

Azeri Star Microfinance (ASM)– Azerbaijan

Final Rating

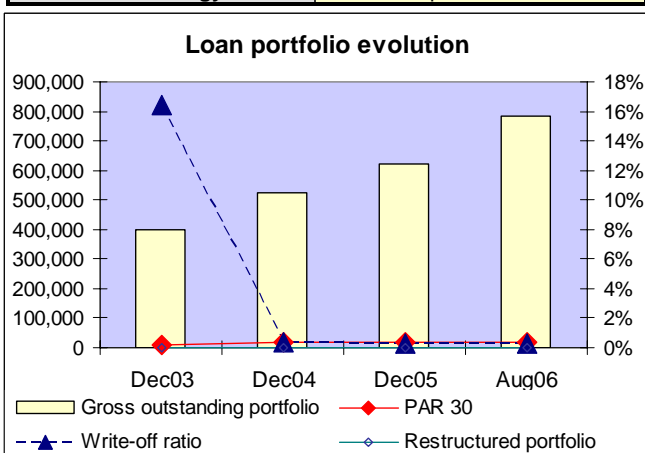
B+

First rating

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

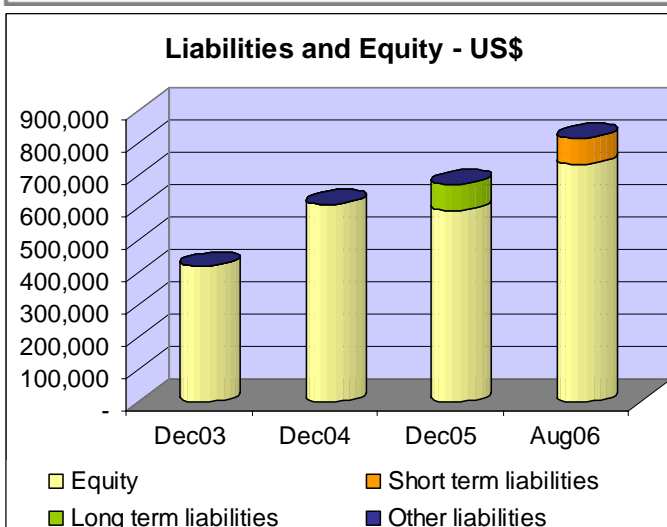
Save the Children Federation (SC/US) started its microfinance activities in Azerbaijan in 1999 with the Community Based Lending and Savings Program (CBLs). Azeri Star Microfinance (ASM) originated from the spin off of the CBLs project that took place in March 2006, and it is fully owned by SC/US. The new legal entity is a Non-Banking Credit Organization registered as a limited liability company with the Ministry of Justice. So far the funding sources have been mainly represented by grants received from US Agency for International Development. In 2005 SC/US borrowed the first commercial loan to finance the CBLs program. The institution's lending activities, mainly group based, target women and low-income population of the central and western regions of Azerbaijan, with a considerable poverty outreach. Raising enough commercial funds to scale up in a sector which is oriented towards mergers and acquisitions represents the main challenge for ASM future.

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



US\$	Aug06
Average disbursed loan size	272
Gross outstanding portfolio	785,507
Total assets	817,600

Number	Dec04	Dec05	Aug06
Active borrowers	3,755	3,815	4,102
Branches (hubs)	1	2	2
Total staff	38	39	38
Loan officers	15	15	11



Financial Indicators	Dec04	Dec05	Aug06
PAR 30	0.4%	0.3%	0.4%
Write-off ratio	0.3%	0.2%	0.0%
Restructured loans	0%	0%	0%
ROE	-1.5%	15.3%	16.3%
AROE	-8.4%	3.1%	2.8%
Oper. Self-sufficiency (OSS)	97.6%	134.7%	128.9%
Fin. Self-sufficiency (FSS)	87.7%	105.0%	103.8%
Staff productivity (borrow.)	99	98	108
LO productivity (borrow.)	250	254	373
Operating expense ratio	68.2%	48.6%	42.7%
Funding expense ratio	0.0%	0.5%	1.4%
Provision expense ratio	1.4%	1.6%	8.4%
Portfolio yield - cash	67.9%	68.4%	67.7%
Risk coverage ratio	975.8%	1147.7%	967.4%
Cost of funds ratio	-	6.9%	11.8%
Debt/Equity ratio	0	0.1	0.1

