

CredAgro – Azerbaijan

Final Rating

BBB

First rating

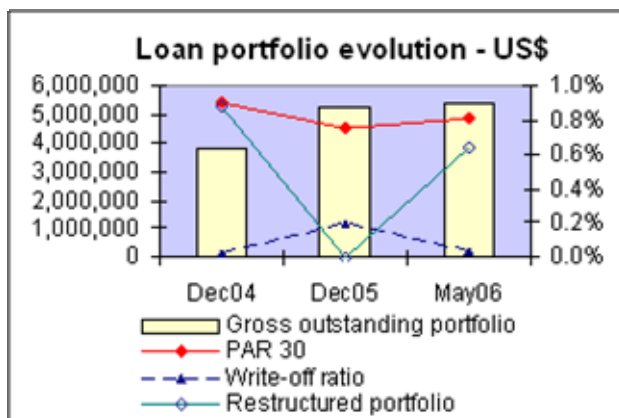
Validity: 1 year if no relevant changes in operations or within the operation context will happen..
The final rating grade does not consider the political and economic context.

CredAgro is a Non-Banking Credit Organization established in May 2000 in the framework of the Azeri Rural Credit project supported by USAID. ACIDI/VOCA, channeling the USAID donations, has been constantly sustaining the development of CredAgro and in 2005 it was granted the property of CredAgro by USAID. With a widespread network of branches, CredAgro targets the upper end of the rural microfinance market, offering a well diversified range of individual products.

CredAgro is a member of AMFA, the Azerbaijan Microfinance Association.

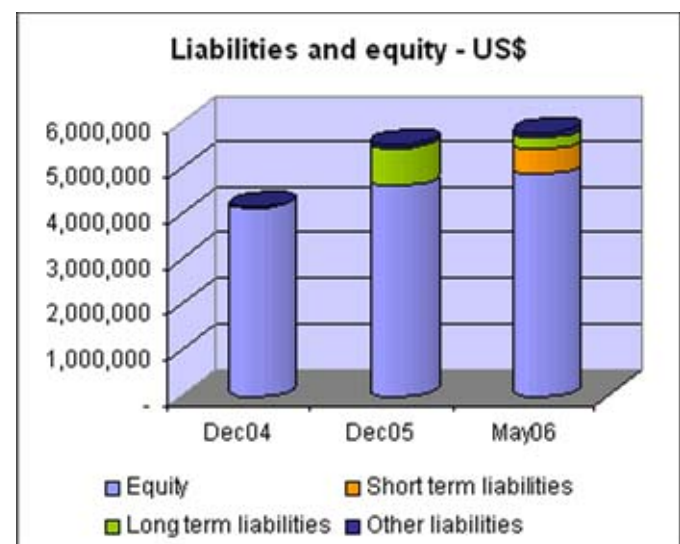
CredAgro started to borrow from commercial sources of funds at the end of 2005, but the capital leverage is still low. The growth of the organization has been recently limited by the shortage of funds, mainly due to the unclear strategy of the owner. In order to feed the future expansion of operations CredAgro will aim at attracting commercial borrowings.

Legal Form	Limited liability company
Inception year	2000
Area of intervention	Rural
Credit methodology	Individual



US\$	May06
Average disbursed loan size	4,946
Gross outstanding portfolio	5,382,362
Total assets	5,779,443

Number	Dec04	Dec05	May06
Active borrowers	1,070	1,287	1,530
Branches (hubs)	6	6	6
Satellites	3	3	3
Total staff	49	53	55
Loan officers	14	15	16



Financial Indicators	Dec04	Dec05	May06
PAR 30	0.9%	0.7%	0.8%
Write-off ratio	0.0%	0.2%	0.0%
Restructured loans	0.9%	0.0%	0.6%
ROE	9.4%	3.5%	5.8%
AROE	2.7%	-8.1%	-2.3%
Oper. Self-sufficiency (OSS)	197.7%	119.3%	135.6%
Fin. Self-sufficiency (FSS)	116.7%	73.0%	93.7%
Staff productivity (borrow.)	27	27	32
LO productivity (borrow.)	76	86	96
Operating expense ratio	10.4%	11.5%	11.8%
Funding expense ratio	0.0%	0.2%	1.0%
Provision expense ratio	0.3%	0.5%	0.4%
Portfolio yield - accrual	21.1%	22.3%	24.2%
Risk coverage ratio	140.4%	167.3%	164.1%
Cost of funds ratio	0%	1.8%	12.5%
Debt/Equity ratio	0	0.2	0.2

As of May 2006 figures are annual

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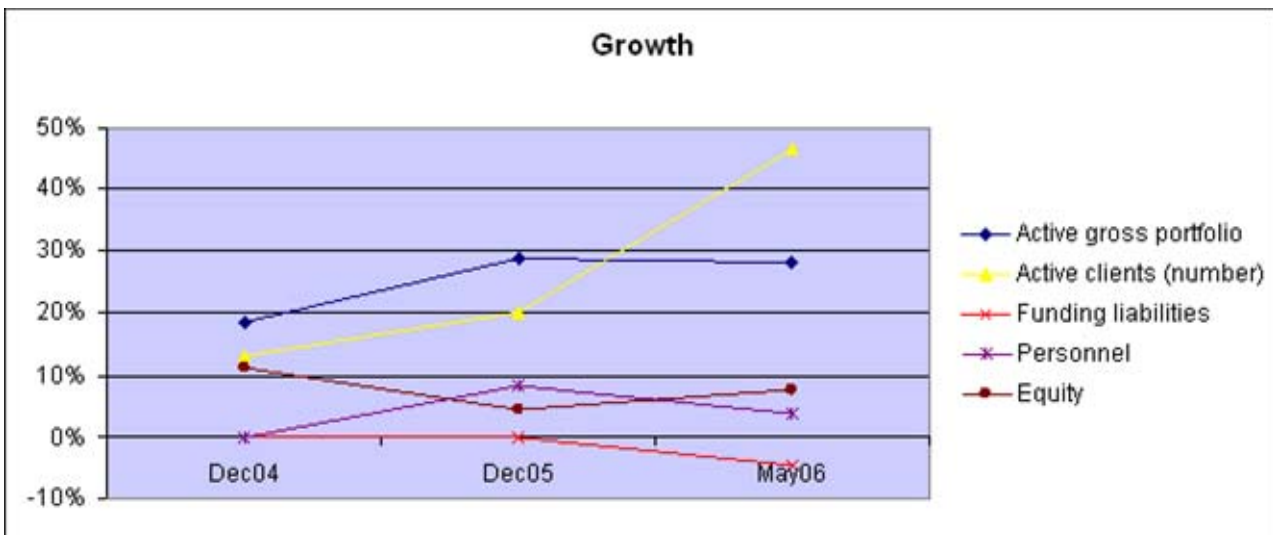
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AREA	Risk factors	Relevance*
<i>External environment</i>	Lack of a law and clear fiscal policy for microfinance	Medium-low
	AC does not participate in the national Credit Register	Medium-low
	Government claims on international grants	Medium-low
	Growing competition	Medium
<i>Governance, management and operations</i>	Some uncertainties of the ownership about its role within the commercial evolution of the institution	Medium
	No professional banking expertise within the Board of Directors	Medium-low
	Improvable level of salary for credit staffs	Medium
	Shortcomings in the MIS	Medium
<i>Financial products and asset quality</i>	Improvable client drop-out analysis	Medium-low
<i>Financial structure and ALM</i>	Effects of shortage of funds occurred in the past months	Medium-high
	Currency risk	Medium-high
	Interest rate risk	Medium-low
<i>Financial and operational results</i>	Financial self-sufficiency not consolidated	Medium
<i>Strategic objectives and future evolutions</i>	No scenario and sensitivity analysis presented in the business plan	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.

Strengths	Opportunities
<ul style="list-style-type: none"> → High quality top management → Diversified range of products → Effective decentralization → High efficiency → Good portfolio quality 	<ul style="list-style-type: none"> → Large unmet demand → Transformation into a commercial bank in the long term → Growth and economies of scale

- Headquarters:
Absheron
- Branches:
Masalli
Guba
Ismayilli
Tovuz
Zagatala
- Sub-branches:
Jalilabad
Lenkoran
Khachmaz



As of May 2006, growth rates are annual

Final opinion

CredAgro operations rely on a well established credit methodology and on a diversified offer. However, the positioning in the upper end of the market makes CredAgro especially subject to the increasing competition of banks.

Despite of the remarkable efficiency, the financial performance is quite weak, mainly due to the vulnerability to currency exchange risk. The reliability and efficiency of the MIS, together with the tools for the financial risk management, represent areas of improvement.

The shortage of funds, due to the restrictions imposed by ACDI/VOCA (holding the ownership) in the past months, has hampered the expansion of operations limiting the capacity of CredAgro to fully meet clients' needs and to consolidate its sustainability. The ownership has, at some point, demonstrated, mainly with the imposed restrictions to the access of commercial funding, not to be comfortable with the commercial evolution of CredAgro. This situation seems to start changing with the opening of doors to borrowing funds occurred in the very last period.

Benchmarking

All figures of peer groups are referred to the MicroBanking Bulletin (MBB) database updated as of December 2004. The CredAgro ratios indicated here do not fully correspond to the ratios presented in the report as they are calculated according to the MBB methodology¹. As for the MFIs Viator (Azerbaijan), and Azercredit (Azerbaijan) rated by *Microfinanza Rating* in 2005, the ratios included were extracted from the *Microfinanza Rating* database and are calculated according to the MBB methodology. Please consider that the figures presented are relative to different periods.

