

Azeri Star Microfinance (ASM)– Azerbaijan

Final report

BB-

Update

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.

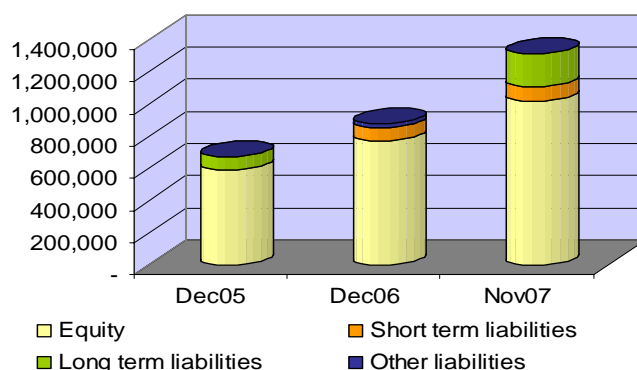
Previous rating: B+ September 2006

Save the Children Federation (SC/US) started its microfinance activities in Azerbaijan in 1999 with the Community Based Lending and Savings Program (CBLs). In May 2003 Azeri Star Microfinance (ASM) spun off from SC and registered as a local Microfinance institution with the Ministry of Justice. With the HQ recently moved to Baku and 3 branches in the central part of Azerbaijan (Barda, Ganja and a sub-office in Mingachevir) ASM targets women and low-income population with a considerable poverty outreach, offering them group-loans of an average amount of almost USD 400 and for a maximum term of 1 year. ASM main source of funds has been represented so far by donated equity received from USAID. Nevertheless in the last years the institution successfully accessed to commercial liabilities thus overcoming the long-lasting shortage of funds. Currently ASM counts on Triple Jump and Oikocredit amongst its investors.

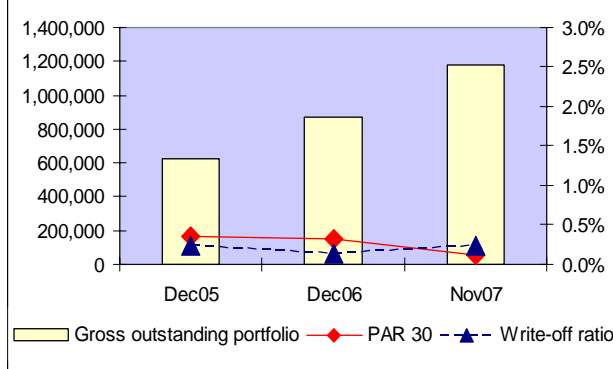
Legal Form	Limited liability company
Inception year	1998
Area of intervention	Rural, peri-urban, urban
Credit methodology	Group and individual

Number	Dec05	Dec06	Nov07
Active borrowers	3,815	4,179	4,258
Branches (hubs)	2	2	2
Total staff	39	37	39
Loan officers	15	12	14

Liabilities and Equity - USD



Evolution of credit portfolio



USD	Nov07
Average disbursed loan size	399
Gross outstanding portfolio	1,179,993
Total assets	1,315,324

Financial Indicators	Dec05	Dec06	Nov07
PAR 30	0.3%	0.3%	0.1%
Write-off ratio	0.2%	0.1%	0.2%
Restructured loans	0%	0%	0%
ROE	15.3%	14.5%	18.3%
AROE	3.1%	4.8%	1.7%
Oper. Self-sufficiency (OSS)	134.7%	135.4%	148.6%
Fin. Self-sufficiency (FSS)	105.0%	113.9%	111.1%
Staff productivity (borrow.)	98	113	108
LO productivity (borrow.)	254	348	304
Operating expense ratio	48.6%	44.9%	41.8%
Funding expense ratio	0.5%	1.3%	1.1%
Provision expense ratio	1.6%	3.3%	-0.4%
Portfolio yield - cash	68.4%	67.0%	62.3%
Risk coverage ratio	1147.7%	697.6%	1638.8%
Cost of funds ratio	-	12.3%	5.5%
Debt/Equity ratio	0	0.1	0.3

As of December 2006 figures refer to the period Mar - Dec 2006
As of November 2007 figures refer to the period Dec 2006 - Nov 2007

CONTACTS

MicroFinanza Rating srl
Corso Sempione, 65
20149 Milan – Italy
Tel: +39-02-3656.5019
info@microfinanzarating.com
www.microfinanzarating.com

Azeri Star Microfinance
AZ 0900, 22 Garabag Str
Barda, Azerbaijan
Tel/fax: (+994 110) 5 26 08
www.asm.az

AREA	Risk factors	Relevance*
<i>External environment</i>	Lack of a microfinance law and clear fiscal policy for microfinance	Medium-low
	Lack of a credit bureau for microfinance institutions	Medium-low
	Growing competition	Medium
	High inflation	Medium
<i>Governance, management and operations</i>	Still to be consolidated Supervisory Council	Medium
	Quite heavy organizational structure	Medium-low
	Staff turnover	Medium
	Difficulties in finding qualified staff	Medium
	Cash handling	Low
	LTS and accounting system are not integrated yet	Low
<i>Financial products and asset quality</i>	Credit products not fully tailored to clients' needs	Medium
	Still relevant drop out rate	Medium-high
<i>Financial structure and ALM</i>	Limited access to financial resources	Medium
	Improvable liquidity management	Medium-low
<i>Financial and operational results</i>	Worsening trend of productivity	Medium
	High operating expenses	Medium-high
	Limited portfolio growth	Medium-low
<i>Strategic objectives and future evolutions</i>	Business Plan not yet updated	Medium
	Limited financial projections	Medium-high
	Lack of different scenarios analysis	Low
	Uncertainties about future ownership	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"> → Committed and skilled Top Management; → Niche target in rural and very poor areas; → Strong MIS department; → Very good portfolio quality; 	<ul style="list-style-type: none"> → Large unmet demand; → Territorial expansion in new areas.

Relevant changes respect to the previous rating

AREA	Relevant changes and comments	Trend
External Environment	<p>The macroeconomic environment, although positive, is characterized by high inflationary pressures, which are increasing costs and require an adaptation of the product offer. The economy grew by 34.5 per cent in 2006, the growth being driven by the booming oil sector and the development of the hydrocarbons industry. Nevertheless, the economy remains highly dependent on the energy sector, and economic diversification is essential for long term sustainability.</p> <p>Competition on the microfinance market has become more intense, especially in the region of Ganja, where an increasing number of banks are downscaling their operations, while FINCA, the main competitor of ASM, is in the process of transforming into a bank. Such a competitive environment exposes the MFIs to the risk of clients over-indebtedness; the same further stressed by the absence of a credit bureau dedicated to microlending¹.</p> <p>No considerable changes have occurred in the legal framework since the last rating. The draft of Microfinance Law is still under discussion in the Parliament and there are no positive expectations about a quick approval of the Law.</p>	Slightly negative
Governance, management and operations	<p>Notwithstanding the efforts and the awareness gained by Board members since the last rating, governance still represents a concern for ASM. A better balance and financial expertise has been brought into the BoD in the last year and at the same time a number of training sessions have been planned for all members. So far the BoD has been strongly relying on the CEO thus not fully and adequately performing its functions.</p> <p>Positive expectations are linked to the establishment of the HQ to Baku. Some improvements have to be registered as far as organizational structure is concerned. Some functions have been grouped into a single person (for ex. MIS specialist); nevertheless there are still some duplications of functions in the credit department which diminish overall efficiency of ASM structure. In response to the relevant turnover and recruitment problems observed during the previous rating, ASM has implemented a new recruitment process aimed at ensuring a better screening of high quality employees, who are also committed to ASM mission. The introduction of staff loans has also represented an important step to increase personnel satisfaction. These measures, together with some changes in the training offered and in the incentive scheme have contributed to reduce the staff turnover ratio to 12.8% as of November 2007.</p> <p>Over the last year the internal control within ASM has been strengthened; the compliance manager, now directly reporting to the BoD, covers also the financial department. Moreover, starting from January 2007 ASM established an Assets and Liabilities Committee (ALCO) in charge of monitoring and supervision of financial and operational risks. Compared to the last rating also the risk related to cash handling has decreased thanks to the opening of a bank account in Mingachevir.</p> <p>The financial department has progressively adapted the internal FS to the output of the audit by fixing all detected discrepancies and achieving consistency with the IAS.</p> <p>Minor changes have been adopted into the MIS; historical information is now easily available and reliable, while data have been correspondently converted into the new currency. In January 2007 different levels of access and use rights and restrictions have been properly introduced and implemented in order to ensure a good security of the system and to allow timely reporting to LOs, credit and branch managers on the status of the portfolio. Thanks to the development of a cash module (April 2007), which has been integrated to the MIP accounting software, the reconciliation between finance and cash is performed automatically. Furthermore, the development of specific macros have enhanced the detection of mistakes at the data entry level, improving reliability of data while streamlining the error detection process.</p>	Positive

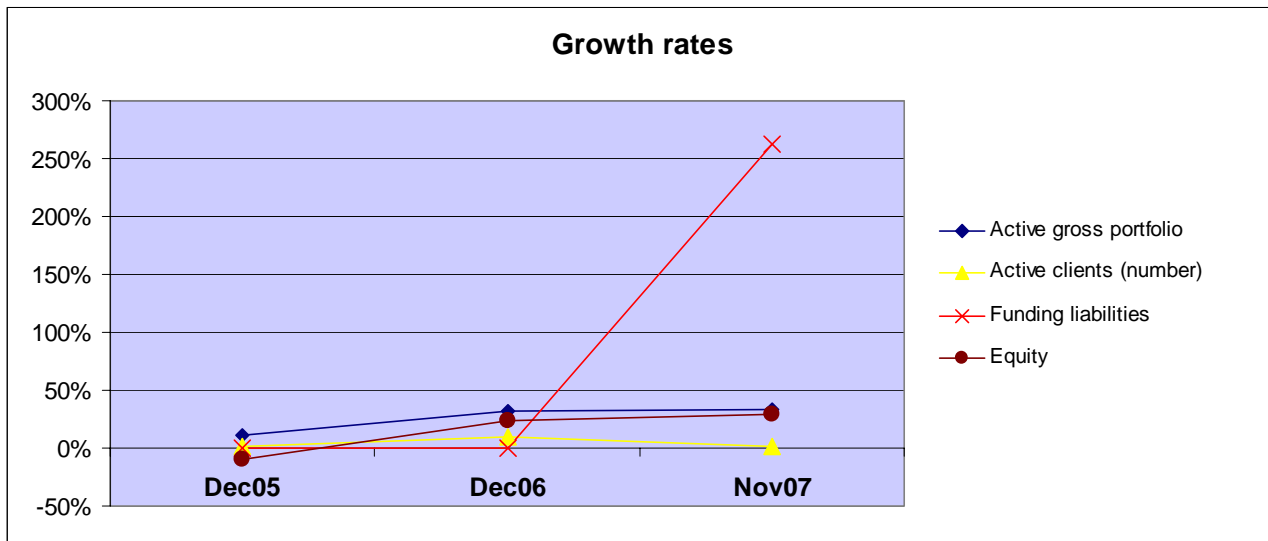
¹ The National Bank, thanks to the support of ACDI/VOCA, is planning to open and adapt the existing banking credit registry to MFIs once the new Microfinance Law will be in place.