As of August 2006 figures are for the period March - August 2006

Except for the period March 2006 - July 2006 ASM financial statements have not been independently audited

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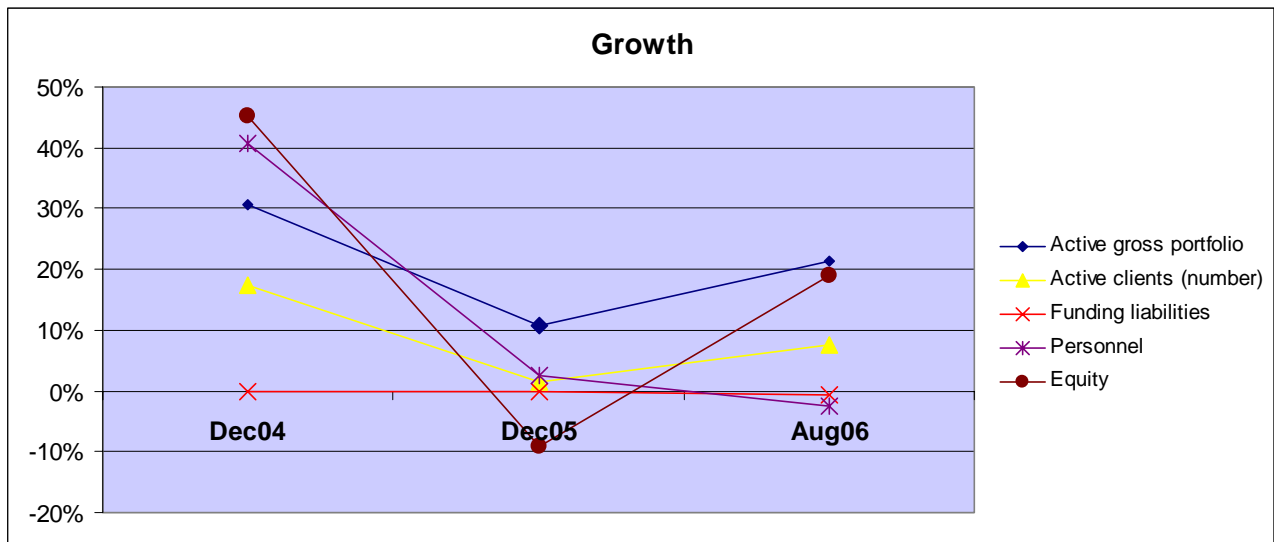
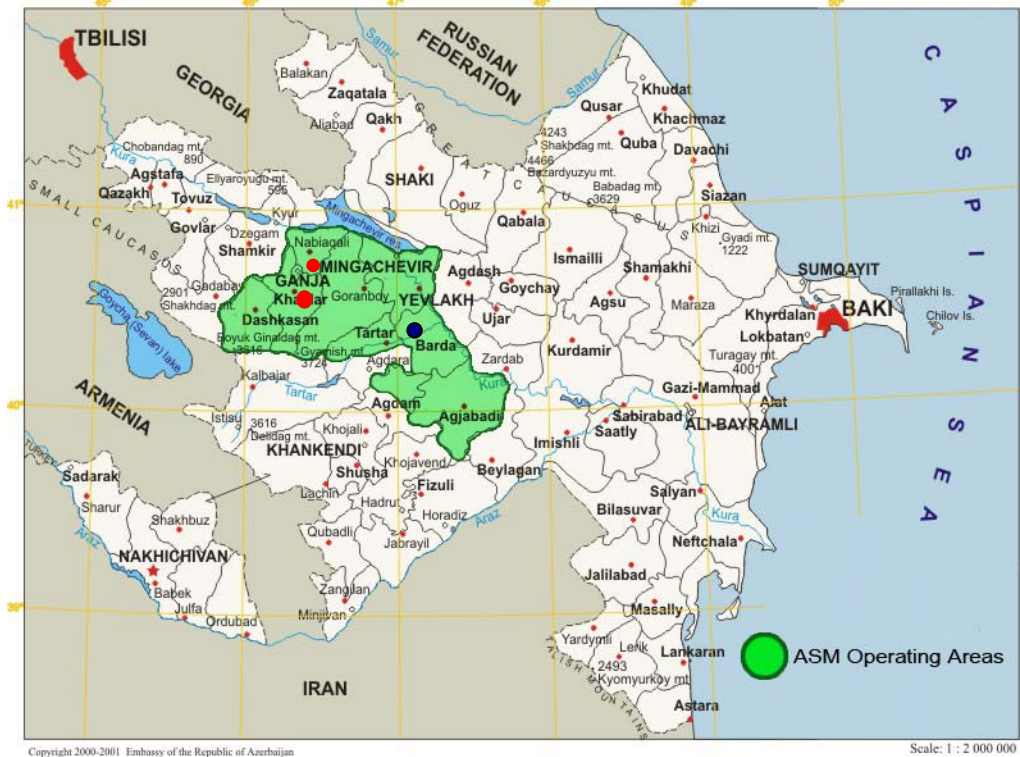
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AREA	Risk factors	Relevance*
<i>External environment</i>	Lack of a microfinance law and clear fiscal policy for microfinance	Medium-low
	Lack of a credit bureau for microfinance institutions	Medium-low
	Growing competition	Medium-low
<i>Governance, management and operations</i>	Scarce Supervisory Council participation to ASM governance	Medium
	Staff turnover and lack of stable local human resources	Medium-high
	Improvable internal control function	Medium-low
	Unreliable financial statements before spin off	Medium-high
	Shortcomings in some accounting procedures	Medium
	Shortcomings in the accounting software	Medium
<i>Financial products and asset quality</i>	Poor product diversification	Medium-low
	High drop out rate	Medium-high
	Portfolio concentration in the livestock sector	Medium-low
<i>Financial structure and ALM</i>	Shortage of funds	High
	Lack of proper financial risk management	Medium
	Currency Risk	Medium
<i>Financial and operational results</i>	Improvable productivity and efficiency	Medium
<i>Strategic objectives and future evolutions</i>	Lack of different scenarios analysis	Low
	Negotiations for funding still in early stage	Medium
	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 management; → Niche target in rural and very poor areas; → Strong MIS department; → Very good portfolio quality; 	<ul style="list-style-type: none"> → New institutional phase as LLC; → Large unmet demand; → Transfer of the headquarters to Baku; → Territorial expansion in new areas.

