gross loan portfolio)
Liquidity to Opex Ratio (Liquid assets + receivables from gross portfolio for next 30 days) / (Operating Expenses)	Tier I Ratio (Tier I Capital) / (Risk weighted assets)	Provision Coverage Ratio (Loan loss reserve) / (Portfolio at risk > x days)	AROE (Operating Expense) / (Average gross loan portfolio)
Loans to Tot. Assets Ratio (Gross loan portfolio) / (Total assets)	Minimum Equity (Total Equity > x)	Open Exposure Ratio (Portfolio at risk > x days – Loan loss reserve) / (Total Equity)	ROA (Operating Expense) / (Average gross loan portfolio)

III- Calibrating the Financial Covenants

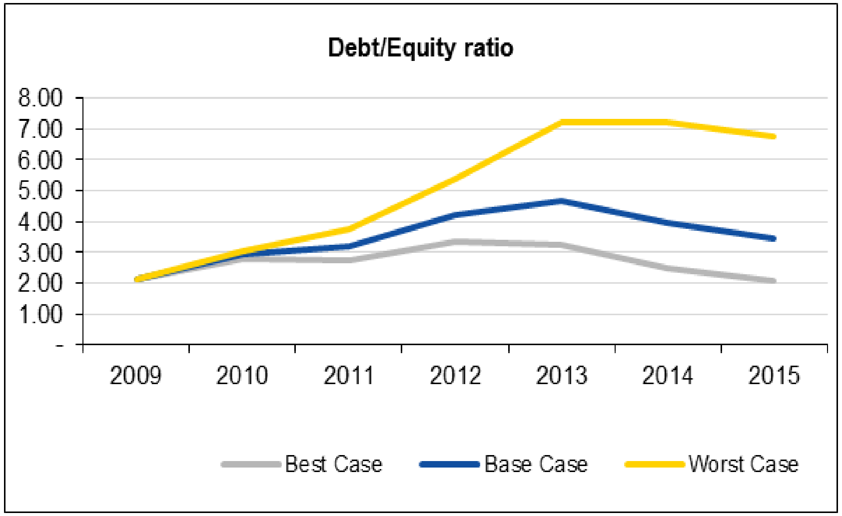
Calibrating the Financial Covenants

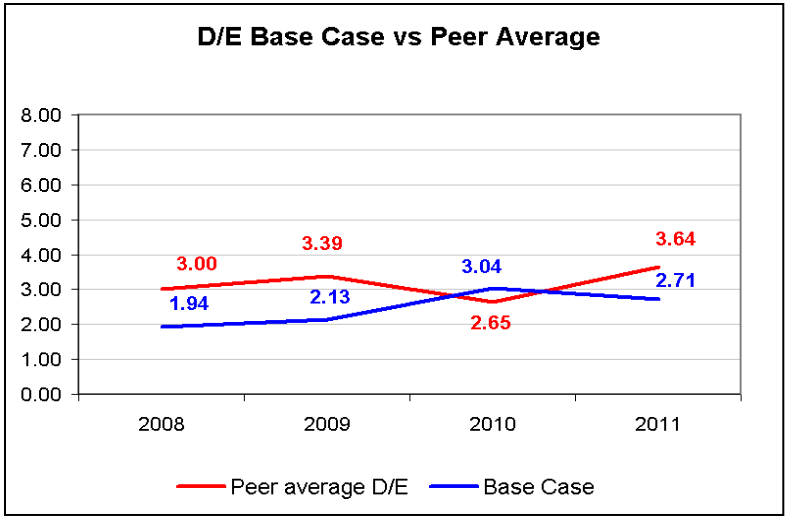
- Basic principles, financial covenants:
  - shouldn’t be set at a level below their current value
  - should respect the counterparty’s strategy
  - should be set at realistic levels
  - can be “evolutive”

- Different methods or sources of information can be used to calibrate the financial covenants:
  - Counterparty’s expectation (Due Diligence information)
  - Stress testing of the counterparty’s business plan
  - Historical analysis of the counterparty’s financial performance
  - Peer analysis