<p>Financial products and asset quality</p>	<p>Compared to the last rating visit, ASM has enhanced flexibility and diversification in product offer with the aim to better satisfy clients needs and correspondently react to changes in credit demand.</p> <p>Drop-out remained high in the last year due to the severe shortage of funds but slightly decreased from 59% during September 2005 – August 2006 to 52%. Though the MIS tracks clients' desertion and reasons for it, the information gathered from LOs is not enough detailed and deeply analyzed.</p> <p>In the last year ASM portfolio quality though already excellent, further improved with PAR30 dropping from 0.3% to 0.1% and write off ratio standing at 0.2%.</p>	<p>Slightly positive</p>
<p>Financial structure and ALM</p>	<p>After having suffered for almost one year of a severe shortage of funds, ASM finally accessed to fresh financing from Triple Jump which allowed the institution to sustain and push portfolio growth. Nevertheless, the growth rate didn't receive very appealing rates, as the ones registered in the microfinance market of the country. Further negotiations are currently ongoing with OikoCredit and other international investors. With respect to the previous rating financial risks significantly diminished. Currency risk has been eliminated thanks to the willingness of investors to lend in national currency. Moreover starting from January 2007 ASM created an ALCO committee and developed a risk management manual to monitor financial and operational risks potentially affecting the institution.</p>	<p>Positive</p>
<p>Financial and operational results</p>	<p>ASM registers positive trends for profitability and sustainability ratios with ROE and ROA passing respectively from 14.5% to 18.3% and from 13% to 14.9% and sustainability consolidating well over 100%. At the same time operating expenses follows a decreasing trend (from 45% to 42% in the last year), though maintaining quite high levels. Given the growing path of competition and the rising use of expensive financial resources it will be more and more important for ASM to control operating expenses. Still improvable however the productivity (by number) both for loan officers and in general for staff.</p>	<p>Slightly positive</p>
<p>Strategic objectives and future evolutions</p>	<p>ASM still relies on the Business Plan (December 2006 – December 2008) produced in 2005 and not yet updated. The same for the financial projections as in order to adequately update both planning documents the management is waiting to have two fully reliable financial statements². Nevertheless complete review and update of the business plan and of the financial projections is foreseen during 2008, including also multiple scenarios analysis.</p> <p>As for the definition of a long term strategy for ASM, discussions are ongoing about the possible ownership structure to adopt. As of today a possible solution has not been defined yet as at the same time a concrete exit plan for Save the Children does not exist.</p>	<p>Stable</p>

² Financial information contained in FS pre spin off is not reliable and do not clearly disclose the results of the activity of the microfinance program.



As of November 2007, growth rates are annual



Final opinion

After having suffered for more than one year and a half from a serious shortage of funds, in June 2007 ASM finally accessed fresh funds from Triple Jump and Caucasus Credit. This allowed the institution to accelerate its portfolio growth (32.8%), which however lagged behind the very high growth rate characterizing the microfinance market in Azerbaijan (87%). The negative effects of the lack of funds are reflected in a still high drop-out, which does not benefit yet from the efforts made in diversifying the product offer and enhancing flexibility. Even if partially explained by its considerable outreach in depth, operating expenses still stand at high levels, potentially undermining ASM overall satisfactory profitability in the case of drop in portfolio yield triggered by downward competitive pressure on interest rates. Improvements have been achieved in terms of financial structure, MIS and the internal control function, while the governance structure needs to be further strengthened. At the same time, the fact ASM still relies on the old Business Plan and updated financial projections are missing represents a weakness. The expected withdrawal of Save the Children from ASM within the next 2 years requires a careful definition of an exit strategy.

Benchmarking

All figures of peer groups are referred to the MicroBanking Bulletin (MBB) database updated as of December 2006. The ratios of ASM presented here do not fully correspond to the ratios presented in the report as they are calculated according to the MBB methodology³. As for the MFIs Viator (Azerbaijan) and Azercredit (Azerbaijan) rated by *Microfinanza Rating* in 2007, 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	VIATOR Azerbaijan June 2007	AZERCREDIT Azerbaijan March 2007	ASM Azerbaijan Nov 2007	NGO	Solidarity (groups of 3 to 9 borrowers)	ECA Small FSS
Gross Loan Portfolio gross loan portfolio adj for standardized write-offs (US\$)	3,275,503	4,564,419	1,179,665	2,834,536	2,169,146	864,689
Average Loan Balance per Borrower on per capita GNI Average loan balance per borrower/ GNI per capita(%)	10.1%	14.2%	7.60%	17.5%	15.8%	43.4%
Portfolio at Risk > 30 Days outstanding balance of loans overdue > 30 days / gross loan portfolio (%)	0.3%	0.0%	0.13%	2.6%	0.8%	0.8%
Adjusted Return on Equity AROE adj net operating income after taxes / avg tot equity (%)	3.0%	5.3%	-1.47%	2.6%	2.0%	11.8%
Portfolio yield Financial Revenue from Portfolio / Adjusted Average Gross Portfolio	39.8%	41.4%	62.30%	33.4%	28.4%	41.8%
Debt/ Equity Ratio adj.tot.liabilities/adj.tot.equity	0.10	1.70	0.29	1.3	1.8	0.9
Operating Expense/ Loan Portfolio (operating expense + In-Kind donations) / avg gross loan portfolio (%)	23.7%	26.4%	41.82%	27.7%	24.9%	22.8%
Borrowers per Loan Officer n. of active borrowers / n. of loan officers	357	256	304	236	222	163
Borrowers per Staff n. of active borrowers / n. of staff	112	34	103	135	145	68

ECA Small FSS, Eastern Europe and Central Asia, Gross Loan Portfolio (US\$) < 2 million, Financial Self-Sufficiency > 100%

Regardless of its still limited dimension (portfolio is still below US\$ 2ml), AzeriStar Microfinance shows satisfactory performances compared to similar peer groups and to other MFIs in Azerbaijan.

Portfolio quality is amongst the best performing peers as well as productivity (both per loan officers and per staff). Portfolio yield registers the higher value, the same being linked to the still high operating expenses which affects the overall profitability of ASM. Indeed, AROE, negative due to the inflation adjustment, is the lowest within all the peer groups.

Financial leverage, though gradually but slowing increasing, is still amongst the lowest values.

³ 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).

Table of contents

1. External Environment and ASM positioning	8
Institutional background	8
Political and macroeconomic context.....	8
Microfinance sector	9
Regulation and supervision.....	9
Azeri Star Microfinance market positioning.....	10
2. Governance and operational structure	11
Ownership and Governance	11
Organisation and structure.....	12
Human Resources	12
Internal control and operational risk management.....	13
Accounting and external audit.....	13
Management Information System	13
3. Lending operations	15
Financial products.....	15
Lending procedures	16
Collaterals and accessibility	16
4. Assets structure and quality	17
Assets structure	17
Portfolio structure.....	17
Loan portfolio quality	18
5. Financial structure and ALM	20
Liabilities and equity structure.....	20
Assets and Liabilities Management.....	21
6. Financial and operational results	22
7. Strategic objectives and financial needs	24
Strategic objectives and strategies	24
8. Details of the risk factors	25
Annex 1 - Financial statements	28
Annex 2 - Financial statements' adjustments	30
Annex 3 - Financial ratios	31
Annex 4 - Definitions	32
Annex 5 - Guidelines of reporting and accounting	33
Annex 6 - Rating Scale	35

1. External Environment and ASM positioning

Institutional background

Save the Children Federation US (SC/US) started its microfinance activities in Azerbaijan in 1999 with the Community Based Lending and Savings Program (CBLs). In March 2006, **SC/US handed over the assets of the CBLs program to the Azeri Star Microfinance**, the limited liability company registered with the Ministry of Justice.

After the spin off ASM started a process aimed especially at strengthening the governance of the newly registered entity and at obtaining reliable financial information in order to enable the management to monitor performances. The last year has been focused on governance and on fundraising as the severe shortage of funds – which was one of the main concerns of the previous rating – has badly affected the growth of the institution. Finally ASM succeeded in accessing to fresh financing and received a loan from Triple Jump. Moreover negotiations are ongoing with Oikocredit, Blue Orchard and Minlam.

Noteworthy is the considerable **outreach in depth**, which ASM has maintained over the last years, by targeting women and the low-income population of the central and western regions of Azerbaijan.

Political and macroeconomic context

The **political situation is stable** with Ilham Aliyev expected to remain in control of the political scene over the next period and winning a second term of office in October 2008. However, there is little prospect of a resolution of the conflict with Armenia over the disputed region of Nagorny Karabakh within the next future, as peace negotiations are likely to stall at least until elections in both countries are over (Azerbaijan and Armenia will each hold a presidential election in 2008).

Sovereign risk⁴

Azerbaijan	Foreign currency		Domestic currency	Rating Outlook
	Short term	Long term	Long term	
MOODY'S	P-2	Baa2	Ba2	Stable
S&P	na	na	na	na
Fitch	B	BB+	BB+	Stable

Azerbaijan

Macroeconomic Indicators	Dec04	Dec05	Dec06	Dec06-Nov07
<i>Exchange rate in USD (end of period)</i>	0.981	0.919	0.871	0.849
<i>Exchange rate variation</i>	-0.4%	-6.3%	-5.1%	-2.7%
<i>Inflation rate (end of period)</i>	10.4%	7.4%	11.4%	19.3%
<i>Inflation rate (average of the period)</i>	6.7%	11.9%	8.3%	16.0%
<i>Deposit rate</i>	9.2%	8.5%	10.7%	11.4%
<i>Lending rate</i>	15.7%	17.0%	18.0%	18.9%
<i>Real GDP growth</i>	10.2%	24.3%	31.0%*	29.2%*
<i>GDP per head (USD)</i>	1,023	1,532	2,399	3,635

Source: International Finance Statistics, EIU. * Estimation

The macro-economic environment is positive and economic growth is rapid, mainly due to the booming oil sector and the development of the hydrocarbons industry, which have attracted huge foreign direct investment lasting recent years and leading to **robust growth in monetary aggregates**. **Real GDP growth has accelerated** from 10.2% in

2004 to 31.0% in 2006, while base-period effects will result in a steady **deceleration in real GDP growth from an estimated 29.2% in 2007 to around 10.5% in 2009**. GDP per head has tripled in 2007 compared to 2004.

⁴ **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).

Nevertheless, large inflows of oil export revenue, rapid credit growth and a comparatively loose fiscal policy have kept **year-on-year inflation in double digits** for more than a year, and this is expected to remain stable at least until the second half of 2009, although it should decelerate gradually from an estimated average annual rate of **more than 16% in 2007 to around 10.5% in 2009**.