Financial ratios, US\$	<i>CredAgro</i>	ECA High	Non Banks (FSS MFIs)	Individual	Viator, Azerbaijan Sep05	AzerCredit, Azerbaijan Dec05
Gross Loan Portfolio gross loan portfolio adj for standardised write-offs (US\$)	5,379,446	5,277,689	15,717,164	44,094,691	2,086,517	2,315,672
Average Loan Balance per Borrower on per capita GNI Average loan balance per borrower/ GNI per capita(%)	170%*	197%	76%	86%	39%	43%
Portfolio at Risk > 30 Days outstanding balance of loans overdue > 30days/gross loan portfolio (%)	0.8%	2.7%	3.5%	4.2%	2.2%	0.9%
Adjusted Return on Equity AROE adj net operating income after taxes/avg tot equity (%)	-2.3%	15%	51%	8%	0.1%	-11.0%
Portfolio yield Financial Revenue from Portfolio/ Adjusted Average Gross Portfolio	24.2%	25.2%	35.5%	34.5%	37.7%	41.9%
Debt/ Equity Ratio adj.tot.liabilities/adj.tot.equity	0.2	1.8	2.4	6.9	0.1	0.8
Operating Expense/ Loan Portfolio (operating expense + In-Kind donations)/avg gross loan portfolio (%)	11.8%	14.3%	26%	20%	22%	33%
Borrowers per Loan Officer n. of active borrowers/n. of loan officers	96	94	280	238	337	216

ECA High, Eastern Europe and Central Asia, Avg. Balance per Borrower/ GNI per Capita > 150% and ≤ 275%

All figures are referred to the MicroBanking Bulletin database updated as of December 2004. Average loan balance per borrower on per capita GDP

CredAgro is compared to two sets of peer groups: the first considers the MFIs operating in ECA countries with high target, the non-banking financially self sufficient MFIs and the organizations using the individual lending methodology; the second one considers two MFIs already rated by *Microfinanza Rating* in Azerbaijan.

Considering the first set of peer groups, CredAgro has not yet achieved the size attained by Non Banks (FSS MFI) and Individual lending MFIs (from three to nine times larger in terms of portfolio). This is reflected in the very low debt to equity ratio of CredAgro (0.2) compared to the two peer groups mentioned above (2.4 and 6.9).

The outreach in depth as estimated by the average loan balance per borrower on per capita GNI (170%) is comparable to the ECA high MFIs (197%), much higher than the other two peer groups. Thus, the productivity level of CredAgro (96 borrowers per loan officer) is significantly lower than Non Banks (FSS MFI) and Individual lending MFIs but in line with the ECA high (94 borrowers per loan officer).

CredAgro's portfolio quality (0.8% PAR30) is above the already good level shown by Viator and Azercredit (2.2% and 0.9% respectively). The negative level of AROE (-2.3%) is intermediate between the returns registered by Viator (0.1%) and by Azercredit (-11%), and are partially due to the high inflation affecting the Azeri economy. The lower portfolio yield of CredAgro (24.2%), brought about by the different market positioning (the other two Azeri MFIs serve lower layers of the market), is compensated by the significantly higher performance in terms of efficiency (operating expenses / average loan portfolio equal to 11.8%).

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 CredAgro positioning

Institutional background

CredAgro is a **Non-Banking Credit Organization** which was established in May **2000** as a limited liability company in the framework of the **Azeri Rural Credit project** supported by ACDI/VOCA. **ACDI/VOCA, channeling the USAID donations**, has been constantly sustaining the development of CredAgro, providing technical assistance for the capacity building, granting US\$ 3 million as loan capital and supporting the operating expenses of the institution over time. In 2005 USAID granted the property of CredAgro to ACDI/VOCA, which is currently the sole owner of the organization. With its developed network of branches, CredAgro targets the **upper end of the rural market**, partially **overlapping** with the **banks** which are **downscaling** their operations, and is now the fifth larger MFI in Azerbaijan in terms of portfolio.

Political and macroeconomic context

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

Sovereign risk²

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

Since 1994, with the normalization of the economic situation and of the relationship with Armenia, the country has attracted growing international interest and foreign direct investments because of its rich oil and natural gas reserves in the Caspian Sea basin. **Azerbaijan has enjoyed in recent years strong growth and stable macroeconomic environment.**

Azerbaijan

Macroeconomic Indicators	Dec03	Dec04	Dec05	Apr05-May06
Exchange rate in US\$ (end of period)	4.923,0	4.903,0	4.593,0	4.497,5
Exchange rate variation	0,6%	-0,4%	-6,3%	-5,5%
Inflation rate (end of period)	3,6%	10,4%	7,4%	6,6%
Inflation rate (average of the period)	2,2%	6,7%	11,8%	8,4%
Deposit rate	9,5%	9,2%	8,5%	8,8%
Lending rate	15,5%	15,7%	17,0%	17,2%
Real GDP growth	11,2%	10,2%	24%*	27.5%*
GDP per head (US\$)	877	1.023	1.532	2064**

Source: International Finance Statistics, EIU, National Bank of Azerbaijan.

* Estimates

** Estimate for 2006

Since 2000, the **Gross Domestic Product** has grown on average by **10.6%** per year, reaching 21% in 2005 due to the **oil boom and gas production**. A surge in hydrocarbons output is supposed to support Azerbaijan's economic expansion in 2006-07, with the most of production exported to Western markets. Real GDP growth is therefore expected to accelerate from an estimated 24% in 2005 to 27.5% in 2006.

The annual **inflation** in the period 2000-2003 stands at a modest 3%, while in **2004** it jumped to **10.4%**. The sharp rise of the prices provoked by the significant hard-currency inflows continued in 2005 (7.4%). However, the consumer price inflation decelerated in **2006 (6.6%)**, and it is expected

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

to further slowing down to about 5% in 2007. The inflationary pressures will be maintained under control by allowing a nominal appreciation of the local currency.

A new currency, the **New Manat**, corresponding to 5,000 Manat, was introduced at the beginning of 2006.

While affirming itself as oil and gas exporter, its non-oil economy is national market-oriented and is characterized by a low competitiveness (compared to neighbour countries). Over 40% of Azerbaijan's population is still living in poverty because the oil sector, as a capital-intensive industry, provides employment for less than 1% of the workforce³.

Microfinance sector

The market coverage of Azeri MFIs is still very low, as microfinance reaches only 10% of an estimated 670,000 rural households' potential market; however, the microfinance sector is rapidly growing. The leading actor is the **Microfinance Bank of Azerbaijan (MFBA)**, which was founded by a group of international shareholders⁴ and is financed by the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC/WB), among others. As of March 2006 this fast-growing bank presents an outstanding loan portfolio worth more than US\$ 17.5m and 5,724 clients. **AgrarCredit**, with an outstanding portfolio worth almost US\$ 12m and 3,627 clients is the second MFI by size. The third one is **FINCA**, which serves more than 27,000 active clients and has an outstanding portfolio almost worth US\$ 10.5m. The remaining MFIs, largely managed by international humanitarian organizations, have a smaller portfolio and a lower number of branches, even if some of them have a considerable outreach in depth.

Besides the specialized MFIs, **banks have recently started to penetrate the sector**, hiring staff with microcredit experience and downscaling their offer with competitive products (both consumer and production), thus **increasing the level of competition**.

The Azerbaijan Microfinance Association (AMFA), which performs an active role in lobbying, training and benchmarking, includes 20 organizations (3 are non-member reporting MFIs): the majority if them operates in microlending, while 2 members are devoted to SMEs lending and one is a second tier MFI. As of March 2006, the total outstanding portfolio of the organizations reporting to the Association is more than US\$ 72m, and on the overall, they are able to reach more than 70,000 clients.

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

Originating from the generally insufficient communication between the foreign donors of the MFIs and the local government, the whole sector is now facing the **claims of the Azeri government on the use and ownership of the capital granted to MFIs**. In general, the creation and the funding of MFIs from foreign donors were allowed by the Azeri government under bilateral agreements with the foreign governments involved for the humanitarian purpose of the microfinance organizations. The donations that CredAgro received from **USAID** (channelled by ACDI/VOCA) were accepted by the Azeri government in the framework of the **financial assistance that the USA Government intended to grant to the Rural Credit project**.

In the future evolution of several Azeri MFIs, the opening to equity investors or the complete exit of the donors will raise the issue of the ownership of capital, which is currently property of the donors by contract, and of the Azeri people according to the government claims (humanitarian purpose). Moreover, once the law will be approved and some MFIs will be transformed into fully commercial organizations, they may be willing to distribute dividends. The Azeri government may be opposing this scenario to the extent that fiscal advantages were granted to the MFIs because of their humanitarian missions (exemption from paying social taxes and profit taxes, the latter valid until 2005). One possible exit form this impasse is the **calculation of the taxes relative to the past periods** that MFIs may be asked to **pay retroactively**.

³ UNDP Azerbaijan

⁴ EBRD, IFC, Black Sea Trade and Development Bank, LFS Financial Systems

It is expected that the approval of the new microfinance law (term for the NBCO to choose between the non profit and the for profit status) will facilitate the donor agencies and the Azeri government to come to an arrangement.

Regulation and supervision

A **specific law for microfinance** is **lacking** at the moment, but the National Bank is currently working on a **draft of Microfinance Law**, which may be submitted to the Parliament in autumn this year. **AMFA** is currently lobbying the National Bank to obtain a suitable regulatory framework. Among the advantages that the present draft would bring, it is worth mentioning the possibility for MFIs to acquire a **full for-profit status**, the future development of prudential norms and a closer supervision from the National Bank of the organizations that will be allowed to collect savings (subject to specific requirements). On the other hand, some degree of **uncertainty** remains about **social tax exemption**, which is temporary and has not a defined term (the last communication covers the year 2006).