Calibrating the Financial Covenants

- Example 1: Capitalisation, set of a D/E Ratio



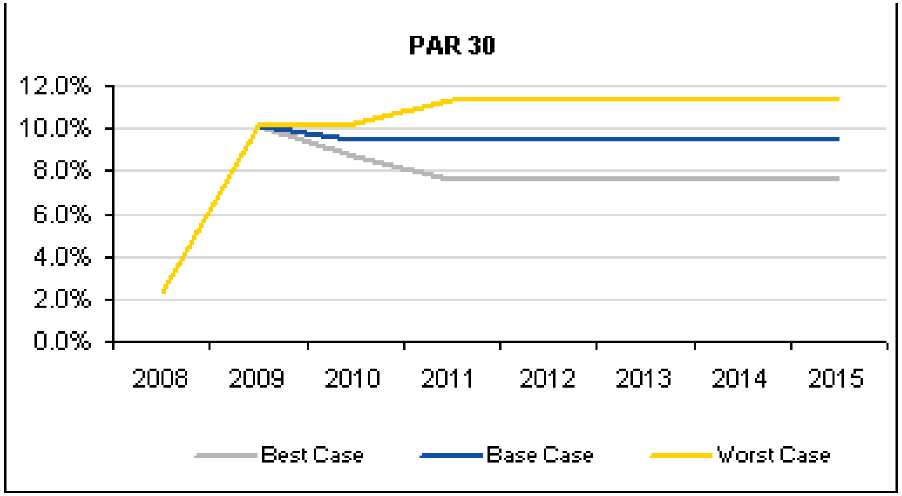


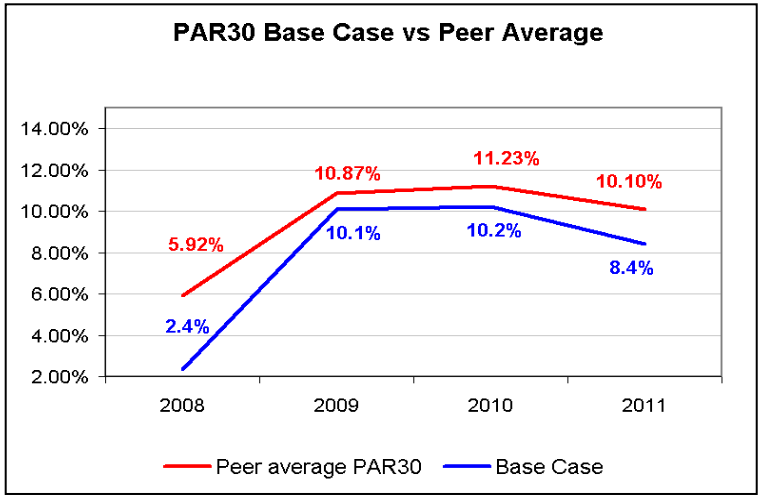
Peers: Panel of MFI for Eastern Europe

- Assuming the Base Case is representative of MFI development expectations, an **appropriate risk capacity level** for D/E covenant would be in the range of [3 - 5]
- Peer comparison validates this expected range for D/E and indicates that the MFI has historically been below the average of the sector