Foreign-currency inflows from oil exports will **strengthen the Manat in both nominal and real effective terms in 2008-09**. The National Bank of Azerbaijan will attempt to sterilise foreign-currency inflows through the sale of T-bills and the use of Azerbaijan's overseas oil fund, SOFAZ. However, the amount of short-term paper involved will be small. Azerbaijan's rate of inflation will remain high compared with the rates recorded by its trading partners. This will help to produce a real effective appreciation of the Manat of around 40% between the end of 2006 and the end of 2009.

Microfinance sector

Nowadays, the microfinance industry in Azerbaijan encompasses four types of institutions – non-bank financial institutions, microfinance bank, downscaling banks and credit unions. According to the Azerbaijan Micro-finance Association (AMFA)⁵ statistics, as of October 2007 the scale of lending activities⁶ reached USD 316 million in active loans served to over 230,000 clients. The majority of clients are served by non-bank financial institutions, among which FINCA Azerbaijan is the largest player. The industry is growing rapidly, at an impressive rate of 87% for loan portfolios and 72% for active borrowers, which are figures well above the ECA average.

The leading actor - with an outstanding portfolio which increased by 140% to USD 114 million from USD 47,6 million in December 2006 - remains the **Microfinance Bank of Azerbaijan (MFBA)**. The same counts with a number of clients which nearly tripled during the year and ended 2007 at 47,683. Moreover it is worth mentioning that in August 2007, the MFBA issued bonds on the international capital markets, being a pioneer for Azerbaijan and for a single microfinance institution.

The second actor, but the first in terms of number of clients reached, with 68,562 active clients as of September 2007, is **FINCA** while **CredAgro** is the third MFI by portfolio size, presenting an outstanding portfolio of USD 23 million and 6,851 clients.

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

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

Regulation and supervision

No considerable changes have occurred in the legal framework since the last rating. The **draft of the Microfinance Law submitted by the National Bank to the Parliament is still under discussion**, and no positive expectations exist on a quick approval.

Supervision is currently carried out by the National Bank through quarterly reports (financial statements and portfolio classification).

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

⁵ The Azerbaijan Micro-Finance Association gathers together 22 microfinance institutions out of which 7 represent downscaling commercial banks and 15 non-bank credit organizations.

⁶ The combined portfolio refers to AMFA members and non-members providing microfinance services.

ASM does not participate to the Credit Register set up by the National Bank of Azerbaijan in 2005. The same however still has a limited effectiveness as it contains only information about loans bigger than USD 1,000 and from few financial institutions. Given the increasing competition, this could represent a risk for potential clients' over-indebtedness. However, the risk is mitigated by the frequent informal exchange of information among MFIs operating in the same areas.

Azeri Star Microfinance market positioning

Still limited in size, ASM concentrates its operations in **the central and western regions of Azerbaijan**, having consolidated its positioning in the market there. In the last year, however, in order to increase its visibility and to facilitate the access to international investors, ASM moved its headquarters to Baku.

ASM serves a target niche, which is mainly constituted by women (60% of total active clients) and the low layers of the rural poor, presenting a **considerable outreach in depth** with an average disbursed loan amount of almost USD 400 and an average disbursed loan size on per capita GDP of 11% as of November 2007.

In the last year the severe shortage of funds suffered by the institution limited the growth and badly affected the market share, which followed a decreasing trend in favour to ASM's major competitors. As of September 2007, ASM presents a market share of approximately 2% of total microfinance borrowers⁷ (3%, when not considering the banks), while its share of portfolio outstanding stands at 0.3% (1.2%, not considering the banks). Nevertheless, thanks to the successful access to fresh resources, **ASM revised its offer** adapting the credit products to the changing needs of its clients.

Competition has become more intense, especially in the Ganja region, where an increasing number of banks (such as Capital Bank, Republika Bank etc) have started to downscale their operations, while FINCA, the main competitor of ASM, is in the process of transforming into a bank. This will progressively sharpen the competitive environment by requiring MFIs in future to pass from an informal information exchange to the participation to an effective credit bureau, in correspondence to the arising risk of clients over-indebtedness. In this regard, the National Bank is planning to develop and adapt the existing banking credit registry to MFIs with the support of ACID/VOCA.

Compared to FINCA and other banks ASM offers more transparent products by not charging additional fees and ensure good accessibility of the financial services to the rural population living in remote areas as it accepts repayments on the field. However ASM still presents some **competitive disadvantages**:

- Smaller loans and shorter terms than the ones requested by clients, especially for the agricultural sector
- Shorter grace periods;
- Higher interest rates than FINCA and banks.

Main competitors (USD)

Institution	Gross portfolio	Products	Loan size (USD)	Loan maturity (months)	Interest rate	Active clients
Azeri Star	1,090,810	group and individual	175 - 2,269	4 - 24	1.5% - 4% declining	4,140
Finca	36,203,758	group and individual	50 - 30,000	4 - 24	2.5% - 3.7% declining	68,562
FinDev	3,504,370	group and individual	100-3,000	4 - 18	2.5%-3.75% declining	4,461
Viator	3,507,889	group and individual	100 - 5,000	3 - 24	2.75% - 3% declining	10,042
AzerCredit	6,761,183	group and individual	150 - 10,000	3 - 18	3% - 4% declining	10,927

Figures as of September 2007

⁷ The borrowers considered are the ones included in the matrix realized by AMFA, which also takes into account non-members institutions.

2. Governance and operational structure

Ownership and Governance

In the last year ASM governance underwent a serious revision of its function and effectiveness. As a result of this there was a restructuring within the Board of Directors with some changes in the composition of the main governing body accompanied by a set of brainstorming and training sessions dedicated to BoD members in order to clarify and create commitment to the work of the Board. Undoubtedly ASM governance is still quite **young** and inexperienced; for this reason still strongly relying on the contributions of the CEO who always participate to the Board meetings even if without voting right. Currently the Chairman of the BoD, who took over the position of the former temporarily chairman, is drafting a set of guidelines to be incorporated in a **governance manual**, which is expected to be approved at the next BoD meeting in February 2008.

Since the previous rating, the **composition of the Board has slightly improved** thanks to the involvement of a new member with an economic / banking profile. Furthermore, BoD meetings now take place 4 times a year, even if, due to location constraints⁸, 2 of them are physical meetings and 2 are distance meetings. For each meeting ASM management prepares quarterly reports with the results achieved in the last period; these represent the base for the discussion and the decisions of the BoD and for the overall assessment of the work done by the CEO.

Board of Directors

Members	Charge	Background and current profession
Mr. Giacomini	Chairperson	Mr Giacomini has 10 years experience in Central Asia and Caucasus in the field of education and media development (program design and management). He is currently (temporarily) country representative of SC/US in Azerbaijan
Mr. Mamedov	Deputy chairperson	Mr Mamedov has 15 years experience in the field of renewable energy. He worked 5 years in SC/US in management positions of community development program. Currently, he is Program manager of BP community development program World Vision International
Mrs. Conklin	Member	Ms Conklin is the Program Coordinator for Save the Children's Office of Economic Opportunities. She has five years experience in international development with a specialization in microfinance
Mrs. Guliyeva	Member	Mrs Guliyeva has 7 years experience in humanitarian NGO in organisational development, human resource management and donor relations. She is currently attending a Master course in Regional Development Planning and Management in Germany
Mr. Schroeder	Member	Mr. Schroeder is economist with legal background and experience in international development cooperation specializing in project management and private sector development.

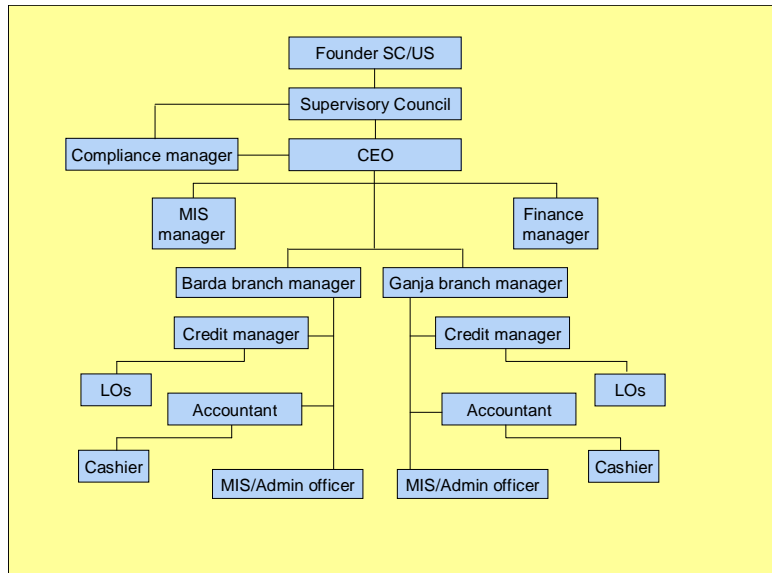
As far as the ownership is concerned no solutions have been studied yet considering **that Save the Children will hand over the ownership of ASM** in a time frame of **two years**. Certainly, the Chairman of the Board is aware of this issue and also of the importance of having an exit plan which defines a set of gradual steps to be followed by the top management and by the Board in order to guide the MFI through a smooth transition. Even though, not yet discussed by the BoD,

⁸ One member of the BoD is based in Egypt.

currently the main option taken into consideration is **the transfer of the ownership to the staff**⁹, while second-best solution considers the attraction of equity investors. Both hypotheses bring about **different risks**, which are linked to the capacity of ASM to build a strong and sound governance capable to steer the institution over this transition process and the ability to attract investors sharing the same mission without incurring in a mission drift.

Organisation and structure

No relevant changes have been brought into ASM **organizational structure** compared to the last rating visit; the institution still operates through two branches, one in Barda and one in Ganja plus a service point in Mingachevir. With almost a year of delay the Headquarters with the Top Management have been finally moved to Baku. However, according to ASM plans, a **new branch will be opened in Agdash**, while individual loans will be provided in Baku by the end of 2008.



Despite the change introduced with the merging of the Office manager position with the MIS specialist position, **the structure of ASM is still heavy** with a partial overlapping of functions between the Branch manager and the Credit manager positions.

The current level of decentralization is to be considered adequate, as well as the **communication flow** between the HQs and the branches. In fact, the limited size of ASM and the frequent travels of the management to Baku and to the field offices ensure an effective follow-up and monitoring of consistent implementation of decisions while gathering constant feedbacks from staff.

Human Resources

As of November 2007, ASM personnel is composed of **39 employees**, out of whom 14 are loan officers. The **staff allocation ratio**, equal to **35.9%**, has improved over the last year, in correspondence to the employment of 4 new loan officers and is expected to increase progressively along with the expansion of ASM.

