

Azeri Star Microfinance Evaluation

AHAP II Microfinance Program

September 19, 2004

By

Kershaw Burbank Jr., Ph.D.

Under Contract to Mercy Corps International

Funded by USAID Contract # _____

Kershaw Burbank Jr., Ph.D.
9 Long Lane
Malvern PA 19355
USA
e-mail: kburbank@att.net

INTRODUCTION

This evaluation was conducted in Baku, Barda, and Ganja, Azerbaijan from August 23 to September 5, 2004, under contract to Mercy Corps International's AHAP II Grant from the United States Agency for International Development (USAID).

I want to thank the staff of Mercy Corps Azerbaijan for their hospitality and help in conducting this evaluation. I want to especially thank and acknowledge the work, help, and friendship of Chingiz Mammadov and Elchin Alimardanov, Mercy Corps' Economic Opportunities Program Officers. Without their able translation and assistance, the evaluation could not have been done.

1 Executive Summary

1.1 Summary of major conclusions

In 2002, Save the Children began to turn around its failing *Azeri Star Microfinance* (ASM) program. Since then, it has overcome all its more challenging problems and emerged as a thriving microfinance program. ASM has been operationally sustainable for the last three months and shows promise of being able to maintain its profitability and to achieve Financial Self-sufficiency in the next year.

ASM is on the verge of becoming an independent MFI which can become operationally self-sufficient on a sustained basis. ASM can continue its Operational Self-sufficiency and reach Financial Self-sufficiency in the proposed AHAP extension period as planned if it can raise the additional \$130,000 necessary to fund expansion, keep and develop key managers, and expand rapidly and profitably into the promising Ganja market while reducing projected ongoing administrative costs.

1.2 Summary of Major Recommendations

To accomplish this we recommend the following which are further explained later in the text:

RECOMMENDATION: *Additional funding under the Project Extension should be conditional upon ASM applying for the license by September 30, 2004, and taking all subsequent actions in a timely manner.*

RECOMMENDATION: *We strongly recommend that Save appoint two or three external people to its Supervisory Council and suggest that they consider adding one or more clients and one local non-competitive NGO manager knowledgeable about MFI management. They may appoint a number of SCF staff to the Council to ensure that they will maintain control but still reap the advantages of local perspectives while modeling “Board behavior” and training Board members. We further recommend that Mercy Corps and USAID make further funding conditional on SCF appointing at least two local persons to the Supervisory Council.*

RECOMMENDATION: *ASM should specifically assign fund-raising tasks to middle managers to support the Executive Director in this work, get training for ASM managers in proposal writing and fund-raising, and make a plan for developing further relationships and financing.*

RECOMMENDATION: *We recommend that the Program Manager attend the courses in Strategic Planning and Business Planning with Microfin at the Microfinance Center in Poland. (See <http://www.mfc.org.pl/> for details.)*

RECOMMENDATION: *As ASM expands, we recommend that ASM make special efforts and pay special attention to hiring and training up staff who are not from Baku but from Barda and Ganja and who may have fewer credentials but who will be happy to work in Barda or Ganja.*

RECOMMENDATION: *We strongly recommend that ASM management revise its structural plan for the expansion of ASM. The Barda and Ganja Branch offices should each have a Branch Manager with profit/loss responsibility for the Branch while administrative core functions of finance, accounting and MIS are centralized in an administrative secretariat in Barda reporting to the Program Manager. (See Appendix 1 for a rough revised Organization Chart.)*

RECOMMENDATION: *Each Branch Manager should then perform a task analysis to maximize their profitability and to cut expansion costs by limiting the number of additional posts to fit the needs of the local Branch's client and loan volume. Each Branch Office should need only one MIS data clerk to enter data and an Administrative Officer who can also act as Cashier for collections and disbursements at the Branch Office.*

RECOMMENDATION: *With the expansion to Ganja and the overall move to becoming an independent MFI, the work of the Program Manager will increase exponentially forcing him to delegate much more the day to day tasks and causing him to focus on the strategic issues facing the MFI. He will not be able to oversee the Barda Branch Credit operations personally and needs to appoint a Branch Manager there but the Barda Branch Office does not then also need two Credit Managers. With a Branch Manager, Barda may not need any Credit managers but certainly needs no more than one beside the Branch Manager.*

RECOMMENDATION: *We recommend that the Compliance Manager be hired or terminated only by the Supervisory Council and report to both the Audit Board and the Executive Director. In this way, the Compliance Manager can freely investigate issues that involve the Executive Director without fearing for loss of job. The Audit Board would also then have the direct authority to ask the Compliance Manager to investigate any matter deemed appropriate and the Compliance Manager could bypass the Executive Director without fear if he needed to do so.*

RECOMMENDATION: *We recommend that ASM engage a credible auditor (even a local one) who knows or can learn how to audit MFIs using the CGAP formats and procedures and get a good audit for 2003 and 2004 as part of their move toward independence*

RECOMMENDATIONS:

1. *All accounting functions and financial projection work needs to be transferred to ASM and the Barda office to decrease dependency on SCF Baku staff and for ASM to gain control over its own finances and accounting functions.*

2. *To prepare for this transfer of functions, Mercy Corps and USAID should build training budgets into the Proposed Project Extension in order to ensure that the finance and accounting staff in Barda are trained enough to take over all the financial duties of an independent MFI. The ASM Finance Manager needs*

additional training in managing the finances of an MFI and in planning those finances using Microfin. The Micro Finance Center in Poland has excellent courses to cover both of these areas. The Finance Manger and other finance Department staff should be sent for training to the MFC courses as part of the Proposed Project Extension and financial functions be transferred within 30 days after that.