- Headquarters: **Barda**
- Branches: **Ganja**
- Sub-branches: **Mingachevir**



As of August 2006, growth rates are annual

Final opinion

The recent spin off from SC/US and the new phase as an independent institution represents a positive evolution for ASM, which is also showing good levels of profitability and sustainability, although a positive record is not available due to the short institutional life of the newly established LLC. Given the recent separation, the governance function of ASM is not fully adequate yet. At the same time, the institution is suffering from rather high levels of staff turnover, with employees' retention which might be improved by the planned transfer of ASM HQs to the capital city, Baku. The difficulties in separating the microfinance program from the other activities of SC/US limit the reliability of the financial statements prior to the spin off. Moreover, the new accounting software and the accounting procedures present some shortcomings.

The main challenge for ASM is now represented by the shortage of funds. Negotiations with potential investors are at early stages and dimensions could limit external actors' interest towards the institution.

Benchmarking

All figures of peer groups are referred to the MicroBanking Bulletin (MBB) database updated as of December 2005. The ratios of ASM indicated here do not fully correspond to the ratios presented in the report as they are calculated according to the MBB methodology¹. As for the MFIs Findev (Azerbaijan), Normicro (Azerbaijan) and Azercredit (Azerbaijan) rated by *Microfinanza Rating* in 2005 and 2006, 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	AzeriStar	MBB 2005			Microfinanza Rating		
		ECA Small Low	NGOs (FSS MFIs)	Solidarity (groups of 3 to 9 borrowers)	Findev Azerbaijan Dec05	Normicro Azerbaijan Aug06	Azercredit Azerbaijan Dec05
Gross Loan Portfolio gross loan portfolio adj for standardised write-offs (US\$)	785,507	621,575	2,997,624	1,600,332	830,849	1,888,251	2,315,672
Average Loan Balance per Borrower on per capita GNI Average loan balance per borrower/ GNI per capita(%)	9.0%*	17.5%	22.9%	19.1%	31%	21%*	43%
Portfolio at Risk > 30 Days outstanding balance of loans overdue > 30 days / gross loan portfolio (%)	0.4%	0.2%	2.1%	0.9%	1.5%	0.9%	0.9%
Adjusted Return on Equity AROE adj net operating income after taxes / avg tot equity (%)	5.4%	32.5%	4.1%	-0.4%	8.8%	0.9%	-11.0%
Portfolio yield Financial Revenue from Portfolio / Adjusted Average Gross Portfolio	68.4%	65%	40%	38%	45.0%	38%	41.9%
Debt/ Equity Ratio adj.tot.liabilities/adj.tot.equity	0.1	0.1	1.4	1.4	0.4	0.4	0.8
Operating Expense/ Loan Portfolio (operating expense + In-Kind donations) / avg gross loan portfolio (%)	48.5%	23.7%	29.1%	30.3%	29%	21.1%	33%
Borrowers per Loan Officer n. of active borrowers / n. of loan officers	373	239	227	222	575	430	216
Borrowers per Staff n. of active borrowers / n. of staff	108	122	129	146	180	139	78