Personnel	Dec04	Dec05	Dec06	Nov07
Total	38	39	37	39
Loan officers	15	15	12	14
Other staff	23	24	25	25

ASM presents a **solid management team**, mostly coming from internal promotion and strongly committed to the institution. Their skills and competences have been mainly acquired along with the growing experience and the increasing number of trainings. Other staff is adequately qualified and properly trained. In response to the relevant turnover and recruitment problems observed during the previous rating, ASM has implemented a **new recruitment process** which is structured into two stages: the technical test and the interview, ensuring a better screening of high quality employees, who are also committed to ASM mission. Furthermore, the introduction of **staff loans** has represented an important step to increase personnel satisfaction and end the difficult period of shortage of funds. These measures have contributed to reduce staff turnover from 24.3% as of December 2006 to 12.8% as of November 2007. At the same time, the **difficulty to find qualified staff** and the consequent **competition on human resources** in the Azerbaijani microfinance

⁹ This option however is not foreseen and not allowed under the Azeri Law.

sector still remain a big challenge for ASM, which may take more than one month to recruit new personnel with negative consequences on daily and planned operations. **Staff retention problems** may still arise due to the lack of formal career paths.

At the moment, given the limited size of the institution, a dedicated **HR manager position** is **missing**, with the Executive Director being in charge of it and with the MIS Manager bringing his support in the organization in trainings. **Internal and external training has improved over the years**, especially for what concerns the accounting area. Indeed, specialized trainings on international accounting standards have been attended by interested staff and this has helped to fix the shortcomings of the financial department. At the local level, ASM benefits from the membership of AMFA, which provides different training opportunities for its members, while some staff attended also external trainings organized by the Azerbaijani Banking Training Centre (ABTC).

An annual **staff performance appraisal** is in place, with direct supervisors for each department assessing correspondent employees.

Based on the information gathered from AMFA compensation survey, **salaries** in ASM are in line with the microfinance sector. All staff, including the administrative one and management, is benefiting from a monthly **performance-based bonus system**, which has been recently revised – increasing the minimum number of borrowers to be served in order to get the bonus to 200 - and improved, showing to be successful and effective.

Internal control and operational risk management

Significant improvements have been brought into the position of the **compliance manager** over the last year; on the one side through the participation to different internal and external trainings which allowed him to cover also the financial audit, on the other side making him directly reporting to the Board.

At the same time, in January 2007 ASM established a **risk management commission** (composed by the compliance manager, the financial manager and the MIS manager), with the aim of detecting and mitigating the main financial risks, namely liquidity, operational and credit risk. Up till now, the risk management commission has produced 2 semiannual reports, which identify negligible risks for ASM. A risk management manual has also been produced, even if it has not yet been approved by the BoD (approval is expected at the next meeting in February 2008).

The compliance manager relies on an ambitious **audit plan, developed for the whole year and approved by the BoD**. According to it monthly visits to the branches are foreseen; the same includes a random visit to 15/20 groups of borrowers.

Compared to the last rating, **cash handling risk has sensibly decreased** thanks to the opening of a bank account in Mingachevir, what however implies higher bank fees. Lending operations are still carried out in cash: disbursements take place in branches or in the service point of Mingachevir, and repayments are collected from clients on the field.

All manuals, with the exception of the HR manual, are in place and are regularly updated by the compliance manager.

Accounting and external audit

After the spin off and consequently starting with the period March - December 2006, ASM appointed a local auditor, who conducted the audit **according to IAS and International Financial Reporting Standards**. Though the Auditor expressed an unqualified opinion about ASM Financial Statements, some inaccuracies have been detected. Subsequently, the financial department fixed all detected discrepancies and achieved consistency with the IAS.

In general **Financial Statements produced after the spin-off are reliable**.

Management Information System

No major changes have to be registered within the MIS department.

The MIS in ASM is still composed of two separate and **non-integrated software**: an **internally produced loan tracking system (LTS)**, built with Visual Basic on SQL Server and the **Sage MIP Fund Accounting software**, which is recognized to be one of the best solution for non-profit financial management needs of organizations, although it is not fully tailored to MFIs. Portfolio data are reconciled on a weekly basis, while formal reconciliation of the bank statements to the general ledger (cash book balance) is prepared at the end of the day. The MIS manager is in charge of the monthly consolidation of data coming from the branches via email in Excel sheets and currently consolidation is still **manually conducted**. Nevertheless ASM is planning to integrate the two software by the end of 2008 thus reducing significant amount of manual work.

Compared to the last rating visit, the **access to historical data** in the LTS has been facilitated. Nowadays, historical information is easily available and reliable, while the conversion of portfolio data into the new currency has also been finalized.

Moreover, **reporting** has been streamlined as currently LOs, credit and branch managers can produce themselves on their needs any kind of report they may need. Indeed, in January 2007, the MIS manager introduced levels of access, use rights and restrictions according to the position covered, thus on the one side improving the effective use of the system and on the other side guaranteeing an adequate security.

In the last year a **cash module** (April 2007) has been created; the same which has been integrated to the MIP accounting software allows to get automatic reconciliation between finance and cash. Furthermore, the development of specific macros have enhanced the detection of mistakes at the data entry level, improving reliability of data while streamlining the error detection process.

In general the features of the MIS fit **the operational and managerial needs of an institution of this size**. Nevertheless some issues are still to be fixed with reference to the accounting package, which is not detailed enough for an MFI, requiring to manually calculate some operating expenses (e.g. loan loss reserve, depreciation etc.). Therefore, ASM is planning to develop its own accounting software in order to customize it to the institutional needs. Moreover, an additional module is needed for the budget, which is currently realized manually.

Back up and disaster and recovery policies and procedures are adequate, as the MIS department performs daily incremental and monthly complete back ups of both portfolio tracking and accounting databases, which a CD-ROM copy always kept outside the main office.

3. Lending operations

Financial products

In November 2007 ASM amended its Credit Manual with a series of changes that **enhanced flexibility and diversification of its product offer**, thus satisfying clients' needs in reaction to the changes in credit demand. An example of this has been the unexpected level of inflationary pressures which determined a strong demand for bigger loans and which forced ASM to make

Credit methodology

	Credit products						
	Business	Livestock	Graduated	Individual (Business)	Staff	Consumer	Graduated (Grace)
<i>Credit methodologies</i>	Group	Group	Group	Individual	Individual	Individual	Group
<i>Currency of the credit</i>	AZN	AZN	AZN	AZN	AZN	AZN	AZN
<i>Type of interest</i>	Flat	Flat	Declining balance	Declining balance	Declining balance	Declining balance	Declining balance
<i>Min. interest rate (%)</i>	3.5%	3.5%	4.0%	4.0%	1.50%	4.0%	4.0%
<i>Max. interest rate (%)</i>	4.0%	3.5%	4.0%	4.0%	1.50%	4.0%	4.0%
<i>Average interest rate (%)</i>	3.5%	3.5%	4.0%	4.0%	1.50%	4.0%	4.0%
<i>Description of commissions</i>	na	na	na	na	na	na	na
<i>Min. credit amount (US\$)*</i>	170	170	442	340	567	340	442
<i>Max. credit amount (US\$)*</i>	374	374	647	2,269	50% of annual salary	1,134	647
<i>Max credit amount for the first loan (US\$)*</i>	374	170	442	1,134	50% of annual salary	1,134	442
<i>Average credit amount (US\$)*</i>	297	307	488	0	2,779	835	614
<i>Min. loan maturity (months)</i>	4	6	6	6	8	6	6
<i>Max. loan maturity (months)</i>	12	12	12	18	24	18	12
<i>Average loan maturity (months)</i>	5.9	7.9	7.7	0	20.3	14.0	12.0
<i>Periodicity of interests payments</i>	monthly	monthly	monthly	monthly	monthly	monthly	monthly
<i>Periodicity of principal payments</i>	monthly	monthly	monthly	monthly	monthly	monthly	monthly
<i>Grace period (months)</i>	0	2	0	0	0	0	2
<i>Collaterals / guarantees</i>	Group guarantee	Group guarantee	Group guarantee	Physical Collateral	na	One person guarantor	Group guarantee

*Loan disbursed

some adjustments to existing products, while introducing new financial services. Changes mainly refer for the Business and Livestock loans, on interest rate: the same for the first cycle has been reduced from 4% to 3.5% on flat rate basis. For Graduated loans the maximum loan amount has been increased up to USD 647, while the requirements for its application have been loosened: groups have to successfully complete only two loan cycles of Business/Livestock loans in order to have the possibility to apply for the Graduated loan (before, it was 4 loan cycles). Moreover, a two-month grace period has been introduced for the Graduated loans. Maximum loan maturity has also been increased for all products and principal plus interest repayment is scheduled on a monthly basis (before, periodicity was every 4 weeks).

Two **new loan products** have been introduced in October 2007, **Staff loans** and **Consumer loans**. Both staff and consumer loan have demonstrated to be successful products, by meeting large demand of the target clientele and consequently increasing rapidly. One more product which will probably meet the needs of many clients is the individual loan; however, due to shortage of

funds, it has not been promoted during the last period and therefore it is not reflected in the active portfolio. The idea of ASM is to re-introduce and promote the individual loan product along with the successful access to fresh funding, by introducing also gradual changes like an increase in the maximum loan amount, through a pilot test phase which will finalize the full-scale product design.

In general, ASM enhanced product offer seems to exert first positive effects on the drop-out ratio, although **the amount of funding liability still constrains ASM capacity to fully meet the changing needs** of its target clientele, especially for what concerns the loan amount ceiling. **Interest rates are still rigid** and not sensitive to the clients' credit history. A possible reduction of the interest rate is not expected within the following 2 years (up to 2009).

Lending procedures

No main changes have occurred in the **lending process**, which is **well structured** and allows to keep a good quality of the portfolio. The orientation meetings with clients and field visits prior to the disbursement contribute to a **sound screening mechanism**, which is also supported by the informal exchange of information on clients black lists among other MFIs. Group loans applications are approved by LOs and the credit manager, with the support of the branch manager, while individual loans will require the involvement of a credit committee. Along with the development of the individual lending methodology ASM is dedicating specialized LOs to this product, for which the business requires a more in depth analysis.

As far as the business analysis of group loans is concerned, it is worth mentioning that **sometimes the level of accuracy of the analysis is not adequate** in order to precisely determine the repayment capacity of the applicant. This is especially the case for livestock loans. However, the compliance manager who easily detects such problems also offers from time to time trainings to the LOs in order to strengthen and streamline their operations.

Loan processing takes one week for new groups and 2 days for repeated loans, what is satisfactory for the clients and in line with the market. Loan approval is quick and flexible, as it is performed on the field and is based on easy procedures.

During the repayment period, a **good monitoring system** is in place, which relies on frequent visits to clients and personal relationship built up by LOs. In case of arrears, there are standardized procedures to be followed which seem to be effective in maximizing loan recovery. **Write-offs** or alternative measures must be approved by the BoD. ASM does not have any restructuring policy.

The credit manual has been updated in October 2007.