3. SCF should ensure that the Baku office staff train and delegate to the Finance and Accounting staff in Barda the interim work necessary for ASM staff to become truly independent during the Extension period.

RECOMMENDATION: We recommend that ASM do a cost analysis to understand better the Credit Officer and administrative time and expense costs required to develop new client groups and then reconsider how quickly ASM should respond when groups begin to desert to a competitor's product. ASM should at the very least closely monitor such situations and recognize that the loss of four groups may signal a ground swell of desertions that can quickly wipe out an MFI's best customer base. ASM may want to respond promptly by changing its loan terms for proven groups in order to protect these proven relationships. Simply raising the maximum loan available may be enough to retain most clients.

RECOMMENDATION: We recommend that ASM's Supervisory Council and Board of Directors take steps to monitor periodically in a structured way the intangibles of corporate culture, sense of mission, and staff morale in order to maintain the current good teamwork and excellent working atmosphere.

RECOMMENDATION: All accounting functions and financial projection work needs to be transferred to ASM and the Barda office to decrease dependency on SCF Baku staff and for ASM to gain control over its own finances and accounting functions.

RECOMMENDATION: We recommend that ASM Program Manager and new Financial Manager in Barda both get training in Microfin as soon as possible in order to be able to more accurately project the cash flow of ASM during the Extension period.

RECOMMENDATION: We recommend that actual profit and loss be reported for each Branch and for the organization overall on a monthly basis.

RECOMMENDATION: We recommend that Mercy Corps and USAID give serious consideration to including an additional \$50,000 of loan capital as requested by ASM.

2. Institutional Factors

2.1 Legal structure

Azeri Star Microfinance (ASM) has completed registration with the Ministry of Justice as a "Non-Banking Credit Organization Limited Liability Company" under the

laws of Azerbaijan. ASM is currently seeking licensing by the National Bank of Azerbaijan. Final application papers will be given to the National Bank by September 15 and ASM should receive its license within the following 30 days.

ASM has been slower than ADRA Kredit to move through the legal process but is completing the final steps.

RECOMMENDATION: Additional funding under the Project Extension should be conditional upon ASM applying for the license by September 30, 2004, and taking all subsequent actions in a timely manner.

2.2 History

The 2003 evaluation encapsulated well ASM's early history:

Save the Children began the Community Based Lending and Savings (CBLS) Program in 1998 under the auspices of AHAP I, and received continued funding under AHAP II. The program is headquartered in the city of Barda, and serves Barda and surrounding areas. The program was designed to reach IDP's and members of communities that are hosting large numbers of IDPs. These are some of the poorest communities in Azerbaijan and the need for a microfinance program is great. Most target clients are involved in small-scale agricultural trades, such as livestock rearing, or in petty trade.

At the end of 2001/beginning of 2002 CBLS began to experience severe delinquency problems. The problems had several different causes, the primary cause being a poorly designed loan product that relied to heavily on community leaders' recommendations and did not include adequate follow-up from loan officers. There was also an atmosphere of lax policies and procedures in the office that resulted in open corruption. As a result Save the Children (STC) fired almost all of the CBLS staff, including the expatriate technical advisor. One exception is the current program manager, Rufat Abbasov, who was new at the time and tasked with much of the clean up.

Save the Children and the remaining skeleton staff dedicated quite a bit of time and energy in redesigning the CBLS program, introducing new loan products and training new staff members. The result is a well-designed loan program that so far has excellent portfolio quality.

Since 2003, ASM has registered legally and is pursuing licensing with the National Bank. ASM has continued to expand its loan operations cautiously and has more than doubled the number of loans and the amount of loans disbursed since 2003 while also developing its MIS and accounting systems.

Competition has increased in ASM's areas as at least six other MFIs (FINCA, ACDI/VOCA, World Vision, Oxfam, NHE and NRC) are competing for the same groups of micro-entrepreneurs in ASM's areas of operations.

In May, 2004, ASM reached operational self-sufficiency of 101% on a monthly basis for the first time and has continued to maintain a marginal operational self-sufficiency. Financial self-sufficiency is in the 85-95% range for the last three months.