ECA Small, Eastern Europe and Central Asia, Gross Loan Portfolio (US\$) < 2 million. * Referred to the GDP per capita

All figures are referred to the MicroBanking Bulletin database updated as of December 2005

AzeriStar Microfinance is compared to two sets of peer groups: the first considers the MFIs operating in ECA countries with low target, the NGO (FSS MFIs) and the organizations using the solidarity lending methodology; the second one considers three MFIs already rated by *Microfinanza Rating* in Azerbaijan.

The benchmarking shows that ASM is comparable in portfolio size to the ECA small low peer group and to Findev, while it is smaller than the other groups considered. The expected growth will be most likely accompanied by an increase in the debt to equity ratio, which is now low (0.1) both in absolute and in relative terms.

The higher portfolio yield and operating expenses registered by ASM reflect on the one hand the lower competitive pressure in the areas where it operates and on the other hand the small size of portfolio.

The AROE stands at 5.4%, intermediate between the best performing MFIs (Eca Small Low, Findev), and the lower levels of the other groups (NGOs, Normicro, Solidarity lending MFIs and Azercredit)-

The distinctive characteristic of ASM compared to the other organizations is the considerable depth of outreach: the average loan balance per borrower on per capita GNI, equal to 9%, is far below the other figures.

Overall, the portfolio at risk > 30 day of ASM compares favourably with the others. Loan officer productivity in terms of borrowers is higher than the MBB peer groups and Azercredit, while Findev and Normicro perform better in this respect. However, due to ASM's low staff allocation rate, the staff productivity of ASM is lower than any other MFI, except from Azercredit.

¹ The MBB adjusts the financial data to produce a common treatment for the effect of: a) inflation, b) subsidies, and c) loan loss provisioning and write-off (see *MBB*, Appendix I: Notes to Adjustments and Statistical Issues).

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1. External Environment and ASM positioning

Institutional background

The **Save the Children Federation US (SC/US)** started its microfinance activities in Azerbaijan in 1999 with the Community Based Lending and Savings Program (CBLs). So far, the **funding sources** have been mainly represented by the small grant received from Chevron Texaco Corporation, and by additional **grants from US Agency for International Development (USAID)**, overall worth US\$ 630,500². In **2005** SC/US borrowed the first **commercial loan** to finance the CBLs program (US\$ 80,000, from Caucasus Credit). In **March 2006** the **spin-off process** took place and **SC/US handed over the assets of the CBLs program to the Azeri Star Microfinance limited liability company, registered with the Ministry of Justice**, keeping 100% ownership of the new legal entity.

ASM targets women and the low-income population of the central and western regions of Azerbaijan, operating through two branch offices in Barda and Ganja, and a service point in Mingachevir.

Political and macroeconomic context

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

Sovereign risk³

Azerbaijan	Foreign currency		Domestic currency	Rating Outlook
	Short term	Long term	Long term	
MOODY'S	P-2	Baa2	A3	Stable
S&P	na	na	na	na
Fitch	B	BB	BB	Stable

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

years strong growth and stable macroeconomic environment.