The regulatory provision currently in force is an addenda to the “Rules for licensing of credit organisations, their branch offices (issue of permit for banking transactions) and for organisation of their activity” of the National Bank of Azerbaijan, dated November 1996. **Supervision** is 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)**. MFIs registered as limited liability companies are **not allowed to collect savings**, unless they transform themselves into banks. MFIs are required to pay profit taxes since 2005. However, thanks to their social orientation, they are currently **exempted by decree from paying social taxes**.

CredAgro does not participate to the Credit Register established by the National Bank, whose effectiveness is by the way still limited. However, the MFI does not even systematically exchange information about clients with the credit organizations operating in the same areas. Given the increasing competition, this **represents a risk of over-indebtedness of clients** for the future.

CredAgro's market positioning

CredAgro is providing **credit, leasing and consumer** products to the **upper segment** of the **rural** market of microfinance. Operating in the **Absheron** area, in the **south** (Jalilabad, Masalli and Lankaran), in the **west** (Ismayilli, Zagatala, and Tovuz), and in the **north** (Khachmaz and Guba), CredAgro is exposed to the increasing competition coming from banks and, to a lesser extent from non banking credit organizations. CredAgro, serving the upper segment of the market, is particularly affected by the recent trend of **banks to downscale** and penetrate the microfinance market, especially in the Absheron peninsula, which presents a higher concentration of providers. Among the main non-banking competitors of CredAgro are **Agrar Credit**, providing agricultural loans and **Finca**, especially in the southern region. The areas of operation of **MFBA**, **International Bank of Azerbaijan** and **Kapital Bank** largely overlap with CredAgro's. Competition with banks may become stronger considering that **CredAgro's clients open bank accounts** to repay the loans with many Azeri banks, and even if now there is no evidence of a particular client drop-out

Main competitors, figures as of March 2006

Institution	Gross portfolio	Products	Loan size	Loan maturity	Interest rate	Active clients
CredAgro	5,382,362	individual	300 - 50,000	3 - 36 months	22% - 28% declining	1,530
Agrar Credit	11,951,000	group and individual	1,000 - 100,000	3 - 5 years	7% -24% yearly	3,627
Finca	10,452,339	group and individual	10,000 - 50,000	4 - 12 months	2.5% - 3.5% monthly, declining	27,288
MFBA	17,544,427	individual	10,000 - 125,000	3 - 36 months	2.5% - 3.5% monthly, declining	5,724

flow directed towards these banks, the phenomenon may occur in future. CredAgro is mitigating this risk diversifying the partner banks, and, along with the expansion of operations, it may become cost effective to shift to the cash system.

If the pricing of the banks' products is substantially in line with the CredAgro's, the latter presents the following **competitive advantages**:

- Expertise in rural finance
- Transparency of operations
- Access not only for companies, but also for physical persons, to the leasing products

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

- Longer procedures to issue loans, prolonged by the current lack of funds
- Shortage of funds, entailing shorter maturity and lower amounts
- Higher vulnerability to staff turnover
- Impossibility to offer deposit and payment services to clients

2. Governance and operational structure

Ownership and Governance

CredAgro is 100% owned by **ACDI/VOCA**, a US non-profit corporation, and it is incorporated in Azerbaijan as a limited liability company. The original source of funds for lending capital and operational start-up was USAID, under a cooperative agreement. In 2005 USAID granted the property of the MFI to ACDI/VOCA even CredAgro currently operates independently from USAID under the governance of ACDI/VOCA and of the Supervisory Board.

The **Supervisory Board** of CredAgro includes four members and, by Statute, it has to meet at least four times a year. Meetings of the board are currently held five to six times a year.

CredAgro, as limited liability company, is not required by law to have a Supervisory Board, but ACDI/VOCA decided to set up a governance body dedicated to the institution which has also applied to the Azeri authorities to be officially recognised.

The composition of the Board seems quite balanced in terms of expertise and background of the members. However, a **specific professional banking expertise**, which will be crucial for the future evolution of CredAgro, **is currently lacking**.

At the moment CredAgro lacks a governance written manual (or guidelines) and a written methodology for assessing the management. The Supervisory Board is not organized into committees even if the proposal to set an Audit Committee and an Evaluating Committee is under discussion.

Supervisory Board		
Members	Charge	Background and current profession
Fred Smith	Chairman	Vice President for ACDI/VOCA in the Europe & Asia Division. Specialized in micro- small- and medium-sized enterprise (MSME) development with extensive experience in the design and implementation of technical assistance programs supporting MSME, micro and rural credit, and business development services.
Azer Humbatov	Member	Experience in banking, microfinance, grant management and training, has acquired valuable experience in working with different projects of international financial institutions such as the Asian Development Bank and the World Bank. Currently Mr. Humbatov works as a Banking and Financial Specialist, International Finance Corporation (World Bank Group), Azerbaijan Corporate Governance Project.
Gulnara Hasanova	Member	General Manager of Aqua-Vita - TAJ company, a leading water production and distribution company in Azerbaijan. Currently enrolled in an MBA program with the Open University Business School of London. She holds a Master of Education degree.
Elchin Mammadov	Member	Resident Director of the Baku Office of Ledingham Chalmers law firm providing advisory services on all aspects of Azeri commercial law with emphasis in banking and finance, oil and gas, taxation and investment.

The **relationship between the ownership and the top management** has experienced some difficulties in the recent past, reflecting **some uncertainties of ACDI-VOCA** (owner of CredAgro) about increasing the commercial borrowings and, more in general, **about the growing commercial nature of CredAgro**. This situation has led to some problematic consequences, such as the still undefined strategy about CredAgro's institutional evolution and about the role of ACDI-VOCA within the institution, and the **dangerous stand-by in the approval of commercial**

borrowing imposed by the owner, in spite of clear growth potentials and of availability of a variety of sources of funds. The position of ACIDI/VOCA on “opening CredAgro’s doors” to external borrowings has been maintained quite rigid so far (only the funds from Blue Orchard have been approved and received), but clear signs of a positive evolution are visible in the very last period as **new borrowing funds have been approved just after the conclusion of the rating visit of Microfinanza Rating’s analysts.**

Organisation and structure

CredAgro’s headquarters (HQs) are based in **Baku**, in the same building of the Absheron branch. The other **five branches** are located in Guba, Masalli, Ismayilli, Tovuz and Zagatala; moreover, the sub-branches in Xachmaz, and in Jalilabad and Lenkoran, report to the Guba and Masalli branches respectively.

CredAgro’s organizational model on the territory is based on regional branch offices and related sub-offices. Administrative functions like accounting, office administration and management are centralized at the regional office, thus improving the efficiency of operations. Currently, such a structure is visible only in Guba and Masalli Rayons, where the decentralization of operations is deeper, with 2 local Credit Committees that can independently approve loans up to US\$ 5,000⁵.

The same organizational model will be adopted in other regions along with the expansion process of operations.

The typical structure of the regional office includes a branch manager, a bookkeeper, a senior loan officer and the administration officer. The sub-branch staffs are normally represented by loan officers.

The regional **branches prepare monthly financial statements and, with the chief accountant, the annual budget.** The

communication flow between the HQs and the branches is good: meetings are held in Baku for managers, accountants and loan officers with an adequate frequency.

Personnel	Dec03	Dec04	Dec05	May06
Total	49	49	53	55
Loan officers	13	14	15	16
Other staff	36	35	38	39

Human Resources

As of May 2006, CredAgro counts a total of 55 staff, out of which 16 loan officers. The staff allocation ratio (33%) presents room for improvement; the future staff composition will mainly depend on the opportunities of up-scaling that will arise for CredAgro in the next future.

CredAgro relies on personnel of good quality, both at central (headquarters) and at local level.

The **General Director**, Mr. Eldar Jafarov, is an economist with professional experiences in agri-businesses financial and development services. It started its relationship with ACIDI/VOCA as business development consultant within the Azeri Rural Credit (ARC) Project in 2000 and then as loan officer. Mr. Jafarov is the Director of CredAgro since 2002 and is currently also the Chairman of the Azerbaijan Microfinance Association (AMFA) and this is confirming his in-depth knowledge of the microfinance sector and the management capacities.

The **Management Committee** of CredAgro includes, besides the Director, the Operation Manager, the Chief Accountant, the HR Manager and the Lawyer.

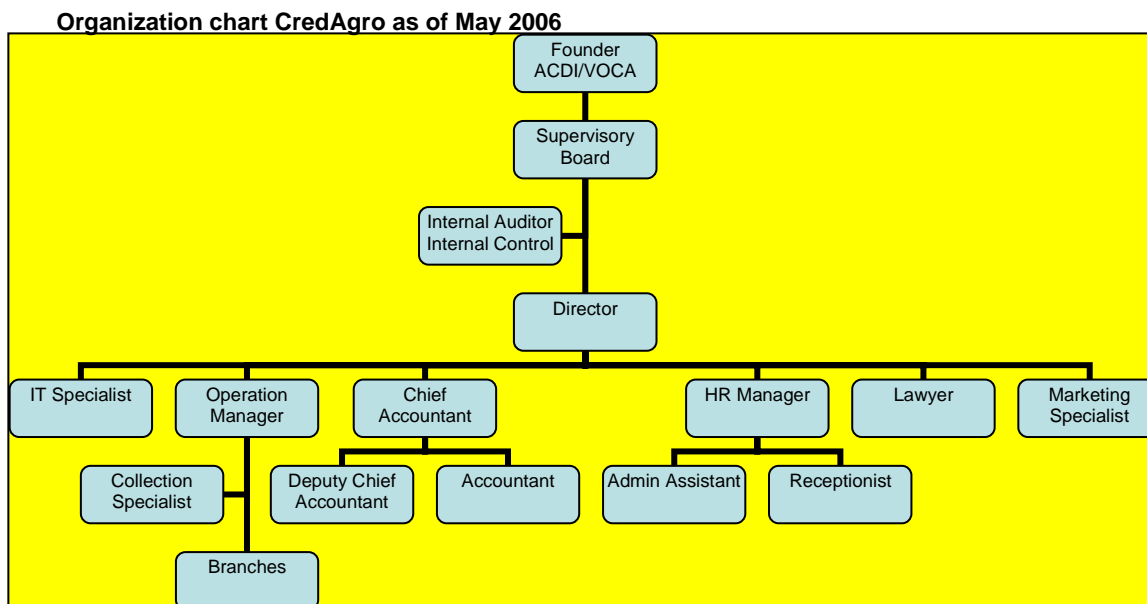
Other functions are covered by the **Marketing Specialist**, the **IT Specialist** and a **Collection Specialist**.