2.3 Ownership and Board of Directors

Corporate law in Azerbaijan uses different terminology from corporate laws in the USA and elsewhere. Azeri Star Microfinance (ASM) is wholly owned by Save the Children, which is the Founder under Azeri law and appoints the General Meeting. The General Meeting in turn appoints the Supervisory Council. The Supervisory Council oversees the policies and strategic management of the MFI in the same way that a Board of Directors would in the United States. The Supervisory Council appoints an Auditing Council which functions as an Audit Sub-committee would for a Board of Directors in the US. The Supervisory Council also appoints a Board of Directors and a Chairman of the Board who is also the Executive Director of ASM. Although called a Board of Directors, this body does not function as a BOD would in the United States but rather as an Executive Management Team consisting of the top three officers in the company tasked with day to day operations.

Save the Children (SCF) will retain its position as Founder and therefore appointer of the General Meeting which appoints the Supervisory Council and other Boards. All Supervisory Council and other Board members are Save the Children employees. No external local Council or Board members have been appointed even from client groups or from other INGOs like Mercy Corps. This is a serious governance problem in that ASM does not get the benefit of outsiders' perspectives on its operations and can easily miss significant environmental threats or opportunities. This situation is worsened in that most of the Supervisory Council members are expatriate staff who lack intimate knowledge of the local history, values, culture and language that can easily mask potential threats in the environment. From a positive viewpoint local Board members may also serve as informal PR spokesmen who add credibility to the NGO.

The 2003 evaluation strongly recommended that SCF add external perspectives to its governance structures. Since then, Mercy Corps monitoring reports have also echoed these concerns but SCF has not responded by appointing any external local people to the Council. We view this as a serious shortcoming to an INGO program attempting to become an independent local MFI.

RECOMMENDATION: We strongly recommend that SCF appoint two or three external people to its Supervisory Council and suggest that SCF consider adding one or more clients and one local non-competitive NGO manager knowledgeable about MFI management. SCF may want to appoint a number of SCF staff to the Council to ensure that they will maintain control but still reap the advantages of local perspectives while modeling "Board behavior" and training Board members. We further recommend that Mercy Corps and USAID make further funding conditional on SCF appointing at least two local persons to the Supervisory Council within reasonable time limits.

2.4 Alliances

ASM has partnerships with:

- Banks in its areas of operation
- Save The Children (ASM founder)
- Mercy Corps
- USAID (through Mercy Corps)
- Azerbaijan Microfinance Association (AMFA)

Other than its relationship with Mercy Corps and the national microfinance association, ASM does not seem to have (or need) any further alliances with NGOs at this point. However, ASM is willing to consider a partnership or merger with another MFI like Oxfam or NHE to combine operations and strengthen staff and economize on operations. Due to heightened competition in the area, it is likely that several of the INGOs with smaller MFIs will in the next 3-5 years decide that they cannot support a small MFI that will never be sustainable long term. At such a point, it would make sense for ASM as a “local and sustainable MFI” be in a position to take over the clients, personnel, and assets of a smaller agency or two in order to compete even more effectively with FINCA, World Vision, and ACDI/VOCA, which are their largest competitors in the area.

ASM badly needs new Donor partners to build its Loan Fund. ASM has approached Asian Development Bank (ADB) and Danish Refugee Council (DRC) to develop further funding relationships and appears to be progressing well in developing those relationships. However, given the long term expansion needs of the loan Fund (an additional \$1.2 million by 2008) to meet strategic objectives and the often long lead time necessary to develop funding proposals and relationships, ASM needs to develop an internal plan and structure for developing fund raising relationships.

RECOMMENDATION: ASM should make a specific plan for developing further relationships and financing. Specifically ASM should also assign some fund-raising tasks to middle managers to support the Executive Director in this work, and to train ASM managers in proposal writing and fund-raising.

2.5 Leadership

The Executive Director/Program Manager and principle leader of the MFI is Rufat Abasov, who has been with ASM since 2001 and has seen it through its reorganization. Rufat has good business experience and appears self-confident in a healthy way. He is willing to defend his ideas when he thinks he is right and yet will change plans if he sees that someone else’s ideas may be better for the institution. He enjoys the respect of his staff. Prahlad Mali, (who we did not have the pleasure of meeting) has done good work in training and mentoring Rufat. We were impressed that Prahlad (and the Save management) trusted Rufat sufficiently that Prahlad could go on home leave at this point of evaluation and proposing a new AHAP project extension.

Rufat is entering a new phase of leadership and organizational management as ASM adds additional branch offices. Until now, all staff have been within easy reach in the office unless they were in the field. With the new offices, Rufat will have to

consciously plan field visits and ensure that he is staying in touch with the realities of the Branch offices. Credit and Branch staff reported that Rufat did visit them. He will have to be even more structured in planning visits and in planning unannounced visits to find out what things are like when no one knows he is coming.

While Rufat has done very well with the day to day and month to month management, it seems clear that Prahlad still is responsible for strategic management. Rufat did not have the most up-to-date Microfin projections for ASM on his computer and said that they were with Prahlad. Rufat needs additional training in Microfin (or another strategic financial projection tool) and would benefit greatly from mixing with his Executive Director peers at one or more of the international training conferences at the MicroFinance Center in Poland or the Microfinance Institute in Boulder, Colorado.