Calibrating the Financial Covenants

- Example 2: Portfolio quality, set of a PAR30 ratio



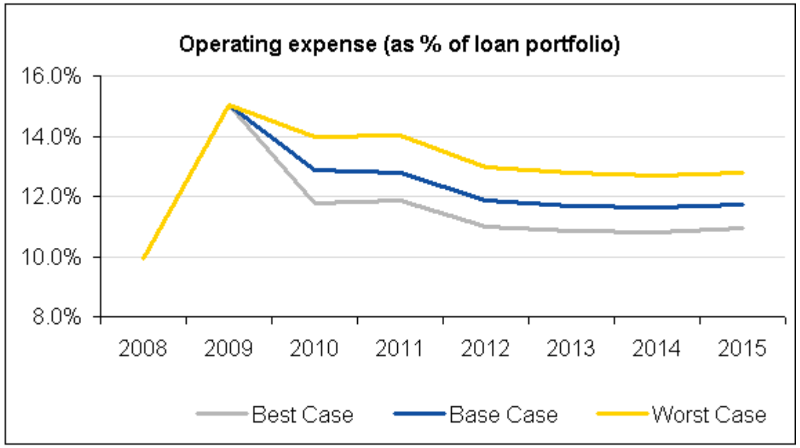


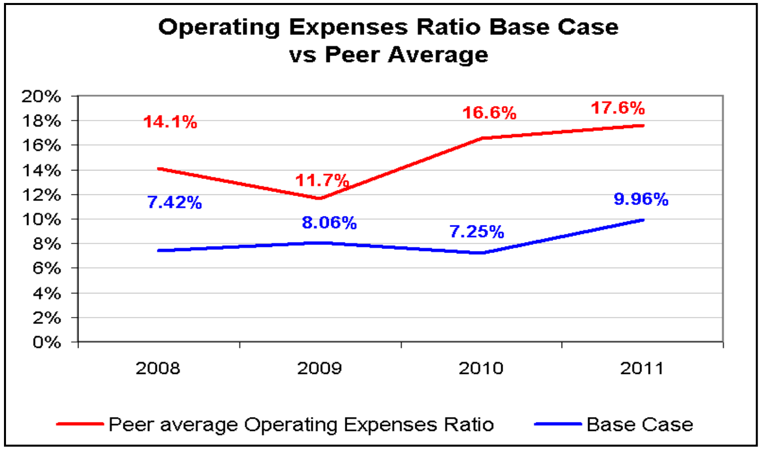
Peers: Panel of MFI for Eastern Europe

- Assuming the Base Case is representative of MFI development expectations then from the peer analysis, the **appropriate risk capacity level** for PAR 30 covenant would be in the range of [9%-10%]
- Peer comparison validates such expected range for PAR30 and indicates that the MFI has historically been in line with/below the average of the sector

Calibrating the Financial Covenants

- Example 3: Profitability, set of an Opex to loan portfolio ratio





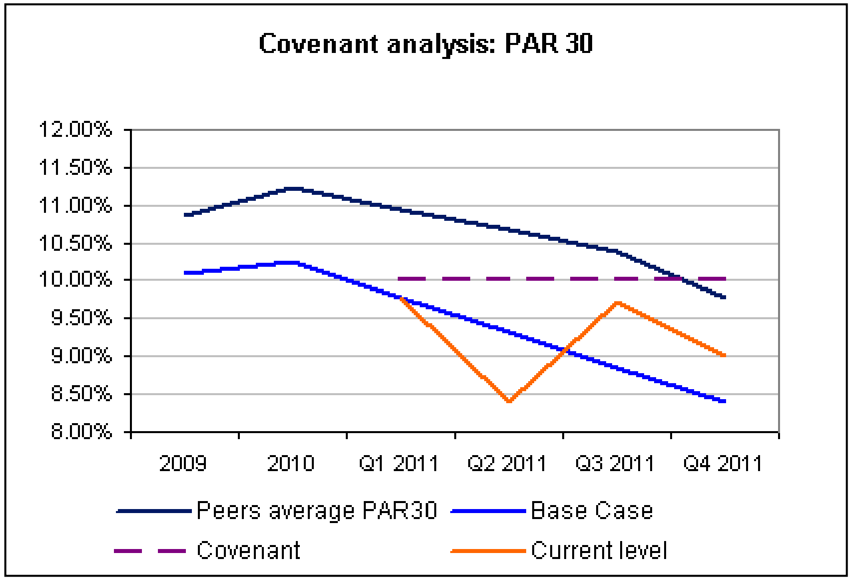
Peers: Panel of MFI for Eastern Europe

- Assuming the Base Case is representative of MFI development expectations then from the peer analysis, the **appropriate risk capacity level** for operating expenses to loan portfolio would be in the range of [12%-17%]
- Peer comparison indicates that the MFI has historically been below the average of the sector

IV- Monitoring

Monitoring

- Evaluate the **trends per risk factor versus your risk tolerance**
  - Monitoring of risk factors / covenant levels against base case (eg. PAR30), the current level and the peer level



Based on historical values, business plan and peer comparison, a financial covenant requiring the PAR30 to be below **10%** has been set for the financial year 2011.