The **Internal Audit** function, which includes an Internal Auditor and an Internal Monitor officer, is independent from the management as it reports directly to the Supervisory Board, and it is well organized in terms of planning, tools (Internal Audit Manual has been completed and up-dated), and specific expertise. In fact, after 6 months of suspended audit operations (November 2005- May 2006), a new Internal Auditor was hired, replacing the person who is now covering the Operational

⁵ Given their recent introduction, consumer loans can be approved by the local Credit Committee up to US\$ 1,000.,

Manager position. The current internal auditor has a wide audit experience in a number of microfinance institutions.

Financial risk management and, in particular, Asset-Liability Management (ALM) **are not yet adequately formalized within the risk management policies** and procedures. However, along with the access to more commercial borrowings, the management is considering the introduction of ALM tools to be systematically used.



Human resource policy is complete and adequate at CredAgro. It is based on systematic appraisal of staff performance and training needs, appropriate training programs for all the management and governance positions, formalized recruitment processes, and effective incentive system.

However, the **salary level is often perceived as lower than expected or not in line with the remuneration offered by competitors**, especially by the credit staff. CredAgro has not so far directly conducted surveys on salary levels within the market and it is currently using external sources of information (like the US Chamber of Commerce survey) for this purpose.

Staff turnover for the period June 2005-May 2006 is 16.4% and it used to be 13.2% in 2005 and 16.3% both in 2004 and 2003. These quite high values reflect the difficult operation environment, considering the market positioning of CredAgro as a micro-small enterprise finance provider, characterized by the **strong competition of banks**.

Management Information System

At the end of 2004, CredAgro introduced a new management information system called RS Bank, a banking system developed and sold by an IT provider based in Moscow and Kiev.

Including the accounting module, the MIS allows the **integration between portfolio and accounting** information; the IT policy manual includes adequate back-up and security policies. However, the **portfolio data is not fully reliable** and **technical assistance and maintenance are not immediately available** as the provider is based in Ukraine.

Other weaknesses refer to the lack of portfolio and financial reporting: the portfolio break-down by loan officers, some relevant statistics and financial analysis and ratios are not automatically and systematically produced by the system.

The IT department is currently understaffed, but a new person should join it in the near future.

The management demonstrates to be aware about all these shortcomings and has already taken measures to reduce some MIS rigidities.

3. Lending operations

Financial products

CredAgro offers a **very well diversified range of products**: for business, consumption and leasing. On average, the **agricultural** (crops and livestock) and the **processing** loans are the most **competitive** ones (around 20% interest rate); in comparison to them, the **consumption** and **leasing** bear sensibly higher rates (**28%** on average), while for the **trade** product **26%** interest rate is charged .

Credit methodology

Credit products							
US\$	Crops	Livestock	Processing	Trade	Consumer	Leasing	Service
<i>Credit methodologies</i>	individual	individual	individual	individual	individual	individual	individual
<i>Currency of the credit</i>	USD/AZN	USD/AZN	USD/AZN	USD/AZN	AZN	USD/AZN	USD/AZN
<i>Type of interest</i>	declining	declining	declining	declining	declining	declining	declining
<i>Min. interest rate</i>	22%	22%	25%	25%	26%	22%	25%
<i>Max. interest rate</i>	22%	24%	25%	26%	28%	28%	25%
<i>Average interest rate</i>	20%	19%	20%	26%	28%	28%	24%
<i>Description of commissions</i>	0.5%	0.5%	0.5%	0.5%	US\$ 10 for each US\$ 1000	1%	0.5%
<i>Min. credit amount</i>	500	500	500	500	300	500	500
<i>Max. credit amount</i>	50,000	50,000	50,000	50,000	10,000	40,000	50,000
<i>Max credit amount for the first loan</i>	50,000	50,000	50,000	50,000	10,000	40,000	50,000
<i>Average credit amount</i>	2,599	3,669	8,777	4,427	997	8,971	5,606
<i>Min. loan maturity</i>	6 months	6 months	6 months	6 months	3 months	6 months	6 months
<i>Max. loan maturity</i>	24 months	24 months	24 months	24 months	24 months	36 months	24 months
<i>Average loan maturity</i>	12 months	15 months	14 months	13 months	12 months	18 months	14 months
<i>Periodicity of interests payments</i>	monthly	monthly	monthly	monthly	monthly	monthly	monthly
<i>Periodicity of principal payments</i>	flexible	yearly	flexible	flexible	yearly	monthly	flexible
<i>Grace period</i>	3 months	3 months	3 months	3 months	-	-	3 months
<i>Collaterals / guarantees</i>	Pledge, mortgage	Pledge, mortgage	Pledge, mortgage	Pledge, mortgage	Pledge, mortgage, guarantors	Pledge, mortgage	Pledge, mortgage

Due to the current **shortage of funds**, the **loan maturity** and **amount** offered are **not large enough to meet** some **clients' needs**. This is especially true for the CredAgro better-off clients, whose businesses grow at high pace. Once new funding will be available, the maturity and loan amounts will be extended to better fit clients' financial needs. The obligation to **activate a new mortgage for each loan** (entailing high transaction costs), established by the Azeri law, is an additional factor contributing to the clients' dissatisfaction with respect to the short maturity.

On the other hand, the **flexibility of the loan repayment schedules** prepared by CredAgro is remarkable, allowing the repayment to be well tailored to the business' cash flow. Besides, the fact that the leasing product is not only accessible to enterprises but also to physical persons (unlike many leasing companies in Azerbaijan) represents an advantage for CredAgro.

Given the exchange rate losses cumulated in 2005, at the end of the year the Supervisory Council approved the possibility to **disburse loans in AZM**, up to the limit of 20% of the total portfolio.

In June 2006 the Supervisory Board approved the **express loan**, which is now in a testing phase (can not exceed 10% of the outstanding portfolio) and is characterized by small amounts (maximum US\$ 3,000), high returns (30% interest rate) and broad accessibility (guarantors as collateral, disbursement in 3 working days).

Lending procedures

The evaluation and monitoring procedures followed by CredAgro are adequate and consolidated. The **assessment** of the client is done through the **5C system**⁶; the estimated capacity to repay takes into account the projected cash flow of the business and of the family, including other financial obligations⁷. Three formats are used for the assessment according to the purpose of the loan: consumer, business or leasing.

The disbursement process for collateralized business loans is quite long, lasting **two or three weeks**, mainly due to the time necessary for the collateral registration. The process is more rapid for consumer and leasing loans.

CredAgro policy allows **rescheduling** loans in case financial difficulty for the client if the new conditions can increase the probability of repayment. The decision of restructuring loans is taken by the central credit committee, which can approve special provisions on the restructured portfolio (separately tracked in the MIS).

The **follow up of late loans** is effective, based on rapid reaction and close monitoring. After one month of delay, the case is passed to the collection specialist and at the same time the central credit committee generally decides to start the court procedure. In 2005, seven cases were solved by court judgement in favour of CredAgro (two in 2006), but the process takes long to be completed (5-6 months).

Collaterals and accessibility

Except for the **consumer** loan and for the **express** loan (in testing phase), which can be backed by **guarantors**, the **other products** require real collaterals (**pledge** or **mortgage**). For the first credit, the collateral estimated value should be at least **200%** of the loan amount, while starting from the second cycle it can be **150%**. As already mentioned the necessity to **activate new mortgages for each loan** is limiting the accessibility of CredAgro products and contributing to some degree of client **dissatisfaction**.

⁶ Character, capacity, capital, conditions, collateral

⁷ Depending on the size of the business, loans can be issued also to clients with other financial obligations.

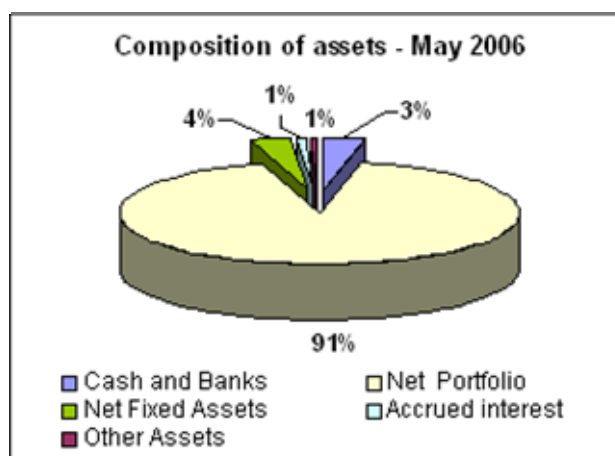
4. Assets structure and quality

Assets structure

The **concentration of resources in the core business is very good**, with net portfolio accounting for **91%** of total assets. **Liquidity** also stands at **adequate** levels, **3.7%** on average in the last 12 months. Net fixed assets represent 4% of the total assets while accrued interest and other assets account both for 1%.

Portfolio structure

As of May 2006 the outstanding portfolio is equal to **US\$ 5,382,362**; the **trade** portfolio represents 47% of the total amount but the portion of **consumer loans is rapidly growing** and it is planned to reach 18% by the end of 2006. At the same time the share of trade and services portfolios is expected to decrease, counterbalanced by the higher growth of leasing.