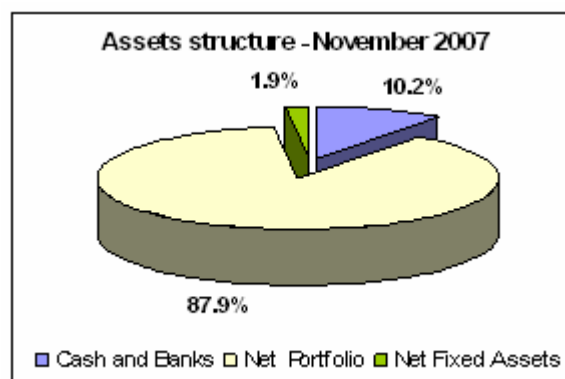
Collaterals and accessibility

Group loans are uncollateralized and the joint liability mechanism seems to work properly. As a policy, individual loans require physical collateral: jewelry, as well as business and household assets are accepted as collateral.

4. Assets structure and quality

Assets structure

As of November 2007, ASM **net portfolio is equal to 87.9% of the total assets**, which represents a satisfactory level of concentration of resources into the core business. Cash and banks, which stands at 10.2% as of November 2007, registered an **average figure of 5.7%** during the last year. However **fluctuations** in the liquidity levels are still **high**, due to inflows of fresh resources and the difficulty in quickly allocating the money available as a result of the past shortage of funds. The two biggest examples of this happened in October 2006 and 2007 when liquidity level reached respectively 8.2% and 15.2%. On the contrary, December 2006 is characterized by the lowest amount of liquidity during the last 2 years, equal to 0.47%. As of November 2007, net fixed assets account for 1.9% of total assets; on average this amount is equal to 2.8% and is expected to increase along with the expansion of ASM.



Portfolio structure

As of November 2007, ASM **outstanding portfolio** stands at **USD 1,179,993**, out of which almost 50% is constituted by Graduated loans, what represents a marked shift towards this product since the last rating visit, where the Livestock loan was preponderant. This is the result of the growth of clients but also of the choice to serve upgrading customer during the period of shortage of funds when it was difficult to attract new borrowers and the institution was indeed focusing on existing clients.

Portfolio features	Jan05-Dec05	Mar06-Dec06	Dec06-Nov07
Gross outstanding portfolio (USD)	621,575	866,205	1,179,993
Business	222,572	254,559	298,378
Livestock	299,145	273,511	231,454
Graduated	89,433	338,136	563,645
Individual (Business)	10,425	0	0
Staff	0	0	44,514
Consumer	0	0	28,615
Graduated (Grace)	0	0	13,389
Gross outstanding portfolio (AZN)	570,979	754,811	1,002,050
Growth of active gross portfolio	10.9%	32.2%	32.8%
Average disbursed loan amount (USD)	228	300	399
Av. disbursed loan size on per capita GDP	15%	12%	11%
Average residual maturity (months)	6.5	6.4	6.7
Number of active borrowers	3,815	4,179	4,258
% of active borrowers women	48.9%	55.0%	59.8%
Drop-out ratio	87.9%	54.1%	51.2%

na: not available

ASM is thinking about changing some features of this product by testing them through a pilot phase starting from beginning of year 2008. Not surprisingly, Staff, Consumer and Graduated (Grace) loans cover small shares of total portfolio, as they are very new (below 3 months of existence). Nevertheless, Consumer loan presents a wide room for growth, given the strong expressed demand of the target clientele.

In the last year portfolio growth followed a quite stable path, registering a 32.8% grow rate, compared to a 32.2% of the previous year. However, in comparison to the microfinance market that grew 87% for loan portfolio over the last year, the growth registered from ASM is limited.

Group Business and Livestock loans account respectively for 25.3% and 19.6% of total portfolio, signing a downward trend over the period of analysis. As a result of the **shortage of funds** experienced until September 2007, the **Individual Business loan** has not been re-introduced yet; at the same time

The average disbursed loan size registered an upward trend during the periods of analysis, passing from USD 228 to USD 399¹⁰. The same, however, does not reflect a true change in target population but mostly refers to the strong increase in inflation rate registered over the years, which made clients poorer and requiring for bigger nominal loans. In real terms, the **outreach in depth** of ASM has slightly increased with reference to the previous rating, as shown by the **average loan size on per capita GDP**, equal to 11% (compared to 15% in 2005 and 12% in 2006), and by the percentage of **female active borrowers (59.8%)**.

Breath of outreach, as defined according to the number of borrowers, suffered for the shortage of funds and finally registered only a **2% growth of active clients** during the period December 2006 – November 2007, what is even lower in comparison to the 8% registered during September 2005 – August 2006. This is particularly true while considering that ASM strategy has been focused on retaining repeated clients rather than attracting new ones.

At the same time this is reflected in clients' retention. In fact, drop-out ratio, which abruptly dropped from 87.9% in 2005, progressively improved during the last year till reaching a still quite high but understandable 51.2%. Moreover, the introduction of new loan products and some critical changes in the product design plus the access to fresh resources will further sustain clients' retention. Beside this, however, attention to the **concrete adequacy of the loan size** to the financial needs of the clientele should be paid in order to avoid clients' dissatisfaction. The re-introduction and renovation of the individual Business loan is expected to partially solve the problem. The MIS is tracking the drop-out rate, providing information on clients' reasons for leaving the organization. Nevertheless, the data gathered from LOs are not detailed enough and present shortcomings in terms of reliability. For the future, some changes will be introduced in the exit survey in order to obtain useful information, which may better explain the phenomenon. Systematic reporting on the results of the survey may represent a valuable management tool.

Breakdown of portfolio by branches over the period of analysis, stresses that portfolio allocation is

November 2007

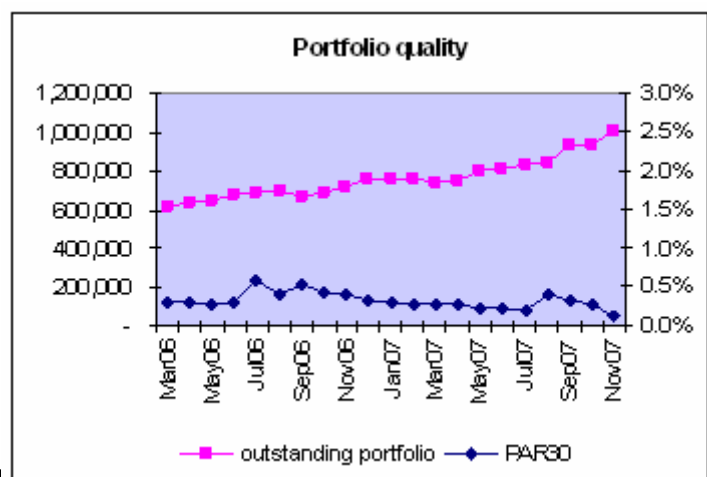
Branch	outstanding portfolio (USD)	% of outst. portfolio	% number of borrowers	PAR > 30 days	PAR > 30 weighted
Barda	658,120	55.8%	52.2%	0.2%	0.1%
Ganja	521,873	44.2%	47.8%	0.0%	0.0%
TOTAL	1,179,993	100%	100%		0.13%

gradually shifting from Barda to Ganja branch, along with the expansion of its market (e.g. Ganja is the second largest city in Azerbaijan) and the consolidation of Mingachevir service point. Moreover, the opening of Agdash branch will further strengthen this trend, while Baku will be included by the end of 2008 in the operation areas of ASM.

Loan portfolio quality

ASM portfolio quality is excellent, with **PAR30** equal to **0.1%** and write off ratio worth 0.2%. The figures show a slight improvement with respect to previous years, where the PAR30 was standing at 0.3% as of December 2006. Besides one small peak in August 2007, PAR30 seems to progressively decrease over time, confirming the good portfolio quality of ASM (see the graph). Restructuring of loans is not permitted.

ASM presents a very **prudential approach** to portfolio management, in accordance with the higher risk it is facing due to the low level of collateralization of the loans. Indeed, ASM relies on a very high risk coverage ratio, equal to **1638.8%**. However, in order to balance efficiency and



¹⁰ However, if considering the amount in Manat, the inci

not to lose resources this year ASM has recorded a reversal of loan loss provision, as shown by the negative provision expense ratio, increasing its net income. More

Portfolio Quality Indicators	Jan05-Dec05	Mar06-Dec06	Dec06-Nov07
Consolidated PAR30	0.3%	0.3%	0.1%
31-60	0.0%	0.0%	0.0%
61-90	0.0%	0.0%	0.0%
91-180	0.3%	0.0%	0.1%
181-365	0.0%	0.1%	0.0%
>365	0.0%	0.2%	0.0%
Arrears rate (> 1 day)	0.3%	0.3%	0.1%
Restructured portfolio	0.0%	0.0%	0.0%
Provision expense ratio	1.6%	3.3%	-0.4%
Loan loss reserve ratio	4.0%	2.3%	2.1%
Risk coverage ratio (30 days)	1147.7%	697.6%	1638.8%
Write off ratio	0.2%	0.1%	0.2%

generally, delinquency reasons remain linked to the poor performance of the clients' business and to the households' vulnerability to external shocks. When analyzing delinquency by portfolio breakdown, it is worth mentioning that the Graduated product is characterized by the highest concentration of PAR30 (0.2%), although the level is very limited. On the other side, the agricultural sector seems to have the highest risk profile, with PAR1 equal to 4.1%. Nevertheless, agriculture counts only for 2.1% of the total outstanding portfolio.