Since 2000, the **Gross Domestic Product** has grown (in real terms) on average by **10.6%** per year, and is expected to grow by 25.6% in 2006, due to the **oil boom and gas production**. A surge in hydrocarbons output is supposed to support Azerbaijan's economic expansion also in 2007, with the most of production exported to Western

Azerbaijan

Macroeconomic Indicators	Dec03	Dec04	Dec05	Sept05 Aug06
<i>Exchange rate in US\$ (end of period)</i>	0.985	0.981	0.919	0.882
<i>Exchange rate variation</i>	0.6%	-0.4%	-6.3%	-4.7%
<i>Inflation rate (end of period)</i>	3.6%	10.4%	7.4%	10.8%
<i>Inflation rate (average of the period)</i>	2.2%	6.7%	11.8%	7.6%
<i>Deposit rate</i>	9.5%	9.2%	8.5%	9.9%
<i>Lending rate</i>	15.5%	15.7%	17.0%	17.4%
<i>Real GDP growth</i>	10.4%	10.2%	24.3%	25.6%**
<i>GDP per head (US\$)</i>	877	1,023	1,532	2,116

Source: International Finance Statistics, EIU. ** Estimation for 2006

* The exchange rate refers to the AZN introduced in Jan 2005.

The AZM/US\$ exchange rate was 4,923 as of Dec 2003, 4,903 as of Dec 04

² The first one in 2000, worth US\$ 300,000 (managed by Mercy Corps International), and the second one in 2002, worth US\$ 330,500.

³ **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).

markets.

The annual **inflation** in the period 2000-2003 stands at a modest 3%, while in **2004** it jumped to **10.4%**. The sharp rise of the prices provoked by significant hard-currency inflows continued in 2005 (7.4%). However, the consumer price inflation decelerated in **2006** (the average inflation rate decreases from 11.8% in 2005 to 7.6% over the period September 2005 – August 2006), and it is expected to further slow down to about 5% in 2007. The inflationary pressures will be maintained under control by allowing a nominal appreciation of the local currency.

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

While affirming itself as oil and gas exporter, its non-oil economy is national market-oriented and it is characterized by low competitiveness. Over 40% of Azerbaijan's population is still living in poverty as the oil sector, being a capital-intensive industry, provides employment to less than 1% of the workforce⁴.

Microfinance sector

The market coverage of Azeri MFIs is still low as microfinance reaches as of September 2006 less than 100,000 borrowers, a marginal part of the overall potential demand. However, the microfinance sector is rapidly growing, both in urban and rural areas. The leading actor is the **Microfinance Bank of Azerbaijan (MFBA)**, which was founded by a group of international shareholders⁵ and is financed by the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC/WB), among others. The MFBA offers competitive products (in terms of processing time and pricing) to the high end of the market. As of September 2006 this fast-growing bank presents an outstanding loan portfolio worth US\$ 35.5 M and 11,398 clients. **FINCA** is also growing quickly, with an outstanding portfolio worth US\$ 16 M and more than 43,000 clients. **AgrarCredit**⁶ is the third MFI by portfolio size, presenting an outstanding portfolio of US\$ 11.2 M and 3,462 clients. **CredAgro**, with US\$ 6.8 M portfolio, is positioned in the high end of the market (rural finance) and offers a large range of products. The remaining MFIs, largely managed by international humanitarian organizations, have a smaller portfolio, even if some of them have a significant outreach (Viator and AzerCredit have 8,231 and 7,536 clients respectively).

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

Even if competition is quite low in absolute terms, the supply side is growing, particularly in the main urban centres (Baku, Sumgayt and Gangia), where many microfinance providers are concentrated.

The Azerbaijan Microfinance Association (AMFA), which performs an active role in lobbying, training and benchmarking, includes 21 organizations (3 are non-member reporting MFIs): the majority of them operates in micro-lending, two members undertake SMEs lending and one is a second-tier organization. Only 2 MFIs within the Association are Credit Unions. As of September 2006, the total outstanding portfolio of the organizations reporting to the Association is larger than US\$ 86 M, reaching more than 90,000 clients.

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

Given the humanitarian mission of many MFIs on the one hand and their commercial legal form of limited liability companies on the other hand, the sector is currently affected by the **ambiguous nature of microfinance organizations** (social versus commercial status). Overall, the role of donors has started reducing in the country, and several humanitarian organizations are considering phasing out and transferring the ownership of MFIs to more commercially oriented international

⁴ UNDP Azerbaijan

⁵ EBRD, IFC, Black Sea Trade and Development Bank, LFS Financial Systems

⁶ Former Agroprom (AIB), state owned bank.

actors. In this context, the **Azeri government might oppose the evolution of MFIs from social to commercial orientation** and express claims on the ownership of the capital granted to MFIs for humanitarian purposes. It is expected that the approval of the **new microfinance law**, which will require MFIs to choose between not-for-profit and for-profit status, will clarify the overall regulating framework and specifically the position of the Government and National Bank of Azerbaijan (NBA) towards the microfinance sector, thus leaving them narrower room for intervention and creating a more stable environment.