As it is shown in the table below, the growth pace of CredAgro has been fluctuating in the last three years, dropping from 53% registered in 2003 to 19% in 2004, and recovering in 2005 (29%). Mainly thanks to the access to the Blue Orchard funding (November and December 2005) the portfolio growth in the **last quarter of 2005 was extremely rapid (119%, annualized)**, justifying the 28.3% rate registered in the period June 2005 – May 2006 despite of the **stagnation** that characterized the **first 5 months of 2006 (0.5% growth, annualized)**.

Portfolio features	Jan03 Dec03	Jan04 Dec04	Jan05 Dec05	Jun05 May06
Gross outstanding portfolio (US\$)	3,217,003*	3,828,057	5,258,421	5,382,362
Crops	665,655	1,267,664	288,588	309,340
Livestock	1,294,964	452,660	944,243	741,146
Processing	255,336	280,092	282,355	201,871
Trade	917,191	1,530,596	272,232	2,527,835
Consumer	0	0	10,122	539,222
Leasing	0	0	0	98,679
Service	na	297,045	764,578	964,269
Gross portfolio (AZM)	15,837,308,000	18,768,962,000	24,151,928,000	24,207,175,000
Growth of active gross portfolio	58.6%	18.5%	28.7%	28.3%
Average disbursed loan amount (US\$)	4,461	5,164	5,463	4,946
Av. disbursed loan size on per capita GDP	509%	505%	357%	239%
Average maturity (months)	na	na	na	12
Number of active borrowers	945	1,070	1,287	1,530
% of active borrowers women	na	5.4%	8.5%	8.2%
Drop-out ratio	21.7%	26.3%	37.9%	56.6%

*The sum of products is not equal to the total outstanding portfolio because of unavailable data for Service. na = not available

This evolution shows on one hand the high potential of CredAgro in terms of fast liquidity allocation, and at the same time the current **shortage of resources**, which is currently hampering its portfolio growth.

The same picture is given by the evolution of the average disbursed loan amount, which decreased by 22% in the first 5 months of 2005. Despite the precedence given to the repeated borrowers, the **waiting lists⁸** of clients and the **limitations imposed on the loan amounts and maturity** are reflected by the **drop-out ratio**, which has constantly increased during the past years and stands at a high **57%** in the last period. Moreover, if new funds will not be available, the situation may

⁸ On average, waiting lists include from 20 to 30 clients in each branch.

even worsen to the extent that the institutional culture in banks will improve and transparency will not be a competitive advantage on banks for CredAgro any longer. Given the increasing competition, the fact that the **reasons behind clients' drop out are not systematically analysed** within the organization and that the written reporting on it is not complete represents a risk of loose monitoring of the market trends.

Targeting SMEs is reflected in the **high average loan on per capita GDP** (239%) and in the **low participation of women** (8.2% of total clients).

As a general policy, no loan can be larger than 1% of the available loan capital⁹ (around US\$ 55,000). However, as of May 2006, 45% of portfolio is composed of loans larger than US\$ 10,000, and **11% of portfolio** consists of **loans larger than US\$ 25,000**.

As far as the portfolio structure by sector is concerned, the

concentration into trade (47% of total portfolio) is mitigated by the diverse nature of the businesses financed (agricultural products, construction materials, drugs, grocery shops, etc). Sector limits on portfolio are approved together with the yearly budget by the BoD.

May-06

Loan amount disbursed (US\$)	outstanding portfolio	% of outst. portfolio	% number of borrowers	PAR ^a	PAR ^a weighted
200-500	23,320	0.4%	6.1%	0.0%	0.0%
501-1,000	124,722	2.3%	15.8%	0.0%	0.0%
1,001-2,000	293,601	5.5%	18.3%	0.7%	0.0%
2,001-3,000	472,310	8.8%	15.5%	0.6%	0.1%
3,001-5,000	640,346	11.9%	14.1%	0.0%	0.0%
5,001-7,000	415,216	7.7%	6.9%	0.7%	0.1%
7,001-10,000	995,002	18.5%	10.8%	1.6%	0.3%
10,001-25,000	1,837,330	34.1%	11.1%	1.1%	0.4%
>25,000	580,517	10.8%	1.4%	0.0%	0.0%
TOTAL	5,382,362	100%	100%		0.8%

^aPortfolio included in the CredAgro's risk categories from 2 to 5, see annex 5 for more details

Loan portfolio quality

The portfolio quality of CredAgro is very good, with **PAR>30** equal to **0.8%** as of May 2006. Credit risk is concentrated in relatively young aging categories (0.6% of PAR30 is from 61 to 90 days late). Considering the restructured portfolio (0.6%) and the write off ratio (0%), the picture remains very positive, with the loan loss reserve ratio large enough to cover potential losses.

Portfolio Quality Indicators	Jan03 Dec03	Jan04 Dec04	Jan05 Dec05	Jun05 May06
Consolidated PAR30	1.0%	0.9%	0.7%	0.8%
31-60	0.1%	0.6%	0.3%	0.0%
61-90	0.4%	0.1%	0.1%	0.6%
91-180	0.4%	0.2%	0.0%	0.2%
181-365	0.0%	0.0%	0.3%	0.1%
>365	0.0%	0.0%	0.0%	0.0%
Arrears rate (> 1 day)	0.7%	0.3%	0.8%	0.5%
Restructured portfolio	0.1%	0.9%	0.0%	0.6%
Provision expense ratio	3.9%	0.3%	0.4%	0.4%
Loan loss reserve ratio	1.2%	1.3%	1.2%	1.3%
Risk coverage ratio (30 days)	124.1%	140.4%	167.3%	164.1%
Write off ratio	0.02%	0.02%	0.20%	0.03%



The portfolio quality graph shows a stable picture of PAR30, with **limited fluctuations** registered in the last 12 months, also in the period of rapid growth of portfolio (last quarter of 2005).

⁹ Cash accounts plus gross loan portfolio less loan loss reserve.

May-06

Branch	outstanding portfolio (US\$)	% of outst. portfolio	% number of borrowers	PAR > 30 days	PAR > 30 weighted
<i>Absheron</i>	865,360	16.1%	13.3%	0.8%	0.1%
<i>Masalli</i>	1,352,156	25.1%	23.4%	0.9%	0.2%
<i>Guba</i>	1,218,560	22.6%	29.4%	0.3%	0.1%
<i>Ismayilli</i>	498,955	9.3%	15.6%	3.9%	0.4%
<i>Tovuz</i>	787,474	14.6%	9.8%	0.0%	0.0%
<i>Zagatala</i>	659,859	12.3%	8.4%	0.0%	0.0%
TOTAL	5,382,362	100%	100%		0.8%

As it is shown in the table of portfolio by branch, half of the portfolio at risk is included in Ismaayilli portfolio, and 30% of it belongs to Lenkoran, sub-branch of

Masally office. The cause of the delinquency concentration in that branches is related to the inadequate management of portfolio carried out by the personnel of the sub-branch (they have now been replaced or responsibilities have been redistributed). The **moderate concentration** of portfolio in **Masalli** and **Guba** branches is mitigated by the fact that the two include the portfolio of the sub-branches.

The analysis by loan product highlights the relatively **higher risk associated to the Service**, with 2% PAR30 and a weighted impact on the total PAR30 of 0.4%. However, the risk remains limited in absolute terms.

May-06

Loan product	% of outst. portfolio	PAR >30 days	PAR > 30 weighted	PAR >1 day	PAR > 1 weighted
<i>Crops</i>	5.7%	0.0%	0.0%	0.9%	0.1%
<i>Livestock</i>	13.8%	1.3%	0.2%	8.9%	1.2%
<i>Processing</i>	3.8%	0.0%	0.0%	1.8%	0.1%
<i>Trade</i>	47.0%	0.3%	0.1%	2.3%	1.1%
<i>Consumer</i>	10.0%	1.3%	0.1%	4.4%	0.4%
<i>Leasing</i>	1.8%	0.0%	0.0%	0.0%	0.0%
<i>Service</i>	17.9%	2.0%	0.4%	5.1%	0.9%
TOTAL	100.0%		0.8%		3.8%

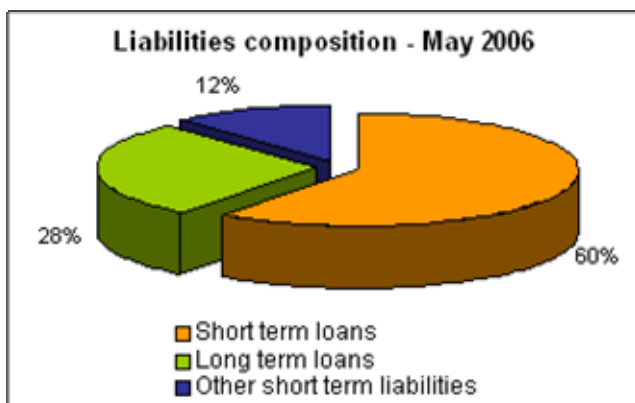
5. Financial structure and ALM

The financial structure of CredAgro is characterised by the major role of equity and by the **large room for increasing the financial leverage**.

As of May 2006 the **debt to equity ratio** is equal to **0.2**. Along the years, equity increased thanks to the donations received and to the progressive capitalization of the earnings produced. At the end of 2005, CredAgro started borrowing commercial funds to feed its growth.

Liabilities and equity structure

28% of CredAgro loans are due in the **long term**, while **60% fall due by May 2007**. CredAgro liabilities include the **three loans** borrowed from **Blue Orchard** at the end of 2005 (2 of them worth of US\$ 300,000 and one of US\$ 200,000), with interest rate equal to the LIBOR 6 months plus 6%.