Recommendation: We recommend that the Program Manager attend the courses in Strategic Planning and Business Planning with Microfin at the Microfinance Center in Poland. (See <http://www.mfc.org.pl/> for details.)

2.6 Human resource management

ASM as a Save the Children program has adopted Save's HR systems. Each position has a Job Description and at least an annual formal performance review. ASM is using Save's HR manuals and will need to re-write them for ASM as it becomes an independent entity. The Office Manager is now maintaining the staff's personnel records. However, no one is clearly tasked with the more important HR work of Task Analysis, Job Design, Recruiting, Selection and Training of new personnel. As the Ganja Branch office is added and many more new people join ASM, the Human Resource work will have to be assigned to some one on a full or part-time basis.

During the last 12 months (August, 2003 to July, 2004), 6 staff resigned and 13 were hired. Three resignations were Credit Officers representing about 20-25% of all the Credit Officers. Several of these moved to competitors. This is an unhealthy turnover rate among the Credit Officers but perhaps unavoidable with the rapid expansion in the microfinance industry in Azerbaijan.

Many of the staff are from Baku including key managers who might readily resign if offered a position with a competitor in Baku.

RECOMMENDATION: As ASM expands, we recommend that ASM make special efforts and pay special attention to hiring and training up staff who are not from Baku but from Barda and Ganja and who may have fewer credentials but who will be happy to work in Barda or Ganja.

2.7 Organizational structure

ASM's current structure is simple with a single main office in Barda and a service point at Ganja. The Program Manager (Rufat) reports to the Supervisory Council. Rufat oversees the Admin/Finance Manager, two Credit Managers, MIS Manager,

and Compliance Manager. They all have their offices at Barda with him. Except for the Credit Supervisor and two Credit Officers at Ganja all functions are in the Barda office building and have easy access to the Program Manager. Currently there is a total of 14 Administrative staff supporting the work of the Program Manager, 2 Credit Managers, and 15 Credit Officers. This is a high Administrative staff to Program staff ratio of 14:18 which is barely cost efficient and profitable.

The key to effective MFI expansion is to expand productive Credit Operations in Branch Offices while centralizing core administrative functions with minimal additions of admin staff. Telephones, computers and electronic communications allow distant field offices to link electronically and to exchange information quickly while minimizing the number of highly paid financial and MIS technical managers who need to centralize information daily for management to have an operational overview.

MFI “best practices” globally suggest that each Branch Office should be a Profit Center and its performance judged on the basis of its contribution to the MFI’s overall profitability as well as the Branch’s contribution to serving previously unserved clients.

ASM’s Strategic Plan and Economic Opportunities Development Program Extension Request to Mercy Corps/ USAID plans to nearly duplicate the administrative structure when the Ganja Office is expanded. This plan nearly doubles the current Administrative Staff of 14 by adding an additional 10 administrative staff (MIS Officer, Admin/Finance Manager, Accountant, Cashier, Office Manager, 3 Guards, Senior Driver, and Cook/Cleaner) without a concurrent doubling of administrative transactions. The 10 Ganja administrative staff will support the operations of a Branch Manager, two Credit Managers and 9 Loan Officers. (See Annex 4: Organizational Chart of ASM Extension Proposal and Appendix 1 attached of a revised Organizational Chart). This is again a high Admin staff to Program staff ratio of 10:12. It is also highly unlikely that all these staff will have enough work to be fully employed all day.

The overall planned corporate structure will then have a ratio of 24 total Admin Staff to 30 Program Staff. We have never seen such a heavy administrative structure in a *cost efficient* MFI and have never seen such a heavy admin structure in a Branch Office.

In discussions with the Managers involved, it became clear that the current plan was devised without a task analysis of the work needed to be performed and a modern Job Design approach to organizational development.

RECOMMENDATION: We strongly recommend that ASM management revise its structural plan for the expansion of ASM. The Barda and Ganja Branch offices should each have a Branch Manager with profit/loss responsibility for the Branch while administrative core functions of finance, accounting and MIS are centralized in an administrative secretariat in Barda reporting to the Program Manager. (See Appendix 1 for a rough revised Organization Chart.)

RECOMMENDATION: Each Branch Manager should then perform a task analysis to maximize their profitability and to cut expansion costs by limiting the

number of additional posts to fit the needs of the local Branch's client and loan volume. Initially, the Ganja Branch Office should need only one MIS data clerk to enter data and an Administrative Officer who can also act as Cashier for collections and disbursements at the Branch Office.