Regulation and supervision

A **specific law for microfinance is lacking** at the moment, but the National Bank is currently working on a **draft of Microfinance Law**, which may be submitted to the Parliament in the following months. **AMFA** is currently lobbying the National Bank to obtain a suitable regulatory framework. Among the advantages that the present draft would bring, it is worth mentioning the possibility for MFIs to acquire a **full for-profit status**, the future development of prudential norms and a closer supervision from the NBA of the organizations that will be allowed to collect savings (subject to specific requirements).

The regulatory provision currently in force is an addenda to the “Rules for licensing of credit organisations, their branch offices (issue of permit for banking transactions) and for organisation of their activity” of the National Bank of Azerbaijan, dated November 1996. **Supervision** is performed by the **NBA** through reports (financial statements and portfolio classification) that the MFIs are asked to submit quarterly.

According to the current regulation, all MFIs (except banks) have to be **legally registered as Non-Banking Credit Organizations (NBCO)** and take the legal status of **limited liability companies**. In order to operate, NBCOs need to be licensed by the NBA. ASM was registered in 2003 and received the license for both branches in 2005; it only started operating as a LLC in March 2006 due to the delay in the transfer of assets from SC/US.

NBCOs are **required to pay profit taxes** since 2005, and ASM will start paying them for the period March-December 2006. Thanks to their social orientation, MFIs are currently **exempted by decree from paying social taxes**; the exemption is temporary (the last communication covers the year 2006) and it is unclear whether it will be maintained in the future.

MFIs are **not allowed to collect savings**, unless they transform into banks.

ASM does not currently participate in any Credit Register⁷, and given the increasing competition, this **represents a risk for potential clients’ over-indebtedness**. However, black lists are informally exchanged with some other MFIs operating in the areas of operations, and AMFA is currently planning to establish a Credit Bureau for its members.

Azeri Star Microfinance market positioning

ASM position is characterized by the **considerable poverty outreach** and the concentration in the **central and western regions of Azerbaijan**. The areas served are **mainly rural**, even if lending operations are also carried out in the urban areas of Ganja and Mingachevir. **Livestock** and **retail trade** are prevailing among the financed activities.

⁷ A Credit Register was established by the NBA, but its effectiveness is still limited.

The **demand** for microfinance services in Barda and in the other **rural areas** served is still **largely unmet**. On the other hand, **competition is present in Ganja**, one of the most active urban centres in the country, and it is **expected to increase** in the future. The main ASM competitors are **Finca**,

with a similar target and methodology, and a large scale of operations, and FinDev, although it offers larger loans. The competition from AzerCredit and Viator, mainly focused on individual lending, is less intense. At this stage of the microfinance sector development, the **demand** seems to be more **sensitive to service quality** than to price.

Main competitors (US\$)

Institution	Gross portfolio	Products	Average Loan Balance	Loan maturity (months)	Interest rate	Active clients
<i>AzeriStar</i>	785,507	group and individual	191	4 - 12	3.5% flat - 4% declining	4,102
<i>Finca</i>	16,411,998	group and individual	380	4 - 12	2.5% - 3.5% declining	43,220
<i>FinDev</i>	1,861,490	group and individual	544	4 - 18	3% - 4% declining	3,424
<i>Viator</i>	2,743,200	group and individual	333	2 - 24	2.75% - 3% declining	8,231
<i>AzerCredit</i>	3,719,036	group and individual	494	3 - 18	3% - 4% declining	7,536

Figures as of September 2006

Compared to Finca, ASM offers a higher frequency⁸ of repayments, more transparency (to the extent that ASM does not require fees in addition to the interest rate), and a more client friendly repayment scheme (ASM loan officers collect instalments at clients' business places). On the other hand, the following are the **competitive disadvantages** of ASM:

- Lack of funds, entailing smaller loans and shorter terms than the ones requested by clients
- Limited product diversification;
- Rigidities in loan cycles: fixed loan ceilings;
- Higher interest rates than Finca.

⁸ However, the four weeks frequency, instead of monthly frequency, is perceived as a disadvantage by clients.