November 2007

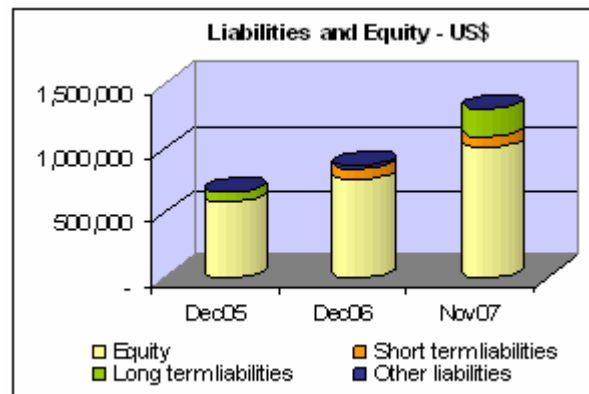
Loan product	% of outst. portfolio	PAR >30 days	PAR > 30 weighted	PAR >1 day	PAR > 1 weighted
<i>Business</i>	25.3%	0.0%	0.0%	0.0%	0.0%
<i>Livestock</i>	19.6%	0.1%	0.0%	0.1%	0.0%
<i>Graduated</i>	47.8%	0.2%	0.1%	0.4%	0.2%
<i>Individual (Business)</i>	0.00%	0.0%	0.0%	0.0%	0.0%
<i>Staff</i>	3.8%	0.0%	0.0%	0.0%	0.0%
<i>Consumer</i>	2.4%	0.0%	0.0%	0.0%	0.0%
<i>Graduated (Grace)</i>	1.1%	0.0%	0.0%	0.0%	0.0%
TOTAL	100%		0.13%		0.20%

November 2007

By sector	outstanding portfolio (USD)	% of outst. portfolio	% number of borrowers	PAR > 1 day	PAR > 1 weighted
<i>Agriculture</i>	24,521	2.1%	1.8%	4.1%	0.1%
<i>Livestock</i>	452,250	38.3%	41.8%	0.1%	0.0%
<i>Production</i>	39,235	3.3%	3.3%	0.1%	0.0%
<i>Service</i>	70,729	6.0%	6.0%	0.0%	0.0%
<i>Trade</i>	511,639	43.4%	44.2%	0.2%	0.1%
<i>Consumer</i>	56,643	4.8%	0.7%	0.0%	0.0%
<i>Other</i>	24,974	2.1%	2.2%	0.0%	0.0%
TOTAL	1,179,991	100%	100%		0.20%

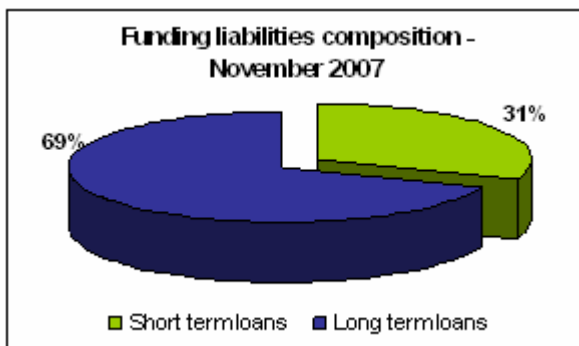
5. Financial structure and ALM¹¹

Although in the last year the financial structure of ASM did not radically changed, the institution **accessed to fresh funding**, thus increasing the share of long term liabilities (see graph aside). So far ASM has been financing its growth thanks to **donated equity** channelled by Save the Children from the US Agency for International Development (USAID). During the previous visit of Microfinanza Rating analysts, for the whole 2006 and till September 2007 ASM **suffered a worrying shortage of funds which badly affected its overall operation**. However, the efforts spent in negotiating with various lenders finally brought fresh resources to the institution. Two loan agreements have been signed in the last year: **a renovated contract with Caucasus Credit¹², and a new one with Triple Jump**. This brought the **financial leverage** of the institution to **0.3**, registering an increase of 164% with respect to the previous rating. Even if this drove ASM out of a quite deep crisis, the current leverage remains low and still leave rather wide room for improvement.

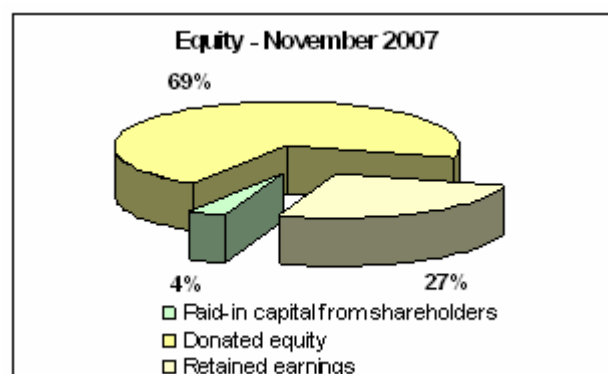


Liabilities and equity structure

As of November 2007 ASM counts on a **long term loan** received from Triple Jump representing **69% of total liabilities** and on a short term loan of Caucasus Credit which covers the remaining 31%. Though the funding strategy did not resulted to be very effective in the short run, finally – **in September 2007 – ASM overcome the sever shortage of funds** and started to work on the recovering of the portfolio growth. Still, the **backbone of the strategy is the attraction of social and commercial investors**, to drive and sustain growth in the future. Currently negotiations are ongoing with BlueOrchard and Deutsche Bank while a contract has already been signed with Oikocredit and the institution is much more confident on the planning side as investors are now more willing to lend to Azeri Star Microfinance.



In the last year **equity registered a growth of 28.6% amounting almost USD 1ml**. 69% of equity is still given by donated equity received from USAID. Paid-in capital from Save the Children, the only shareholder, covers a diminishing share of total equity - 4%, as over years no fresh contributions have been thrown in. Thanks to a consolidating profitability **retained earnings** are gradually gaining importance and currently **represent 27% of equity**.



¹¹ For the analysis of Azeri Star Microfinance financial structure and ALM as of August 2006 the internal financial statements have been used since the final version of the audited ones is not available yet.

¹² Caucasus Credit is a wholesale microfinance institution mainly operating in Georgia and Azerbaijan with the support of the Danish Refugee Council.

Assets and Liabilities Management

Even though the exposure to financial risks diminished in the last year, ASM spent many efforts in improving the overall risk management. A **Risk Management Manual** has been developed and implemented at the beginning of 2007 and according to it the financial manager produced two reports analyzing the main financial risk to which the institution is exposed. At the same time an **ALCO Committee was created**, gathering the Finance, the MIS and compliance manager in monthly meetings. Albeit the ALCO recently started operating and the overall risk management is not very sophisticated and detailed for the moment, this certainly helped increasing the awareness of the management towards these risks and thus drove the attention to the strengthening of this area.

The Risk Management Manual, which includes some norms from the National Bank of Azerbaijan and some basic principle for microfinance, seems to be adequate to the exigencies of ASM, complete in its structure and comprehensive for the topics covered. Reporting seems also to be satisfactory, even if currently there are only two reports available, one for January and one for June 2007.

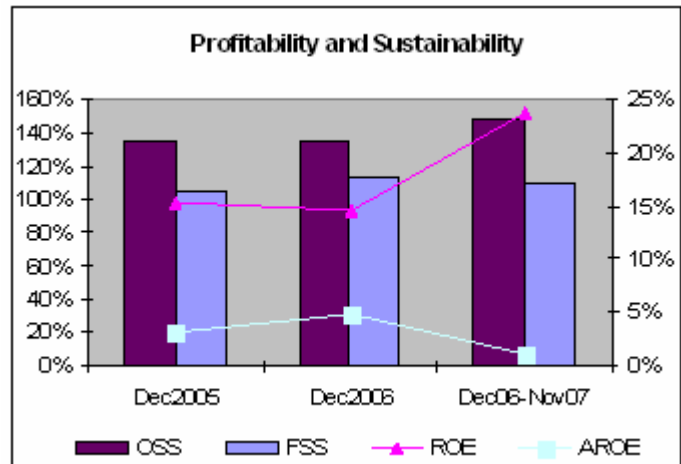
As of today **ASM does not present major financial risks. Maturity mismatch does not represent a constraint** to ASM. Indeed, as of November 2007 current ratio stands at 13.7, the **bulk of the portfolio (97.4%) is short term** while the average weighted maturity is 8 months. On the other side the biggest share of liabilities is, as of today, composed by a long term loan. Moreover liquidity management improved in the last year thanks to the introduction of quarterly cash flow statements and gap analysis.

Since the last rating **ASM eliminate the negative net position in USD**, as all liabilities are currently denominated in local currency as well as ASM outstanding portfolio. Even if the institution will increasingly access commercial funds from international sources, currency risk is not expected to sensibly augment in the next future. Present negotiations indeed confirms the willingness of investors to lend in national currency.

For what concerns interest rate risk, given that most of the portfolio is financed by equity the **interest risk** is only linked to the potential decrease of active interest rates due to **competitive pressures**.

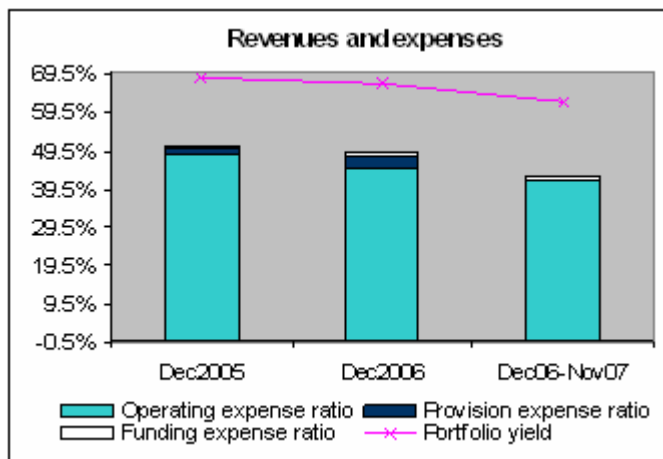
6. Financial¹³ and operational results

In the last year ASM has been **consolidating its profitability and sustainability, marking a positive upward trend** especially during the first eleven months of 2007. For the period December 2006 – November 2007 **ROE and ROA are respectively 18.3% and 14.9%**, registering a slight increase in comparison to 2006¹⁴ (when they were 14.5% and 13%). It is however important to stress that 2006 does not represent a full year as ASM was registered as a LLC in February and thus started operations in March 2006. During the same periods ASM **further consolidated its Operational Self-Sufficiency (OSS) passing from 135.4% to 148.6%**.



Even if the effects of adjustments significantly impact on financial performances, ASM maintains positive levels of profitability and sustainability. Due to a substantial adjustment for inflation, which is following an uneven trend in the last years, and to a minor adjustment due to subsidized cost of funds, **AROE and AROA abruptly drop to 1.1% and 0.9%**. The same impact, even if less important could be seen also in the level of **Financial Self-Sufficiency**, which nevertheless maintains a positive value of **110%** for the period December 2006 – November 2007.

Since the last rating ASM has slightly improved its efficiency, as shows **the downward trend of operating expenses: 44.9% in 2006, 41.8% for the period December 2006 – November 2007. The ratio however remains quite high.** This has been achieved thanks to the growth of portfolio



that even if it does not yet reached the level of economies of scale, for sure it allowed the institution to better manage and reduce the impact of fixed costs. In general, there is still room for improvement in the current level of efficiency, especially considering the burdening organizational structure, overstaffed and resource consuming for an organization of the dimension of ASM. The same positive trend is followed by the provision expense ratio; the same at the time of the previous rating was significantly impacting on the cost structure of the institution. Nevertheless, in 2007, **the provision expense sensibly diminished,**

due to the application of the standard policy for provisioning adopted by the National Bank, and as a consequence, for the period December 2006 – November 2007 the same registers a negative result **turning into a reversal of provision.**

The biggest constraint in terms of performances is still to be referred to **productivity**, which registered in the last year **a downward trend, seen in a drop of number of clients served for both, loan officers and staff in general.** Undoubtedly, during the last periods productivity has been negatively affected by the lack of funds and by the instability of the staff: on the one side

¹³ The absence of audited financial statements for all periods of analysis up to February 2006 does not allow us to ensure the reliability of the data used for the financial indicators analysis performed before that date and for the cross-period September 2005 – August 2006.

¹⁴ 2006, the first year of operations of the new entity, covers a 9 months period.

existing staff was demoralized for the sluggish growth and limited carrier opportunities; on the other side it was and still is difficult for the institution to find skilled and qualified staff.