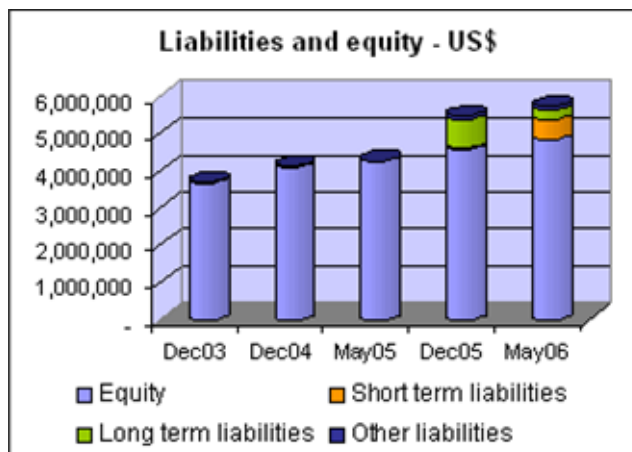
The realization of the relevant **growth potential** of CredAgro depends on the access to borrowings, which has been suspended by the ownership of the MFI in the last months. However, the management has been very active in negotiating with a number of investors, and several agreements are ready to be formalized. The **impasse with ACIDI/VOCA**, translated into the current **shortage of funds**, is reflected by the stagnation of the portfolio growth in 2006 (0.5%, annualized). However, the recent **positive evolution** of the relationship between the management and ACIDI/VOCA increases the likelihood that the lending agreements ready to be finalized will be approved by the owner. Indeed, the **negotiation process is at the concluding stages** with Oikocredit, EBRD and the Global Microfinance Facility (GMF).

As of May 2006 the **total equity** is worth of **US\$ 4.8 million**. If the bulk of it (**71%**) is still represented by the large **donations** received along the years from **ACIDI/VOCA**, the **earnings** produced and retained by CredAgro already account for **29%** of the total equity.

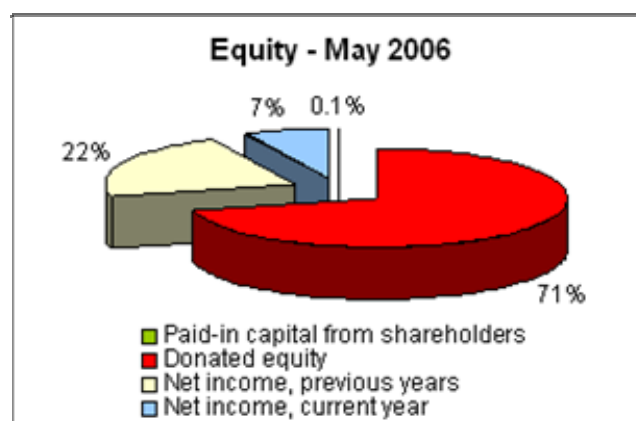
The short term capitalization strategy is based on the net income generated, while in the medium-long term the ownership may be opened to other international and national actors.

Assets and Liabilities Management

Given the planned growth and increase of borrowings, the **lack of appropriate tools for the financial risk management and for the budget variance analysis**¹⁰ represents a weakness. The



The **impasse with ACIDI/VOCA**, translated into the current **shortage of funds**, is reflected by the stagnation of the portfolio growth in 2006 (0.5%, annualized). However, the recent **positive evolution** of the



¹⁰ Monthly analysis for the planned against achieved results.

management is aware of these shortcomings and is planning to introduce interest rate and foreign currency risk analysis in the next future.

As of May 2006 the **current ratio** is equal to **1.9**; despite of the relatively long maturity of the loan portfolio (loan terms vary from 12 to 18 months), the very low leverage minimizes the maturity mismatch risk. However, while attracting new loans, attention will have to be paid to the maturity structure of assets and liabilities.

May-06			
US\$	US\$*	Local currency	Total
Assets	4,813,220	966,223	5,779,443
Cash and banks	147,839	40,655	188,494
Financial assets			-
Portfolio (net)	4,618,830	692,272	5,311,102
Fixed assets		205,705	205,705
Other assets	46,551	27,591	74,142
Liabilities	834,656	73,195	907,851
Deposits			-
Loans	800,000		800,000
Other liabilities	34,656	73,195	107,851
NET POSITION	3,978,564	893,028	

*Exchange rate AZM / US\$: 4497.5

CredAgro presents an **open position in US\$ worth of US\$ 3.9 m (82% of total equity)**, originating from the fact that the loans are issued in US\$ since the beginning of operations. Given the instability of the AZN/US\$ exchange rate (the US\$ depreciation was worth of 6.32% in 2005), **the foreign exchange risk for CredAgro is currently relevant**. Aware of this risk, CredAgro has **started to disburse AZN loans** (the Supervisory Board fixed the maximum portion of AZN portfolio at 20%, corresponding to the operating expenses of CredAgro). The management affirms its intention to apply to the Supervisory Board to increase the AZN denominated portfolio from

20% to 50%, but the **conservative attitude of the owner**, together with the expected depreciation of the US\$, may result in further exchange rate losses in 2006.

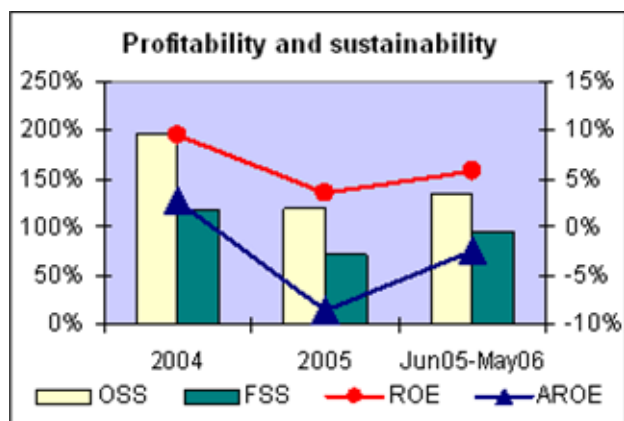
As soon as US\$ denominated borrowings will be received, the open position will decrease.

The **interest rate risk** given by the fixed active interest rate and the variable passive rate to be paid to Blue Orchard¹¹ is widely **mitigated by the low capital leverage** and by the **relevant financial spread**; moreover, CredAgro is currently negotiating loans with fixed interest rates. However, the possibility to index the larger and longer term loans to the LIBOR or EURIBOR considered by the management may become crucial once the level of variable interest borrowings will increase.

¹¹ Indexed to the LIBOR 6 months.

6. Financial and operational results

CredAgro **profitability** is showing a worsening trend since 2004, when both ROE and ROA were at 9.4% (debt to equity ratio was 0), dropping to 3.5% and 3.2% respectively in December 2005 and then slightly recovering to 5.8% and 5.3% as of May 2006. That trend is reflected into the **operational self-sufficiency (OSS)** which reduces from 197% in 2004 to 119% in 2005 and to 135% as of May 2006. The main element affecting profitability and sustainability are the **losses for exchange rate**, stemming from the appreciation of the AZM to US\$ (worth of 6.32% in 2005). On the other hand, the slight improvement shown in the last period is largely due to the higher financial margin achieved in the first five months of 2006 (portfolio yield increased by 19% and lower exchange rate losses).



Financial adjustments have a relevant impact, almost entirely due to the high inflation affecting the Azeri economy: in particular, the relatively stronger adjustment in 2005 is due to the especially high average inflation registered in the period, worth of 11.8%¹². In all the periods, the negative effect of inflation is intensified by the low capital leverage of CredAgro.

AROE drops from 2.7% in 2004 to -8% in 2005 and then partially recovers in the last period, reaching -2.4%. The same trend is followed by the **financial self-sufficiency (FSS)**, which was equal to 117% in 2004, to 73% in 2005 and to 94% in the period June 2005 – May 2006. The worsening trend observed in the unadjusted results is confirmed by these indicators: operating in a fast growing economy, CredAgro has not achieved financial self sufficiency mainly due to the appreciating local currency and the fast growth of the level of prices.

Financial Indicators	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Jun05-May06
Operating expenses ratio (aver. gross portf.)	5.7%	10.4%	11.5%	11.8%
Staff allocation ratio	26.5%	35.0%	31.9%	33.3%
Loan officer productivity (borrowers)	73	76	86	96
Loan officer productivity (US\$)	247,462	273,433	350,561	336,398
Branch productivity (US\$)	536,167	638,009	876,404	897,060
Cost per loan lent (US\$)	187	399	411	390
Cost per borrower (US\$)	204	363	427	439
Funding expense ratio[^]	0.0%	0.0%	0.2%	1.0%
Provision expense ratio	2.3%	0.3%	0.5%	0.4%
Portfolio yield (gross portfolio)	21.3%	21.1%	22.3%	24.2%

CredAgro **efficiency** performances are very good, with an operating expense ratio at 11.8% as of May 2006. The trend shows a worsening of efficiency since 2004 and this is closely related to the missed growth planned, due to shortage of funds.

Loan officers' productivity performances present room for improvements, which are likely to take place once the limitations to the growth so far imposed by shortage of funds will be overcome.

The **provision expense ratio** is very low (0.4%), thanks to the excellent portfolio quality. Funding expenses are still almost insignificant given the very limited access to borrowed funds.

¹² Average inflation was equal to 6.7% in 2004 and to 8.4% in the period June 2005 – May 2006.

The current level of **portfolio yield** (24.2% as of May 2006) is higher than the two previous periods thanks to the introduction of more expensive services like consumer lending and leasing. The current portfolio yield level is allowing CredAgro to maintain a significant margin over the costs, given the very good efficiency and the excellent portfolio quality. Nevertheless, other variables, like inflation volatility, increasing financial expenses and the possible future introduction of social taxes for MFIs (currently exempted) among others, are likely to reduce such margin.