RECOMMENDATION: *With the expansion to Ganja and the overall move to becoming an independent MFI, the work of the Program Manager will increase exponentially forcing him to delegate much more the day to day tasks and causing him to focus on the strategic issues facing the MFI. He will not be able to oversee the Barda Branch Credit operations personally and needs to appoint a Branch Manager there. The Barda Branch Office does not then also need two Credit Managers. With a Branch Manager, Barda may not need any Credit Managers but certainly needs no more than one beside the Branch Manager.*

2.8 Management information system

The MIS system at AMS has been greatly improved since the 2003 evaluation and now seems to meet all current needs on a timely basis. The MIS Manager, Maxim Hajiyev, has done an excellent job of improving this system and getting it up to speed. As a test, we asked for a copy of the previous day's repayments and the MIS manager was able to give us that information almost immediately. The MIS system has been completely diagrammed and a schedule of reports has been created showing who gets them and how often. We asked the MIS Manager to give us a print-out of the previous day's non-repayments and weekly arrears for the previous week. He gave us the report within 15 minutes. Interviews with other staff confirmed that the MIS system was working well. ASM is to be commended for setting up such a good system and for rectifying its prior problems in this area.

2.9 Internal control system, audits, and supervision

ASM has added the post of Compliance Officer since the 2003 evaluation. This person has an MBA and is doing much needed spot checks of clients, groups, internal accounts, etc. He seems to be doing a good job. Currently he reports to the Program Manager. However, as ASM moves toward independence, we suggest that the Compliance Manager needs to be able to act independently of the Executive Director and report directly to the Audit Board while still taking daily direction from the Executive Director for most internal checks and audits. We do not see this as a current problem area but believe that it could become so as ASM becomes more independent of SCF.

RECOMMENDATION: *We recommend that the Compliance Manager be hired or terminated only by the Supervisory Council and report to both the Audit Board and the Executive Director. In this way, the Compliance Manager can freely investigate issues that involve the Executive Director without fearing for loss of job. The Audit Board would also then have the direct authority to ask the Compliance Manager to investigate any matter deemed appropriate and the Compliance Manager could bypass the Executive Director without fear if he needed to do so.*

While Price, Waterhouse, Coopers performed a special audit of the micro-finance program in order to meet Rufat's request for a set of audited accounts that would satisfy donors, the actual audit report which we were given was an audit of all the funds donated, earned, and used during the three year period from June 1, 2000 up to June 30, 2003. This is not a standard audit period and makes it difficult to draw any operational conclusions. Moreover, the audit did not follow recommended CGAP formats used by the MFI industry and was more like the audit that might be performed on a social program or a business.

RECOMMENDATION: We recommend that ASM engage a credible auditor (even a local one) who knows or can learn how to audit MFIs using the CGAP formats and procedures and get a good audit for 2003 and 2004 as part of their move toward independence.

2.10 Financial Manager

ASM's Financial Manager, Gulnaz Hajiyeva, has a strong educational background with a Masters degree in Public Administration and six or seven courses in Finance at the graduate level. While she seems to have basic financial skills and knowledge, she and the Finance Department in Barda are focused principally on day-to-day operations. When asked if she had a cash flow plan, she said that she did not have one beyond the next month. She also did not have a copy of the SCF simplified Microfin software used by ASM for strategic planning and for forecasting financial needs. She did not have any training in Microfin or any other financial planning software. She told us that all the strategic planning was done by Rufat and Prahlad Mali in Baku. She has never seen the Strategic Plan or the Microfin projections. This is not good financial management.

The main SCF office in Baku also maintains the donor related finances with SCF USA and other donors so that the Barda office is not really prepared at this time to take on the financial management duties necessary for an independent MFI. In short, the Finance Department is not functioning at a level appropriate for an independent MFI. These are serious shortcomings which can be remedied with training, mentoring, and delegation of duties.

From an accounting viewpoint, the current accounting software in Barda reportedly does not do an adequate job and the Baku office prepares ASM's accounts for Mercy Corps and USAID. Unfortunately, the Barda office does not compile or even see the expenses of the Baku office. ASM has gotten approval from SCF for technical assistance to install suitable accounting software which will be done during the Proposed Extension Period.

RECOMMEDATIONS:

1. All accounting functions and financial projection work needs to be transferred to ASM and the Barda office to decrease dependency on SCF Baku staff and for ASM to gain control over its own finances and accounting functions.

2. To prepare for this transfer of functions, Mercy Corps and USAID should build training budgets into the Proposed Project Extension in order to ensure that the

finance and accounting staff in Barda are trained enough to take over all the financial duties of an independent MFI. The ASM Finance Manager needs additional training in managing the finances of an MFI and in planning those finances using Microfin. The Micro Finance Center in Poland has excellent courses to cover both of these areas. The Finance Manger and other finance Department staff should be sent for training to the MFC courses as part of the Proposed Project Extension and financial functions be transferred within 30 days after that.

3. SCF should ensure that the Baku office staff train and delegate to the Finance and Accounting staff in Barda the interim work necessary for ASM staff to become truly independent during the Extension period.

3 Services, Clientele, and Market

3.1 Services

ASM currently has three excellent loan products that appear to be working well:

Group Livestock Loans- These loans start at \$140 and can rise to \$300. They are given for income producing agricultural and animal husbandry projects. The term is for 6-8 months with a grace period of two months and the rate is 3.5% per month flat. Collateral must be pledged to the group. Oxfam is offering serious competition to this product (see below). The groups are 7-15 people who guarantee each other's loans.