- Level as of 2010: **10,2%**
- Expected level end of 2011: **8,4%**
- Current level end of 2011: **9%**

→ In such example the financial covenant acted as early warning signal as of Q3 2011 which obliged the MFI to take concrete actions

- **Rerun the stress testing** model, **anticipate corrective actions** and evaluate the need to review the business plan/strategy

Monitoring

- Main monitoring pillars

Reporting Date: **30/09/2011** | **COMPANY ABC** | **STATUS AS OF 30/09/2011: PERFORMING**

I. Transaction Summary

Product	Senior Loan	**Starting Date**	16/05/2011	**External Auditor**	xyz	**Notional Amount**	EUR 5.000.000
Currency	EUR	**Maturity**	30/09/2016	**Rep.**	IFRS	**Drawn**	EUR
Country		**Repayment**	4 installments	**Interest**	Fix	**Balance**	EUR

II. Quarterly Analysis (in K EUR)

BALANCE SHEET	2009	2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Assets						
Cash & Cash Equivalent	1783	2123	2208	2274	2272	
Gross loan portfolio	*7323*	*0*	*0*	*0*	*0*	
-LLR	*-664*	*0*	*0*	*0*	*0*	
Net loan portfolio	**6659**	**6133**	**6001**	**6568**	**6854**	
Investment securities (held to maturity)	17	3	0	0	0	
Intangible assets	0	17	21	18	16	
Property plant & Equipment	772	633	598	549	571	
Other assets	89	313	369	379	375	
Total Assets	**9320**	**9222**	**9197**	**9789**	**10087**	
Equity						
Share Capital	2595	2595	2595	2595	2595	
Retained earnings	-227	-349	-379	-373	-369	
Reserves	140	28	0	0	0	
Total Equity	**2508**	**2274**	**2215**	**2221**	**2226**	
Subordinated debt	0	89	111	124	125	
Other bank debt	6551	6772	6827	7140	7378	
Tax liabilities	0	21	26	19	23	
Other liabilities	261	66	18	284	336	
Liabilities	**6812**	**6948**	**6982**	**7568**	**7861**	
Equity and Liabilities	**9320**	**9222**	**9197**	**9789**	**10087**	
PROFIT AND LOSS ACCOUNT						
Interest income	988	1484	157	327	540	
Interest expenses	-495	-1040	-133	-298	-440	
Interest result	**493**	**444**	**24**	**30**	**100**	
Comission income	0	1636	155	352	548	
Comission expenses	0	0	-7	-17	-26	
Net fees and commission result	**863**	**1636**	**149**	**335**	**522**	
Allowance for loan loss reserve (provisions)	0	0	-120	-86	-137	
Net foreign exchange result	0	0	-15	3	1	
Other income	0	0	25	61	79	
Administrative and other operating expense	-1337	-2388	-241	-507	-722	
Operating result	**19**	**-308**	**-177**	**-165**	**-156**	
Taxe income / (expenses)	-3	0	-1	-8	-8	
Net income	**16**	**-308**	**-178**	**-173**	**-164**	

III. KPIs

Monitoring Ratio	Value Q2	Value Q3	Trend	Average	Status
Liquidity Ratios					
Liquidity Ratio	23.23%	22.52%	Positive	10%	Above Average
Current Ratio	799.96%	676.40%	Negative	150%	Above Average
Portfolio Quality Ratios					
PAR 30	9.52%	9.89%	Negative	9.3%	Average
Provision coverage Ratio	122.01%	113.80%	Positive	80%	Above Average
Profitability Ratios					
Spread on Interests	9.94%	22.82%	Negative	60.00%	Below
Operating expense Ratio	7.73%	10.53%	Positive	11%	Below Average
Capitalization Ratios					
Portfolio to Equity funds	295.71%	307.89%	Positive	295.0%	Average
D/E Ratio	3.4	3.5	Positive	3	Average

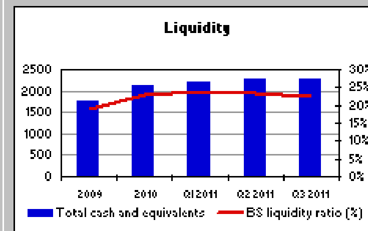
IV. Covenants Monitoring

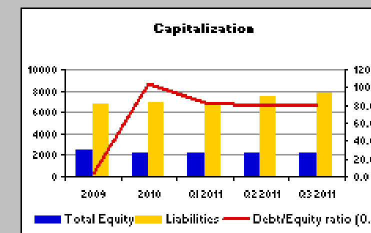
Covenant Type	Threshold	Value Q2	Value Q3	Status Q2	Waiver	Status Q3
D/E Ratio	<5	3.4	3.5	Respected	N/A	Respected
Installements / Total Assets	<33%	15.2%	11.2%	Respected	N/A	Respected
Interest coverage ratio	>1.4	2.2	2.3	Respected	N/A	Respected
PAR 30 / Equity Funds	<15%	-6.1%	-4.1%	Respected	N/A	Respected
Currency exp. BGN / Equity	<25%	1.0%	1.0%	Respected	N/A	Respected
Currency exp. (excl BGN & EUR)/ Equity	<50%	-0.1%	-0.1%	Respected	N/A	Respected