304 active clients were served by ASM LOs as of November 2007, in comparison to the 348 of 2006. The same for total staff, 109 versus 113. Indeed, regardless of the efforts spent in the adaptation of the incentive scheme – which currently weights more the number of active clients – the severe shortage of funds suffered and consequent high drop out registered pushed down the overall level of productivity. Even if from the one side productivity by number of clients registered a downward trend, the need to more closely collaborate with graduating clients, due to the lack of funds, **push upward the productivity by amounts**. LOs are currently managing almost USD 85,000 while staff manages USD 30,000.

Funding expense ratio, though currently standing almost at the same value registered one year ago, **is expected to rapidly grow in the next future to the increased access to commercial liabilities**. For the period December 2006 – November 2007 funding expense ratio stands at a misleading 1.1%. In reality, impact of passive interests is not yet visible in the ratio due to the conditions of the loans and to the use of the cash principle.¹⁵

Financial Indicators	Jan05-Dec05	Mar06-Dec06	Dec06-Nov07
Operating expenses ratio (aver. gross portf.)	48,6%	44,9%	41,8%
Staff allocation ratio	38,5%	32,4%	35,9%
Loan officer productivity (borrowers)	254	348	373
Loan officer productivity (amount)	41.438	72.184	84.285
Branch productivity (amount)	310.788	433.102	589.996
Cost per loan lent	35	36	na
Cost per borrower	71	84	99
Funding expense ratio**	0,5%	1,3%	1,1%
Provision expense ratio	1,6%	3,3%	-0,4%
Portfolio yield (gross portfolio)	68,4%	67,0%	62,3%

Portfolio yield has registered a certain drop in the last two years, passing from the 67% of 2006 till the **62.3% of the period December 2006 – November 2007**. The main reasons behind this fall of yield has to be found in the ever-increasing share of graduated clients, benefiting from declining balance and, due to the lack of funds, the minor share of new clients. Regardless of the drop, the present portfolio yield still allows to cover all operating, financial and provisioning expenses and leave a positive operational margin of almost 20%. Undoubtedly, **the high level of inflation registered during the last period significantly erodes the margin, which finally shrinks to 6.4%, leaving limited room for covering the increasing cost of borrowed funds**¹⁶.

In future, portfolio yield may reduce in response to the downward market pressure on interest rates. Given the current cost structure of ASM and the objective difficulty in cutting costs in the short run, this may represent a risk for the future viability of the institution.

Nevertheless, according to the strategy and as discussed with the management, ASM is not planning to reduce interest rates for the next coming year; but most probably a cutback of interest rates will happen during 2009, in parallel with the introduction of commissions.

Overall, ASM has shown an improved financial performance since the last rating, thus **still having to work on efficiency and productivity**. ASM enjoys a rather heavy operational structure and this, together with a still limited funding possibilities, burden the institutional evolution.

¹⁵ Interests on Triple Jump loan are due twice a year.

¹⁶ It has moreover to be remembered that the present funding expense ratio does not transparently show the real cost of borrowed fund, as interests on Triple Jump loan are paid every six months and are not accrued.

7. Strategic objectives and financial needs

Strategic objectives and strategies

The main features of the projected evolution of ASM are shown within the **Strategic Business Plan for years 2006 - 2008** developed in 2006 and not yet updated. Operational planning is done informally by the Top Management based on the availability of funding from period to period and then shared with branch managers. The Top Management, together with the Board is indeed planning to revise the strategy and prepare a new Business Plan, once two years full reliable audited financial statements will be available (and these are expected by the first quarter of 2008). Additionally, there is a further issue currently under discussion at BoD meetings: the **ownership issue**. The present lack of a clear and comprehensive exit strategy of Save the Children is constraining the development of the long term plan of ASM. Considering that the founder will gradually diminish the involvement in microfinance in Azerbaijan within 2008, possible solutions have to be studied to define the future ownership structure of ASM, also under the hypothetical approval of the Microfinance Law. The most likely opportunities for ASM remain the transfer of the ownership to staff and the involvement of equity investors, although both options bring about different risks, which should be thoroughly addressed when updating the business plan.

ASM **still relies on old financial projections** developed by using Microfin. Projections will be updated along with the Business Plan document during 2008. A presentation of two different scenarios will be included, what may provide the institution with reasonable alternatives in response to the realization of predictable events.

When comparing achieved results with expected figures for 2006 and 2007, some observations need to be done. As shown in the table aside, **ASM**

AZERI STAR MICROFINANCE				
Key financial indicators	Actual 2006	Expected 2006*	Actual Nov07	Expected 2007*
Oustandng portfolio (USD)	866,205	1,109,541	1,179,993	1,513,005
Portfolio growth (AZN)	32.2%	77%	33%	36%
Number of loans	4,179	5,375	4,258	7,110
Equity (USD)	772,302	858,403	1,017,231	1,120,053
Liabilities (USD)	109,148	465,370	298,092	660,000
OSS	135%	149%	148.6%	160%
ROE	14.5%	21.3%	18.3%	26.4%
Operating expenses ratio	42.6%	46%	39%	38%

* Source: 2006-2008 Strategic Business Plan

projected growth was not realistic, being the growth rate assumptions fairly aggressive. In particular, ASM **did not succeed in accessing sufficient funding sources** in order to feed planned growth. The main discrepancy is visible in the expected growth rate of portfolio for 2006, standing at 77%, while the actual figure (32.2%) is far below expectations. **The experience of shortage of funds has consequently undermined the full achievement of defined goals for the period 2006-2008**, expressed in the business plan, with reference to geographical expansion, enhancement of its structure and operations and increase visibility. Nevertheless, **ASM is on the right track to recover higher growth**. On the other hand, when comparing **operating expenses**, the forecasted trend has been close to reality.

Financial needs

ASM will need US\$ 1 ml to sustain the growth till the end of 2008. Of this million, US\$ 400,000 have been already contracted with Oikocredit and US\$ 200,000 are currently being negotiated with BlueOrchard. Further negotiation have been started with KIVA, Deutsche Bank and Minlam. Noteworthy is that the retained earnings will acquire increasing importance in value and amount, for feeding expected growth. In addition, the transfer of the HQs to Baku will facilitate the contacts with investors and streamline the communication flow with them.

8. Details of the risk factors

According to our analysis, the main risk factors of Azeri Star Microfinance are the following ones:

AREA	Risk factors	Relevance ^a	Main measures implemented and/or to implement in the short term	Observations
External environment	<i>Lack of a microfinance law and clear fiscal policy for microfinance</i>	Medium-low	A law has been drafted and is still under discussion in the parliament.	The exemption from paying social taxes is temporary. A draft law for microfinance has not been approved yet.
	<i>Lack of a credit bureau for microfinance institutions</i>	Medium-low	Sharing blacklist of clients with other MFIs operating in the same area	AMFA is planning to establish a credit bureau
	<i>Growing competition</i>	Medium	–	Competition is increasing in ASM areas of operation and especially in Ganja. Moreover FINCA is in the process of transforming into a bank, thus being able to enhance its product offer
	<i>High inflation</i>	Medium	–	Unexpected increase in operating expenses due to high inflation. Changing needs of the target clientele. Erosion of the operating margin
Governance, management and operations	<i>Still to be consolidated Supervisory Council</i>	Medium	SC members are undergoing various trainings on good governance. Physical and distance meetings are more frequently held.	The Supervisory Council lacks finance and banking background and has only recently started operating. Guidelines on sound governance still has to be developed
	<i>Quite heavy organizational structure</i>	Medium-low	Merger of Office Manager and MIS specialist at the branch level	Some positions are overlapping (branch and credit manager), resulting in an improvable staff allocation ratio.
	<i>Staff turnover</i>	Medium	ASM introduced staff loans in September 2007. The incentive scheme has been improved. Overall, staff satisfaction has also increased thanks to recent access to fresh funding	Experienced staff is leaving for better positions in other MFIs and banks. Lack of formal career paths
	<i>Difficulties in finding qualified staff</i>	Medium	Formal training needs assesment is performed at the end of each year and accordingly a training plan is developed	The recruitment of new staff may take more than one month with negative consequences on daily and planned operations
	<i>Cash handling</i>	Low	At the end of year 2006 ASM opened a bank account in Mingachevir	Written policy and procedures are in place.

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

AREA	Risk factors	Relevance*	Main measures implemented and/or to implement in the short term	Observations
Financial products and asset quality	<i>Credit products not fully tailored to clients' needs</i>	Medium	ASM has recently launched consumer and staff loans, while the individual business loan is going to be re-introduced, possibly with higher amount ceiling. Enhanced flexibility in loan conditions	Maximum loan amount still limited
	<i>Still relevant drop out rate</i>	Medium-high	ASM is systematically investigating reasons for clients leaving the institution	Although drop out rate is expected to diminish in the next coming periods thanks to the availability of funds, it is equal to 61.63% for the period Dec06-Nov07.
	<i>Portfolio concentration in the livestock sector</i>	Medium-low	Clients are required some degree of business diversification in order to obtain a loan.	45% of the portfolio is represented by loans given to the livestock sector, which is also the riskiest.
Financial structure and ALM	<i>Limited access to financial resources</i>	Medium	In September 2007, ASM received a loan from Triple Jump. Moreover, negotiations are ongoing with Oikocredit, Blue Orchard and Minlam	As of November 2007 the leverage is equal to 0.3, showing wide room for improvement.
	<i>Improvable liquidity management</i>	Medium	–	ASM still lacks proper financial risks handling policies and procedures and the financial department expertise in managing risks such as maturity, currency and interest risk is to be developed yet.
	<i>Improvable liquidity management</i>	Medium-low	ASM has recently introduced a manual for risk management and an ALCO Committee	The liquidity pattern is characterised by high fluctuations
Financial and operational results	<i>Worsening trend of productivity</i>	Medium	Incentive scheme takes into account a higher target of number of active clients	The low level of productivity is closely linked to the high drop out and to the HR issue
	<i>Improvable efficiency</i>	Medium	–	Operating expense ratio has slightly decreased from 45% for the period Mar06-Dec06 to 42% for the period Dec06-Nov07

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

AREA	Risk factors	Relevance*	Main measures implemented and/or to implement in the short term	Observations
Strategic objectives and future evolutions	<i>Business Plan not yet updated</i>	Medium	ASM is planning to update the BP and financial projections during 2008	Planned growth for 2006 has not been achieved (77% planned against 32.2% real)
	<i>Limited financial projections</i>	Medium-high	5-years financial projections will be developed at the beginning of 2008	1 year of financial projection is a limited horizon
	<i>Lack of different scenarios analysis</i>	Low	Scenarios analysis is considered within the BP which will be produced in 2008	The business plan is lacking projections presenting conservative, realistic and optimistic scenarios.
	<i>Lack of different scenarios analysis</i>	Medium	Two members of the SC are supporting the fund raising function.	The CEO has contacted several potential investors. However negotiations still lag in a preliminary stage.
	<i>Uncertainties about future ownership</i>	Medium-low	The founder together with the SC and the CEO are considering few options (ownership to the staff or foreign investor)	Since ASM has accessed to fresh resources, the merger option has been rejected. By the end of 2008 Save the Children will downsize operations in the country.