Group Business Loans- These loans start at \$120 and can rise to \$300 in last cycle. They are given for income producing small businesses and trade projects. The term is for 12 months and the rate is 3% per month flat. Collateral must be pledged to the group. The groups are 7-15 people who guarantee each other's loans.

Individual Loans- These loans are given to individuals who can pledge collateral. Loans start at \$300 and can rise to \$2,000. They are given for income producing small businesses and trade projects. The term is for 12 months and the rate is 3% per month flat. Collateral (usually gold jewelry) must be brought to the Barda office and kept there until the loan is repaid. Individual loans are only given to confirmed group clients who need them.

These are all well received by clients with whom we talked. All clients also expressed their desires for larger loans and easier terms (which is standard microfinance client behavior world-wide regardless of the loan size or terms).

By comparison, FINCA loans are comparable in terms and rate but require additional savings and group processes raising transaction costs for clients. In Ganja, many FINCA clients are interested in switching to the ASM loans which are seen as lower in transactions costs and do not require savings.

Oxfam offers similar livestock loans but with a higher loan principle (\$500) than ASM's and with a 4% per month declining balance rate that is less expensive than ASM's loans. One Credit Officer reported losing 4 groups and 39 clients to Oxfam in July and was concerned that another 2 groups and 15 clients were threatening to also

go over to Oxfam. These groups were all experienced client groups having repaid several loan cycles. Losing proven client groups is very expensive to an expanding MFI as these are better customers who have already proven to be good risks. The costs of finding and training new client groups are sizeable and rarely considered by management when deciding whether or not to respond to a competitive threat like this.

RECOMMENDATION: We recommend that ASM do a cost analysis to understand better the Credit Officer and administrative time and expense costs required to develop new client groups and then reconsider how quickly ASM should respond when groups begin to desert to a competitor's product. ASM should at the very least closely monitor such situations and recognize that the loss of four groups may signal a ground swell of desertions that can quickly wipe out an MFI's best customer base. ASM may want to respond promptly by changing its loan terms for proven groups in order to protect these proven relationships. Simply raising the maximum loan available may be enough to retain most clients.

3.2 Outreach

ASM continues to expand its outreach in rural areas and is currently serving six rayons. ASM's expansion further into the Ganja urban market has uncovered a higher demand for ASM's products than can be currently served by the existing staff or the loan portfolio. In Ganja, demand for ASM loans is so high that the Credit Officers there estimate that they have turned away 150 to 200 inquiries for loans during July alone. ASM intends to expand also into the surrounding rayons of Dashkasan, Khanlar, and Samukh. The Program Extension request is critical to achieving this expanded outreach.

3.3 Clientele

ASM has more than doubled its number of active Group Loan clients from 1,604 in July 2003 to 3,932 in July, 2004 while also adding 21 new individual loans. The proportion of female clients continues to be an issue for ASM which commissioned a study to examine the issue and to recommend action. That study is part of the Program Extension Request.

RECOMMENDATION: We recommend that Mercy Corps and USAID give serious consideration to including an additional \$50,000 of loan capital as requested by ASM.

4. Strategic Objectives

We reviewed ASM's final draft of the Strategic Plan for December 2004 through December 2008 and believe it is a good plan for rapid growth which will more than double the size of ASM in all aspects. The plan will stretch the organization and will give it clear goals and objectives for the next four years. However, there is no discussion in the plan of ASM's corporate culture and no discussion of the

organizational strains that can ensue *from too rapid growth* in an MFI. Many rapidly growing MFIs through out the world have come to recognize too late that their rapid growth in clients, loan funds and staff have outpaced the ability of the organization to effectively assimilate all the new people, to manage them effectively, and to adjust to all the organizational change while maintaining their distinctive corporate culture, their sense of mission, and their excellent morale.

RECOMENDATION: We recommend that ASM's Supervisory Council and Board of Directors take steps to monitor periodically in a structured way the intangibles of corporate culture, sense of mission, and staff morale in order to maintain the current good teamwork and excellent working atmosphere.

4.1 Mission and objectives

ASM has an excellent Mission or purpose statement focused on poverty alleviation.

Azeri Star Microfinance's goal is to provide sustainable financial services through a local independent MFI to vulnerable micro-entrepreneurs and others resulting in positive change in the life of children in Azerbaijan.

In meetings with employees, they played back this same mission in a number of ways suggesting that they have internalized the mission and own it themselves. As ASM adds new branches in other places, these branches may develop a separate and different corporate culture that in time creates internal management problems.

4.2 Objectives for the near to medium term

ASM has clear goals and objectives for the near and medium term as well as the longer range four years period.

5. Financial Performance

Overall the financial performance of ASM has improved markedly since the last evaluation in 2003 and should continue to improve if ASM can expand in a cost effective way by minimizing administrative costs and by maximizing profit producing credit operations. No annual reports were provided.