2. Governance and operational structure

Ownership and Governance

The full ownership of ASM is currently held by Save the Children, USA. The international humanitarian NGO is considering the opportunity to hand over the ownership of the MFI in a time frame of **one or two years**.

As an independent organization, ASM is very **young**. With the spin off, the responsibility was transferred from SC/US to the MFI, and ASM is now **undergoing a delicate process of building a sound governance function**. In the past, the development of governance capacity did not receive primary attention, and the current **governance** is still **not adequate** to the needs of an **independent organization**: the function is concentrated into the SC chairperson, formal meetings are not held often enough and the composition still presents a limited expertise in finance. Beside the central role played by the chairman, good governance would require a more direct involvement of the other members, whose contribution in terms of country experience and external opinion is currently limited.

Board of Directors

Members	Charge	Background and current profession
Mrs. Conklin	Chairperson	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
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
Mr. Mammadov	Member	Mr Mammadov has 8 years experience in management and implementation of development projects (World Bank, USA, EU funded, Mercy corps) and a background in social and political research
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. Giacomini	Member	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

However, ASM is planning to increase the frequency of SC meetings, and during the year there is a regular, even if not formalized, information flow between SC members and top management.

Formally, the Supervisory Council (SC) came into existence in 2003, even if it started functioning only in 2005. The SC currently consists of five members: **two representatives of SC/US**, and **three Azeri Nationals**, one of whom (Vice Chairperson) is a former Save the Children employee.

The current chairperson has experience in microfinance and knows the organization since the beginning; however she is based in the States and rarely goes to Azerbaijan. She is temporary covering the chair position and will be replaced as soon as a new SC/US country director of Azerbaijan will be appointed.

It is worth mentioning that the Azeri law does not allow professionals working in financial institutions to be members of the SC of other organizations operating in the same sector.

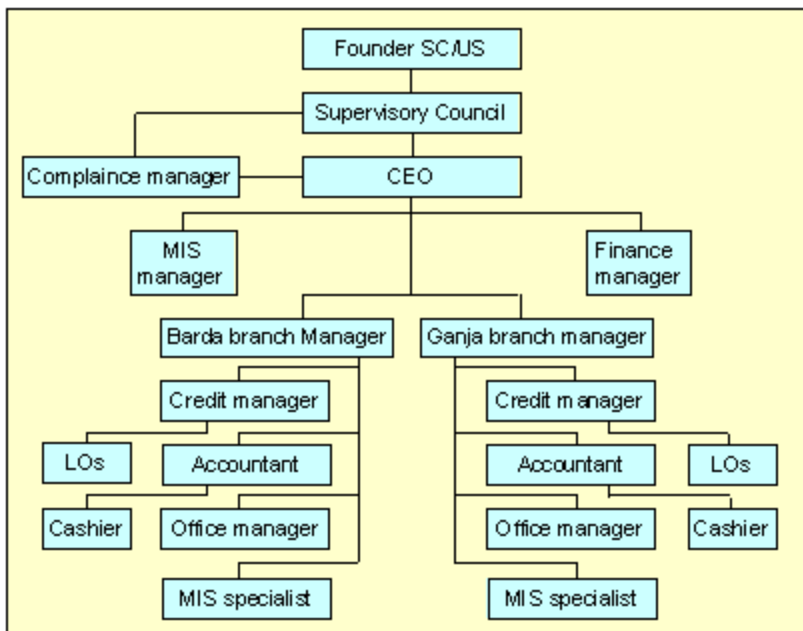
Organisation and structure

ASM network includes **two branches (Barda and Ganja)** and one **service point in Mingachevir**. The **headquarters** are currently in the same premises of the Barda branch but will be soon **moved to Baku** in order to increase the MFI visibility to external actors, in particular international ones. Moreover, it is planned that in the second quarter of 2007 either the **Mingachevir service point will be up-graded to branch** or a **new branch will be opened in Agdash**.

Personnel	Dec03	Dec04	Dec05	Aug06
Total	27	38	39	38
Loan officers	11	15	15	11
Other staff	16	23	24	27

The level of **decentralization is adequate** to the size and geographical extent of operations, and properly balanced by the system of internal control. Branches have their own budgets and prepare separated financial and portfolio reports, albeit they are not fully treated as profit centres. They are in charge of ordinary portfolio and liquidity management, as well as accounting tasks. **Communication effectiveness** between branches and HQs, currently supported by the fact that the head office staff is based in Barda, will have to be verified once the **head office will be moved to Baku**. As of now, **monthly meetings** are held between the **management committee** (composed by CEO, finance manager and MIS manager) and the **branch managers**, and overall internal communication is adequate.