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

Azeri Star			
Balance Sheet (USD)	Dec05	Dec06	Nov07
ASSETS			
Cash and bank deposits	38,368	4,151	134,746
Short term financial assets	-	-	-
Net outstanding portfolio	596,712	846,296	1,155,513
Gross outstanding portfolio	621,575	866,205	1,179,993
Performing portfolio	619,387	863,351	1,178,500
Portfolio at risk > 30 days	2,188	2,854	1,493
(Loan loss reserve)	24,863	19,909	24,480
Accrued interest	-	-	-
Other short term assets	-	-	-
Total short term assets	635,080	850,447	1,290,258
Long term financial assets	-	-	-
Net fixed assets	37,600	31,003	25,065
Other long term assets	-	-	-
Total long term assets	37,600	31,003	25,065
Total assets	672,680	881,450	1,315,324
LIABILITIES and EQUITY			
LIABILITIES			
Sight deposits	-	-	-
Short time deposits	-	-	-
Short term loans	-	80,000	91,992
Other short term liabilities	-	-	-
Total short term liabilities	-	80,000	91,992
Long term time deposits	-	-	-
Long term loans	80,017	-	206,100
Other long term liabilities	-	-	-
Restricted funds	-	-	-
Total Long term liabilities	80,017	-	206,100
Total liabilities	80,017	80,000	298,092
EQUITY			
Paid-in capital from shareholders	-	36,985	37,952
Donated equity	951,072	648,789	710,455
Quasi-capital	-	-	-
Reserves	-	-	-
Total retained earnings	-	358,410	86,527
Net income, previous years	-	464,182	-
Net income, current year	-	105,773	86,527
Other equity accounts	-	-	-
Total equity	592,663	772,302	1,017,231
Total liabilities and equity	672,680	852,302	1,315,323

Azeri Star			
Income Statement (US\$)	Jan05-Dec05	Mar06-Dec06	Dec06-Nov07
<i>Interest & commissions received on loans</i>	410,197	434,467	600,573
<i>Financial revenue from investment</i>			1,613
<i>Other financial revenues</i>	-	-	6,494
A) Financial revenue	410,197	434,467	608,681
<i>Interest paid on borrowings</i>	2,872	8,448	10,455
<i>Interest paid on savings</i>	-	-	-
<i>Interest paid on mortgage</i>	-	-	-
<i>Other financial expenses</i>	-	46	489
<i>Inflation adjustment</i>	-		
B) Financial expenses	2,872	8,494	10,944
Gross financial margin (A - B)	407,326	425,974	597,737
<i>Loan loss provision</i>	9,809	21,476	4,312
Net financial margin	397,516	404,497	602,049
<i>Other operating revenue</i>	-	-	-
<i>Personnel expenses</i>	204,611	202,374	260,006
<i>Administrative expenses</i>	87,132	88,433	142,878
C) Operating expenses	291,743	290,807	402,884
Net operating income	105,773	113,690	199,164
<i>Extraordinary revenue</i>	-	-	-
<i>Extraordinary expense</i>	-	-	-
Net income before donations, before tax	105,773	113,690	199,164
<i>Taxes</i>	-	25,012	-
Net income before donations	105,773	88,679	199,164
<i>Donations in cash</i>	-	-	-
<i>Revenue not from the operations</i>	-	-	-
<i>Expenses not from the operations</i>	-	-	-
Net income	105,773	88,679	199,164

Annex 2 - Financial statements' adjustments

The financial statements in Annex 1 are the result of **standard reclassification**. They are based on the internal financial statements of SC/US up to February 2006, while for the period March - December 2006 the audited FS of ASM are available. Moreover, internal financial statements have been used to cover the period January – November 2007.

Adjustments (USD)	Jan05-Dec05	Mar06-Dec06	Dec06-Nov07
Reversal of accrued interest on non-perf loans	-	-	-
Subsidized cost of fund adjustment	-	-	14,062
- Interest rate used (national currency)	12.8%	13.5%	14.2%
- Interest rate used (foreign currency)	7.0%	8.4%	8.2%
Inflation adjustment	77,381	60,729	129,544
- Inflation rate used	7.4%	8.0%	19.3%
Loan loss provision adjustment	-	-	-
In-kind subsidy adjustment	8,884	-	-
Total variation of net income	86,265	60,729	143,606

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 kind¹⁷ and soft loans¹⁸)
- provisions are calculated with a standard formula¹⁹
- adjustments for inflation
- adjustments for write-offs

The bulk of the adjustments to ASM FS are related to inflation: the relevant increase of the consumer price index (culminating in November 2007), makes this adjustment accounting for 90% of the total variation of net income in the period December 2006 – November 2007.

¹⁷ Donations in kind are valorized and added to operational expenses.

¹⁸ 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%.

¹⁹ Provisions are calculated according to the following formula:

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

Annex 3 - Financial ratios

Azeri Star - USD

Jan05-Dec05

Mar06-Dec06

Dec06-Nov07

PROFITABILITY

Return on Equity (ROE)	15.3%	14.5%	18.3%
Adjusted Return on Equity (AROE)	3.1%	4.8%	1.1%
Return on Assets (ROA)	14.3%	13.0%	14.9%
Adjusted Return on Assets (AROA)	2.9%	4.2%	0.9%
Operational self-sufficiency (OSS)	134.7%	135.4%	148.6%
Financial self-sufficiency (FSS)	105.0%	113.9%	110.0%
Profit Margin	25.8%	26.2%	32.7%

LOAN PORTFOLIO QUALITY

Portfolio at risk (PAR30)	0.3%	0.3%	0.1%
Arrears rate (> 1 day)	0.3%	0.3%	0.1%
Restructured loans	0.0%	0.0%	0.0%
Provision expense ratio	1.6%	3.3%	-0.4%
Loan loss reserve ratio	4.0%	2.3%	2.1%
Risk coverage ratio (30 days)	1147.7%	697.6%	1638.8%
Write-off ratio	0.2%	0.1%	0.2%
Adjusted write-off ratio	0.2%	0.5%	0.3%

EFFICIENCY AND PRODUCTIVITY

Staff allocation ratio	38.5%	32.4%	35.9%
Loan officer productivity (borrowers)	254	348	304
Loan officer productivity (amount)	41,436	72,184	84,285
Staff productivity (borrowers)	98	113	109
Staff productivity (amount)	15,936	23,411	30,256
Branch productivity (amount)	310,788	433,102	589,996
Operating expenses ratio (average gross portf.)	48.6%	44.9%	41.8%
Cost per loan lent	35	36	52
Cost per borrower	71	84	99
Personnel expenses ratio (average gross portf.)	34.1%	31.2%	27.0%
Admin. expenses ratio (average gross portfolio)	14.5%	13.6%	14.8%

ASSETS/LIABILITIES MANAGEMENT

Portfolio yield (gross portfolio)	68.4%	67.0%	62.3%
Funding expense ratio**	0.5%	1.3%	1.1%
Cost of funds ratio**	nc	12.3%	5.5%
Adjusted provision for inflation (av. gross port.)	12.9%	9.4%	13.4%
Current ratio	nc	nc	13.71
Liquidity over total assets	5.7%	0.5%	10.2%
Debt/equity ratio	0.14	0.14	0.29
Capital adequacy ratio	88.1%	87.6%	77.3%

* calculated for the period September - August 2006

nc: not computable

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

OUTREACH

Average disbursed loan size	228	300	399
Average disbursed loan size on per-capita GDP	14.9%	12.5%	11.0%
Percentage of active borrowers women	48.9%	55.0%	59.8%

GROWTH (amount in national currency)

Growth of active gross portfolio	10.9%	32.2%	32.8%
Growth of active borrowers	1.6%	9.5%	1.9%
Growth of total assets	3.1%	24.3%	45.4%
Growth of funding liabilities	nc	nc	263.1%
Growth of operating expenses**	-12.6%	-5.4%	35.0%
Growth of equity	-9.2%	23.6%	28.4%

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

Azeri Star Microfinance does not provide non-financial services and its financial statements reflect exclusively the results of its financial activities. The Financial Statements (FS) currently are prepared using the cash basis, and the financial department is not planning in the short term to introduce the accrual basis, if not requested by the NBA. The FS were audited for the first time for the period March - December 2006 by a local auditing company (TID Consulting), which is going to audit FS for 2007 as well.

Loan loss provision and write-offs

ASM is applying the loan loss provision policy of the NB, which is also applicable to MFIs.

The finance manager prepares the aging report on a monthly basis and based on that report he calculates the amount of provision for the current month. This provisioning amount will then be compared with the already existing balance of loan loss reserve. If the existing balance of reserve is less than the calculated amount, the difference will be provisioned. But if the existing reserve balance is more than the calculated amount no additional provisioning will be required. The Accountant will then make necessary entries to the Loan Loss Provision and Loan Loss Reserve Accounts.

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

Aging portfolio in arrears	% provision
0 - 30 days	2%
31 - 60 days	6%
61 - 120 days	25%
121 - 180 days	50%
> 180 days	100%

Insider loans

Staff loans have been introduced in October 2007.

November 2007

Insider loans (US\$)	Outstanding balance	Loan term	Interest rate	Collateral	PAR > 1 day
Management	17,500	24 months	18% annual	guarantor (another employee)	0%
Staff	21,710	24 months	18% annual	guarantor (another employee)	0%

Donations

Donations received (USD)

Year	Amount	Destination	Source
2006	565,355	Grant for loan capital	USAID
	15,722	Investment (e.g. grant financing or donation of property, vehicles, computers)	USAID
Sub-total	581,077		
2007	44,000	Grant loan capital	SCF
Sub-total	44,000		
TOTAL	625,077		

Details of funding liability

November 2007

Loans borrowed					
Source	Currency (in which the loan is due)	Outstanding Balance (USD)	Outstanding Balance Short Term (USD)	Outstanding Balance Long Term (USD)	Agreement, kind of product and collateral
DRC (Caucas Credit)	AZN	91,992	91,992	0	Short term loan agreement /pledge portfolio/ bearing fixed interest rate
Triple Jump	USD	206,100	0	206,100	Long term loan agreement bearing a fixed interest rate
TOTAL		298,092	91,992	206,100	

November 2007

Funding liabilities features						
Source	Loan amount (USD)	Disbursement date	Maturity date	Principal repayments	Interest repayments	Interest rate
DRC (Caucas Credit)	91,992	3 June 2007	9 June 2008	Starting from 6/12/2007 monthly	monthly	14%
Triple Jump	412,200	9 June 2007	31 August 2011	I part - 31/12/2010; II part - 31/12/2011	semiannually	14%

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.