5.1 Income statement and balance sheet

Income statements and Balance sheets are reported on a monthly basis to SCF management and to Mercy Corps as well as a host of operating ratios which give a good picture of the financial performance of the program on a monthly basis. However, we saw no Annual Reports that accumulated data for a year or even six months and reported the operating and financial ratios as accumulated for the period. While monthly reports give good trend information and are most useful for management in spotting problems and opportunities, there needs to be a set of annual

reports that cause management to stop and reflect on the overall longer term performance and trends of the organization.

5.2 Adjustments for inflation and subsidies

ASM has made adjustments for inflation and subsidies in the Financial Sustainability ratios but these may be overstated. ASM may actually have a slightly higher Financial Ratio than has been shown. Here is why. Because SCF/ASM has not incurred any capital costs in developing the Loan Fund, the industry wide process is to calculate the Financial Sustainability ratios as though there had been a cost of capital assuming that with independence an MFI will be forced to rely on commercial credit markets for some portion of its loans funds.

As we understand it, ASM has used an imputed cost of capital by assuming that the cost of capital is equal to the average equity for the period less Fixed Assets which is then multiplied by the estimated inflation rate. There seem to be two possible problems with ASM's ratios. First, the actual CGAP formula for this calculation calls for using Net Fixed Assets which would be historic cost less accumulated depreciation. ASM has not included the depreciation which substantially raises the value for Fixed Assets. The net difference is not very large but may become more important when and if ASM increases its Fixed Assets stocks.

Secondly, the monthly CBLS data reports use a 1% per month inflation figure (annualized at over 12%) which does not agree with reports from other objective sources reporting on Azerbaijan. World Bank uses a 3.9% price deflator for 2003 while the CIA Factbook puts inflation in 2003 at 2.9%. C-Bonds, a commercial bond website, tracks Azerbaijan's inflation rate at 3.3% for all of 2003. Thus, using a 12% inflation rate may substantially overestimate real inflation.

A more appropriate rate might be to use the interest cost that would be required if the equity were to be borrowed locally or on the international commercial credit markets (LIBOR plus several points). That would give a better predictor probably of the real financial sustainability costs.

The CBLS system returns good data for most analysis but is dependent on adjustments from the Baku office for specific areas like capital costs and expenses by Baku staff charged to the program. Financial self-sufficiency ratios and other ratios depending on adjusted figures are not well understood by Barda staff because they are calculated in Baku with no reference to the Barda staff.

RECOMMENDATION: Again, we recommend strongly that all accounting functions and financial projection work needs to be transferred to ASM and the Barda office to decrease dependency on SCF Baku staff and for ASM to gain control over its own finances and accounting functions.

5.3 Profitability

As noted previously, ASM's lack of annual income and expense statements makes it difficult to assess profitability between years. However, the Operational Self-

sufficiency and Financial Self-sufficiency measures are good indicators of overall profitability on a monthly basis. But, they do not give a clear indication of the extent of profit or loss. For example, an MFI with income of \$250,000 and expenses of \$500,000 has the same operational self-sufficiency ratio as an MFI with income of \$2,500,000 and expenses of \$5,000,000. But the size of the loss is much larger with one than the other. The “bottom line” in business is the “bottom line” and NOT a ratio. It is important that MFI managers keep their eye on their actual profit or loss in real monetary terms and not just on their ratios.

We have mentioned earlier that Branch operations need to measure their own profitability and this is best done through an income and expense statement for the period rather than a ratio. The same is true for the overall organization. The actual profit and loss should be the most important measure watched throughout the organization just as it is in business.

RECOMMENDATION: We recommend that actual profit and loss be reported for each Branch and for the organization overall on a monthly basis.

5.4 Efficiency

ASM tracks efficiency on a monthly basis in the CBLs reports by two measures: 1) number of active borrowers per Credit Officer; and 2) cost per unit of money lent. Both of these are good measures. The number of Group Loan clients per Credit Officer should be around 300-350 for a good Credit operation while the number of Individual Loan clients per Credit Officer should be around 50-55. Combining the two score makes it difficult to assess quickly and accurately whether or not the Credit Operation is being managed efficiently. ASM gave us a list of the Credit Officers by Loan type and their number of clients and groups. Most Credit Officers met or surpassed these best practices measures for efficiency.

Recommendation: We recommend that measures of the number of loans per Credit Officer should be broken into two measures to account for the differences between Credit Officers working with Groups and those working with Individuals and reported monthly in the CBLs data reports.

The average cost per unit of money lent for the 13 month July, 2003-2004 period was 16.2% which meets best practice standards.

However, we also noted that ASM plans to spend more money on administrative staff in the proposed new branch than most successful MFIs spend. We noted that the proposed Branch expansion for 2004 projected Branch administrative expenses of 70,100 Manat with only 44% going for Branch Managers, Credit Officers, and Credit Managers while 55% was being spent on administrative salaries. This is not an efficient salary structure for the proposed Branch. Generally, administrative salaries should be no more than 35-40% of a Branch’s total salary budget and usually even less in order to make Branch operations profitable.