7. Strategic objectives and financial needs

Strategic objectives and strategies

CredAgro's strategic and operative objectives are described within the **business plan** which has been prepared in 2004 and refers to the period **2005-2009**.

Financial projections have been prepared with Microfin for the same period but have not been recently updated since they largely depend on funding opportunities to be concretized. Scenario and sensitivity analysis based on the most crucial variables are missing.

Projected key financial indicators	Actual May06	2006	2007	2008	2009
Net outst. portfolio (US\$)	5,311,102	6,815,660	8,208,866	9,295,400	10,051,848
Growth of outstanding portfolio	28.3%	28.3%	20.4%	13.2%	8.1%
Number of active loans	1,530	2,070	2,453	2,867	3,267
Total liabilities	907,851	3,017,061	4,148,304	4,897,250	5,161,220
Equity multiplier	1.19	1.68	1.89	1.98	1.96
Operating expense ratio	11.8%	10.30%	8.70%	7.90%	7.80%
Active borrowers per LO	96	99	102	102	102

As shown in the table above, CredAgro plans to **double its portfolio by year 2009**, feeding the growth mainly with borrowings, but also planning an increasing of equity up to US\$ 5.3 million by 2009. This is reflected on the equity multiplier which will reach almost 2 in 2008.

Efficiency and productivity will improve along with the up-scaling of operations.

CredAgro **strategy for expansion** is based on increasing the scale of operations of the existing branches (expanding into neighbouring regions) and considering opening new branches in a second phase. Quality of operations and efficiency are identified as key factors: efficiency will be obtained by replicating the structure already adopted in Guba (north) and Masalli (south) with the centralization of accounting and administration functions into regional offices, each one controlling a number of sub-offices. This is definitely a good approach not only for expansion but also for functional decentralization and it has been confirmed by the experience so far with the local credit committees.

Product diversification represents another important element of the business planning and CredAgro has already introduced two new products that are consumer lending and leasing after a careful analysis of the market demand and supply.

Concerning the institutional evolution of CredAgro, **ACDI/VOCA has not currently a clear strategy**; but is showing its intention to maintain a direct involvement in the ownership. The evolution of the relationship between the owner and the **Azeri government** (see chapter 1) represents another crucial factor. CredAgro is also investigating the feasibility to transform (in the long term) into a fully licensed commercial bank. The **transformation into a bank** is considered an important strategic aspect by the top management, as the most effective way to face the increasing competition by banks. However, a formal and complete feasibility study has not been conducted so far.

Financial needs

CredAgro financial needs for 2006 are estimated worth of about **USD 3.6m**.

The most likely sources of funds for this current year, which would fulfil the needs, are Oikocredit, EBRD and the Global Microfinance Facility (GMF).

CredAgro has developed good relationships with many other investors such as Asian Development Bank, Symbiotics, Deutsche Bank, MicroVest, Triple Jumb, Abn-Amro.

Like several MFIs in the country, CredAgro is monitoring the evolution of the **Asian Development Bank project**¹³, which will include a long term investment worth of USD 25million in Azerbaijan at market interest rate.

¹³ The overall project is supposed to include both financing and technical assistance to MFIs.

8. Details of the risk factors

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

AREA	Risk factors	Relevance*	Main measures implemented and/or to implement in the short term	Observations
External environment	<i>Lack of a law and clear fiscal policy for microfinance</i>	Medium-low	CredAgro, also through AMFA, has been actively contributing to the drafting of the new law and to the lobbying activities	The exemption from paying social taxes is temporary. A draft law for microfinance is under discussion at the Parliament
	<i>AC does not participate in the national Credit Register</i>	Medium-low	-	The existing credit bureau is not very effective and the involvement of financial institutions is limited
	<i>Government claims on international grants</i>	Medium-low	-	Discussions between the Government and the main international donors has started on the use and property of the capital granted to MFIs.
	<i>Growing competition</i>	Medium	A dedicated marketing specialist is monitoring competition	Banks have recently started downscaling. Credagro serves the high end of the rural market
Governance, management and operations	<i>Some uncertainties of the ownership about its role within the commercial evolution of the institution</i>	Medium	-	ACDI-VOCA, owner of CredAgro, has not defined yet its future role and level of involvement in CredAgro; moreover, it temporarily denied (in the past months) the access to new commercial sources of funds
	<i>No professional banking expertise within the Board of Directors</i>	Medium-low	Financial expertise is present within the current BoD	Banking professionals within the BoD would benefit in view of the possible banking evolution
	<i>Improvable level of salary for credit staffs</i>	Medium	Very good incentive system and training policy. The market salary levels are monitored using external official information	The level of salary is perceived, by some of the credit staff, as improvable. Competition from banks is aggressive, and the risk of staff turnover is quite high
	<i>Shortcomings in the MIS</i>	Medium	CredAgro is actively working in order to reduce the identified rigidities of the system	Some important reports are not automatically produced (portfolio breakdown by loan officers, some portfolio statistics and financial ratios). Technical assistance and maintenance are not immediately available

Financial products and asset quality	Improvable client drop-out analysis	Medium-low	-	A complete written analysis of clients' drop out and its reasons is missing. Drop-out ratio is quite high as of May 2006 (57%)
Financial structure and ALM	Effects of shortage of funds occurred in the past months	Medium-high	The management has been very active in attracting lenders and negotiations are at the final stages. The Ownership has recently re-started approving the commercial borrowings negotiated	The limited loan amount and term, together with the length of the disbursement process, stemming from the shortage of funds occurred in the past months, are among the main reasons of clients' dissatisfaction
	Currency risk	Medium-high	CredAgro is gradually converting part of the loan portfolio into local currency. The US\$ borrowings expected in the short-medium term will reduce the mismatch	The open position in US\$ is worth of 79% of total equity. The US\$ has been depreciating with respect to the AZN since late 2004. The tools to manage this risk are not adequate
	Interest rate risk	Medium-low	Some long term, larger loans to clients may be indexed to international rates in the future	Active interest rates charged by CredAgro are fixed. The risk will most likely increase along with the growth of commercial liabilities. The tools to manage this risk are not adequate
Financial and operational results	Financial self-sufficiency not consolidated	Medium	-	Adjustment for inflation is particularly affecting CredAgro financial self-sufficiency in this moment given the almost inexistent leverage of capital
Strategic objectives and future evolutions	No scenario and sensitivity analysis presented in the business plan	Medium-low	-	Scenario and sensitivity analysis is needed to prevent possible delays or shortage of funding and eventually reduced growth

¹ 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

CredAgro				
Balance sheet (US\$)	Dec03	Dec04	Dec05	May06
ASSETS				
<i>Cash and bank deposits</i>	452,183	256,603	125,492	188,495
<i>Short term financial assets</i>	-	-	-	-
<i>Net outstanding portfolio</i>	3,179,485	3,779,548	5,192,862	5,311,102
<i>Gross outstanding portfolio</i>	3,217,003	3,828,057	5,258,421	5,382,362
<i>Performing portfolio</i>	3,186,770	3,793,500	5,219,229	5,338,942
<i>Portfolio at risk > 30 days</i>	30,234	34,557	39,192	43,421
<i>(Loan loss reserve)</i>	37,518	48,508	65,559	71,261
<i>Accrued interest</i>	1,286	5,113	41,583	43,693
<i>Other short term assets</i>	38,456	13,244	9,560	30,449
Total short term assets	3,671,411	4,054,508	5,369,496	5,573,739
<i>Long term financial assets</i>	-	-	-	-
<i>Net fixed assets</i>	43,872	76,128	131,111	205,704
<i>Other long term assets</i>	-	-	-	-
Total long term assets	43,872	76,128	131,111	205,704
Total assets	3,715,284	4,130,636	5,500,607	5,779,443
LIABILITIES and EQUITY				
LIABILITIES				
<i>Sight deposits</i>	-	-	-	-
<i>Short time deposits</i>	-	-	-	-
<i>Short term loans</i>	-	-	20,030	550,000
<i>Other short term liabilities</i>	26,123	7,546	87,055	107,851
Total short term liabilities	26,123	7,546	107,086	657,851
<i>Long term time deposits</i>	-	-	-	-
<i>Long term loans</i>	-	-	800,000	250,000
<i>Other long term liabilities</i>	-	-	-	-
<i>Restricted funds</i>	-	-	-	-
Total Long term liabilities	-	-	800,000	250,000
Total liabilities	26,123	7,546	907,086	907,851
EQUITY				
<i>Paid-in capital from shareholders</i>	4,594	4,612	4,924	5,028
<i>Donated equity</i>	2,975,453	3,015,636	3,368,938	3,463,988
<i>Quasi-capital</i>	-	-	-	-
<i>Reserves</i>	-	-	-	-
<i>Total retained earnings</i>	709,114	1,102,841	1,219,660	1,402,575
<i>Other equity accounts</i>	-	-	-	-
Total equity	3,689,161	4,123,089	4,593,521	4,871,592
Total liabilities and equity	3,715,284	4,130,636	5,500,607	5,779,443

CredAgro				
Income Statement (US\$)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Jun05-May06
<i>Interest & commissions received on loans</i>	586,266	743,834	973,210	1,161,361
<i>Financial revenue from investment</i>	-	-	-	-
<i>Other financial revenues</i>	-	-	-	-
A) Financial revenue	586,266	743,834	973,210	1,161,361
<i>Interest paid on borrowings</i>	-	-	7,189	49,857
<i>Interest paid on savings</i>	-	-	-	-
<i>Interest paid on mortgage</i>	-	-	-	-
<i>Other financial expenses</i>	-	-	287,279	227,096
<i>Inflation adjustment</i>	-	-	-	-
B) Financial expenses	-	-	294,468	276,953
Gross financial margin (A - B)	586,266	743,834	678,742	884,408
<i>Loan loss provision</i>	62,464	10,837	20,773	17,427
Net financial margin	523,802	732,997	657,970	866,981
<i>Other operating revenue</i>	-	-	3,595	3,671
<i>Personnel expenses</i>	124,182	236,136	306,139	331,851
<i>Administrative expenses</i>	32,226	129,248	197,133	233,233
C) Operating expenses	156,408	365,385	503,272	565,085
Net operating income	367,394	367,612	158,292	305,568
<i>Extraordinary revenue</i>	-	-	-	669
<i>Extraordinary expense</i>	-	-	-	-
Net income before donations, before tax	367,394	367,612	158,292	304,898
<i>Taxes</i>	-	-	949	31,829
Net income before donations	367,394	367,612	157,343	273,069
<i>Donations in cash</i>	84,126	23,221	53,635	78,288
<i>Revenue not from the operations</i>	-	-	-	-
<i>Expenses not from the operations</i>	-	-	-	-
Net income	451,520	390,834	210,978	351,357

Annex 2 - Financial statements' adjustments

The financial statements in Annex 1 are the result of **standard reclassification**. They are based on audited financial statements according to international standards, except for the FS for the period June 2005 – May 2006, which were not audited.