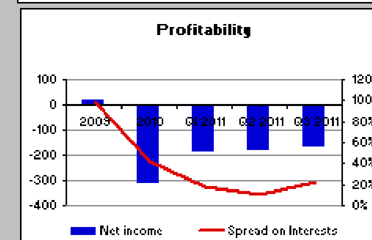
V. Conditions Precedent Monitoring

Covenant Type	Status	Comments
Evidence of the implementation of a scoring system for new micro-loans by the Borrower	Respected	
60% of the first drawdown to be disbursed to final beneficiaries before the second drawdown.	N/A	Condition precedent to the second drawdown

VI. Graphical Analysis







VII. Summary

Liquidity
The liquidity position of the MFI is facing a certain stability since Q1 2011 and can be considered as "above the average". The stable Liquidity Ratio is fluctuating between 23% and 25% which is considered as adequate.

Portfolio Quality
The overall quality of the portfolio has increased since the signing of the agreement. The Portfolio at Risk 30 days and the Provision Coverage Ratio are now, for the second consecutive quarter, below 10% and above 100% respectively.

Capitalization
The overall capitalization of the Company is stable and in line with peers. After the first two drawdowns, for a total amount of EUR 1.5m, the D/E ratio reaches 3.5, which is considered acceptable and in line with peers.

Profitability
At the end of Q3 2011, the profitability remains the only area under surveillance due to the negative profitability that the company is facing since 2010. However a slight increase of this profitability as been noticed during the last quarter. As far as t

Macro Economic Situation
The analysts revised their forecasts as follows:
-GDP growth for the year 2011: from 2.7% to 2.2%. Expectations for 2012: 2.2%
- The unemployment rate for the year 2011: from 9% to 9.3%. Expectations for 2012: 8.8%

Governance
Except the opening of 4 new branches, no major changes occurred during Q3 2011 as far as the governanceis concerned.

VIII. Actions undertaken

On November 15 2011 EIF met Mr xxx (CFO of the Company) to discuss the future development of the Company as well as the status and expected evolution of the company's profitability. According to Mr xxx, the profitability will reach the break even in 2012 and spread on interest is expected to be above 80% in 2012 and to exceed 100% early 2013. The updated Business Plan has been received.

IX. Performance Summary

Indicator	Status	Indicator	Status
Liquidity	No issue	Profitability	Surveillance
Capitalization	No issue	Macro eco situation	No issue
Portfolio Quality	No issue	Governance	No issue

X. Rating Update

Risk Type	At Origination	Last update	Actual
MFI Risk (stand alone)	B		B
T&C Risk	A		A
Rating	**B**		**B**

	Sov. Rating
Agency	Moody's
Rating	Baa2
Outlook	**Stable**

XI. RMM Recommendations

As of Q3 2011, EIF has no particular recommendation.

Monitoring

- Assessment of the main pillars

III. KPIs

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PAR 30 / Equity Funds	< 15%	-6.1%	-4.1%	**Respected**	N/A	**Respected**
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IX. Performance Summary

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Liquidity	No issue	Profitability	**Surveillance**
Capitalization	No issue	Macro eco situation	No issue
Portfolio Quality	No issue	Governance	No issue

V- Summary

Summary

- Covenants Setting: set on a case-by-case basis taking into account the risk and nature of the counterparty and ensuring an adequate mitigation of the liquidity, capitalization, profitability and portfolio quality risks.

- Covenant calibration: primarily derived from a combination of peer analysis, on-going concern, results from the stress testing, financial analysis and Due Diligence conclusions

- Monitoring: an effective an continuing monitoring contributes to long term sustainability results for the investor and MFI.

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