5.5 Loan portfolio analysis

ASM analyzes its Loan portfolio repayments on a daily basis and reports payments and non-payment to the Program Manager who asks for them each day if they are not given to him. The list of MIS reports in Appendix 2 details the reports and who gets them.

The Loan Portfolio has been increasingly disbursed over the last 13 months as Table 1 below shows. Total principal balance outstanding has risen from \$207,616 in July, 2003 to \$490,477 in July, 2004--- a 136% increase in one year. Because number of active loan clients has risen from 1,664 in July 2003 to 3,993 in July, 2004, the average principal balance per client has actually decreased from \$126 in July, 2003, to \$122 in July, 2004. The low balance per client suggests that ASM is keeping its poverty focus. While only \$122 was written off as uncollectible loans in July, 2004, the total write off for the period of July 2003-2004 was \$3,660--- less than 1% of the average outstanding balance during the period. (See Appendix 3 for the detailed July, 2003 to July, 2004 monthly CBLs data report.)

TABLE 1: Azeri Star Loan Portfolio Analysis-July 2003-July, 2004

	<u>Jul</u> <u>2003</u>	<u>Dec</u> <u>2003</u>	<u>July</u> <u>2004</u>
Total Principle Balance O/S	\$207,616	\$400,491	490,477
Number of Active Loans	1,644	3,196	3,993
Avg. Principal Balance/Client	\$126	\$125	\$122
Loan Losses Written off	\$0	\$0	\$122
Loan Loss Reserve	\$8,305	\$16,020	\$19,619
Portfolio at Risk (>30 days)	1.5%	0.2%	0.2%

5.6 Liquidity management

Liquidity management is relatively simple for ASM because it has no savings products to juggle in the cash flow analysis. Nevertheless, as mentioned before, cash flow beyond the next 30 days does not seem to be analyzed or planned by anyone at the Barda office. While no liquidity “crises” have been reported where there is no money for loans, Credit Officers report feeling a constraint that there is a lack of loan capital for them to expand as quickly as they might. The Program Manager also reports this constraint although the timing of when ASM might run out of loan funds seems unclear due to the lack of planning. Clearly, ASM has to do a better job in forecasting its liquidity and look forward to the time when they may borrow capital on the international commercial markets after they become independent and build a financial record for the MFI.

RECOMMENDATION: Again, All accounting functions and financial projection work needs to be transferred to ASM and the Barda office to decrease dependency on SCF Baku staff and for ASM to gain control over its own finances and accounting functions.

RECOMMENDATION: We recommend that ASM Program Manager and new Financial Manager in Barda both get training in Microfin as soon as possible in

order to be able to more accurately project the cash flow of ASM during the Extension period.

5.7 Interest rate analysis

ASM uses flat interest rates of 3.5 and 3%. See the discussion of competition in the section on Services.

5.8 Liabilities and cost of funds analysis

CBLS monthly reports show no Liabilities for any of the report periods.

This overlooks the Contract Agreement with Mercy Corps and USAID which states that the funds are still belonging to USAID until formally turned over. We know that this may be a moot point in that Mercy Corps and USAID have probably already shown the funds as expensed in their accounts when disbursed. Nevertheless, there is a disparity here between the legal reality and the accounting reality. The accounts here show that ASM/SCF now “owns” the Loan funds donated by USAID when contractually ASM/SCF do not yet own them and will not until they are formally turned over.

In terms of subsidies, all of ASM’s equity has been subsidized because all of its equity is from donated funds.

5.9 Capital management

ASM’s plans for using future grants of capital for its loan fund look reasonable given the revised preliminary quarterly operational projections submitted by ASM with the few exceptions noted in sections above. ASM certainly needs additional loan capital and additional operational grants during the next year while it expands and reaches sustained profitability and eventually operational self-sufficiency and financial self-sufficiency. However, ASM’s projections on a quarterly basis project Loan Capital needed as a function of the end of quarter outstanding loan portfolio. However, such a projection does not show up some abnormal months where re-payments are seasonally slow or other factors cause the need for a larger loan portfolio. This is why monthly projections are needed on a Branch by Branch basis rather than projecting only by loan product type.

RECOMMENDATION: We recommend that Mercy Corps and USAID give serious consideration to including an additional \$50,000 of loan capital as requested by ASM.

6 Conclusion

Overall Azeri Star is a very good young MFI. The next two years will be critical for its growth into an independent local MFI which is self-sufficient. Mercy Corps and USAID should continue to assist ASM to reach its goal by supporting a revised proposal (based on this evaluation) for extending the AHAP funding.

It has been a real pleasure meeting and working with the Azeri Star managers and staff. We thank them for their hospitality and wish them well. Any questions or comments are invited and may be directed to me by e-mail at kburbank@att.net.

Respectfully submitted by,

Kershaw Burbank Jr., Ph.D.