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

The main adjustments normally are:

- adjustment for the accrued interest on delinquent loans > 90 days
- elimination of subsidies (donations in kind¹⁴ and soft loans¹⁵)
- provisions are calculated with a standard formula¹⁶
- adjustments for inflation
- adjustments for write-offs

Adjustments (US\$)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Jun05-May06
Reversal of accrued interest on non-perf loans	-	-	-	-
Subsidized cost of fund adjustment	-	-	-	-
- Interest rate used (national currency)	11.6%	11.8%	12.8%	12.9%
- Interest rate used (foreign currency)	4.4%	5.1%	7.0%	7.7%
Inflation adjustment	40,707	257,755	519,437	381,502
- Inflation rate used (average of the period)	2.2%	6.7%	11.8%	8.4%
Loan loss provision adjustment	-	-	-	-
In-kind subsidy adjustment	-	3,200	-	1,736
Total variation of net income	40,707	260,955	519,437	383,238

CredAgro does not accrue interests on loans late more than 90 days.

The bulk of the adjustments are related to inflation: the relevant increase of the consumer price index, combined with the large role of equity in sustaining CredAgro operations, makes this adjustment accounting for almost 100% of the total variation of net income respectively in the periods June 2005 May 2006 and in 2005.

Minor adjustments were made in 2004 and in the period June 2005 May 2006 to account for the in-kind support received (training).

¹⁴ Donations in kind are valorized and added to operational expenses.

¹⁵ In the income statement it is registered the value of the difference between financial costs of the institutions and financial cost evaluated at the market rate. In particular, in the case of loans in local currency, it is considered 75% of the average lending rate in the national market (IFS Line 60P). In the case of loans denominated in foreign currencies (US\$ and Euro), it is considered the average value of LIBOR 1 year plus 3%.

¹⁶ Provisions are calculated according to the following formula:

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

Annex 3 - Financial ratios

CredAgro

Jan03-Dec03 Jan04-Dec04 Jan05-Dec05 Jun05-May06

PROFITABILITY

Return on Equity (ROE)	19.9%	9.4%	3.5%	5.8%
Adjusted Return on Equity (AROE)	na	2.7%	-8.1%	-2.3%
Return on Assets (ROA)	19.8%	9.4%	3.2%	5.3%
Adjusted Return on Assets (AROA)	na	2.7%	-7.3%	-2.1%
Operational self-sufficiency (OSS)	267.9%	197.7%	119.3%	135.6%
Financial self-sufficiency (FSS)	na	116.7%	73.0%	93.7%
Profit Margin	62.7%	49.4%	16.2%	26.2%

LOAN PORTFOLIO QUALITY

Portfolio at risk (PAR30)	1.0%	0.9%	0.7%	0.8%
Arrears rate (> 1 day)	0.7%	0.3%	0.8%	0.5%
Restructured loans	0.1%	0.9%	0.0%	0.6%
Provision expense ratio	2.3%	0.3%	0.5%	0.4%
Loan loss reserve ratio	1.2%	1.3%	1.2%	1.3%
Risk coverage ratio (30 days)	124.1%	140.4%	167.3%	164.1%
Write-off ratio	0.0%	0.0%	0.2%	0.0%
Adjusted write-off ratio	0.0%	0.0%	0.5%	0.1%

EFFICIENCY AND PRODUCTIVITY

Staff allocation ratio	26.5%	35.0%	31.9%	33.3%
Loan officer productivity (borrowers)	73	76	86	96
Loan officer productivity (amount)	247,462	273,433	350,561	336,398
Staff productivity (amount)	65,653	95,701	111,881	112,133
Branch productivity (amount)	536,167	638,009	876,404	897,060
Operating expenses ratio (average gross portf.)	5.7%	10.4%	11.5%	11.8%
Cost per loan lent	187	399	411	390
Cost per borrower	204	363	427	439
Personnel expenses ratio (average gross portf.)	4.5%	6.7%	7.0%	6.9%
Admin. expenses ratio (average gross portfolio)	1.2%	3.7%	4.5%	4.9%

ASSETS/LIABILITIES MANAGEMENT

Portfolio yield (gross portfolio) - accrued	21.3%	21.1%	22.3%	24.2%
Funding expense ratio*	0.0%	0.0%	0.2%	1.0%
Cost of funds ratio*	0.0%	0.0%	1.8%	12.5%
Current ratio	140.54	155.75	9.64	1.87
Liquidity over total assets	12.2%	6.2%	2.3%	3.3%
Debt/equity ratio	0.0	0.0	0.2	0.2
Equity multiplier	1.0	1.0	1.2	1.2
Capital adequacy ratio	99.3%	99.8%	83.5%	84.3%

OUTREACH

Average disbursed loan size	4,461	5,164	5,463	4,946
Average disbursed loan size on per-capita GDP	509%	505%	357%	239%
Average outstanding balance on per-capita GDP	388%	249%	267%	170%
Percentage of active borrowers women	na	5.4%	8.5%	8.2%

GROWTH (amount in US\$)

Growth of active gross portfolio	59%	19%	29%	28%
Growth of active loans	60%	13%	20%	46%
Growth of total assets	50%	11%	25%	27%
Growth of staff	6.5%	0.0%	8.2%	3.8%
Growth of funding liabilities	0%	0%	0%	-4.5%
Growth of operating expenses**	na	133%	29%	10%
Growth of equity	49.4%	11.3%	4.4%	7.8%

na = not available * exchange rate variations not included in the ratio. ** As of May 2006 the growth is referred to the year 2005

Annex 4 - Definitions

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

Other definitions:

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

Operating expenses: Personnel expenses + Administrative expenses

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

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

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

Annex 5 - Guidelines of reporting and accounting

Financial statements

CredAgro does not provide non-financial services; its financial statements reflect exclusively the results of its financial activities. Financial statements are audited by a local company (TDI audit).

Loan loss provision and write-offs

CredAgro sets the loan loss reserve on monthly basis, as the sum of fixed percentages of the portfolio categories shown in the table.

Portfolio classification	% provision
Satisfactory loans	1%
Watch loans	10%
Unsatisfactory loans	30%
Doubtful loans	60%
Loss loans	100%

The branches make a draft classification of portfolio based on quantitative and qualitative indicators, which is then confirmed by the Credit Committee and reviewed by the internal auditor.

The cost of the provision is recorded into the income statement and is cumulated into the loan loss reserve in the balance sheet.

CredAgro writes-off doubtful loans when they are late > 180 days after the approval of the SC. CredAgro has been regularly writing off loans in the last years; however, the amounts written of in a 12 months period have never exceeded 0.2% of the average gross portfolio (2005).

Insider loans

The table shows the situation of the loans borrowed by the top management and the staff as of May 2006.

Insider loans (US\$)	Outstanding balance	Loan term	Interest rate	Collateral	PAR > 1 day
Management	378	12	26%	Guarantor	-
Staff	18,758	13	26%	Guarantor	-

Donations

Donations for loan capital are put in balance sheet (equity), while donations for operating expenses are registered in income statement. In-kind donations are presented only in adjusted financial statements. As shown in the table beside, during 2005 and 2006 CredAgro received some donations from ACDI/VOCA USAID and from ABAD (USAID network).

Year	Amount	Destination	Source
2005	50,709	Grant loan capital	ACDI/VOCA USAID
	48,759	Investment	ACDI/VOCA USAID
2006	26,000	Direct grant for operating expenses	ABAD
TOTAL	125,468		

Details of funding liability

May-06

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
Blue Orchard	US\$	300,000	300,000		Loan agreement, no collateral
Blue Orchard	US\$	300,000	150,000	150,000	Loan agreement, no collateral
Blue Orchard	US\$	200,000	100,000	100,000	Loan agreement, no collateral
TOTAL		800,000	550,000	250,000	

May-06

Funding liabilities features						
Source	Loan amount (US\$)	Disbursement date	Maturity date	Principal repayments	Interest repayments	Interest rate
Blue Orchard	300,000	15/11/2005	15/5/2007	15/11/2006 and 15/5/2007	half-yearly	LIBOR 6 months + 6%
Blue Orchard	300,000	6/12/2005	6/6/2007	6/12/2006 and 6/6/2007	half-yearly	LIBOR 6 months + 6%
Blue Orchard	200,000	14/12/2005	14/6/2007	14/12/2006 and 14/6/2007	half-yearly	LIBOR 6 months + 6%

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.