The key positions at the HQs are the **CEO**, the **finance manager**, the **MIS manager** and the **compliance manager**.



The structure of the branch offices consists of a branch manager, credit manager, office manager, MIS specialist, cashier and LOs. **Branch managers** are in charge of the planning and supervision of activities, delinquency and liquidity management, while credit managers support branch managers in supervising LOs activities and performance, and in managing delinquency. ASM organizational structure is at the moment rather heavy with a relevant part of the staff which is not directly involved in the credit operations, thus impacting overall productivity.

Human Resources

As of August 2006, ASM personnel is composed of **38 employees**, out of which 11 are loan officers. The **staff allocation ratio**, equal to **29%**, is rather **low**, partly due to the large share of support staff (the same ratio, considering only management, LOs and administrative staff is equal to 39%). Back office is structured enough to support a larger number of credit staff, and top management plans to hire more LOs as soon as the current shortage of funds will be solved.

The **CEO** has been working in top management positions since 2001 and enjoys satisfactory skills in strategic planning, while financial management is improvable. SC is currently supporting the CEO in fund raising.

Azeri Star **financial department presents some weaknesses**. The recent spin off, with the shift of accounting and financial management responsibilities from SC/US to ASM, represents a significant challenge for the financial department. The finance manager is currently focused on adopting a new chart of accounts, addressing some shortcomings in the accounting software, as well as the ordinary accounting and liquidity management. Given the new institutional perspective, the financial department expertise in international accounting standards and financial risks management skills present **large room for improvement**.

Over the period September 2005 – August 2006 the **staff turnover ratio is high**, equal to **26%**. Being based in **Barda**, ASM has been experiencing relevant **recruitment and turnover problems**: attracting quality human resources and retaining them in the central region of the country has demonstrated to be difficult. Several junior and senior employees left to Baku or went abroad looking for better opportunities, and this created from time to time important gaps within Azeri Star organization structure⁹. The problem is not as serious in Ganja (the second city of Azerbaijan) as it is in Barda, and the transfer of the HQs to Baku is expected to significantly improve the situation for some key positions.

In light of these issues, albeit **HR management** is overall satisfactory, it presents some room for strengthening. The size of the organization does not justify yet the presence of a dedicated position: HR management responsibilities are spread between the CEO and the branch managers. **Salaries** are in line with the levels offered in the regional financial sector and a procedure to adjust the base salary to inflation is in place. The **bonus system** is well functioning and includes all staff (administrative and support as well). In order to enhance staff benefits, the top management is planning to introduce **employee loans**. Although staff appraisal is a consolidated practice, there is no feedback loop in place to link training needs to strategic planning and a formalized training plan is lacking at the moment. The training budget, which is adequate to the organization, is not supported by systematic tools to identify ASM training priorities (internal audit, international accounting and financial risks management). The top management is considering adopting a more systematic approach to training in future, also involving SC members.

Internal control and operational risk management

The current **compliance manager** is covering this position since 2005; although he has participated in few dedicated trainings, he has no prior audit experience. The **audit commission**, whose existence as a body within the institution is required by law, is not currently active. The compliance manager is focused on **ex-post control of operational risks**, while financial risks monitoring is not carried out yet. **Branch managers** and **credit managers** are also involved in audit activities¹⁰ related to the LOs performance.

Lending operations are carried out in cash: disbursements take place in branches or in the service point of Mingachevir, and repayments are collected from clients in the field. **Cash handling** intrinsically brings about some risks in terms of security and fraud, and, in the case of ASM, this is especially relevant as far as the **Mingachevir service point** is concerned. Indeed, the disbursement procedure in Mingachevir is simplified due to the absence of permanent staff (the process only involves LOs and the cashier), and cash needs to be withdrawn in Yevlah and carried to the service point, given that ASM does not have a current account in Mingachevir yet. The cash transferred is not insured. The risks related to cash handling are mitigated by an overall **satisfactory system of internal control**. The **ex-post control** is adequate to the size of operations, including surprise visits to clients, audit of lending, cash and accounting operations. **Ex-ante control** is satisfactory, based on segregated functions¹¹, double inputting of data performed by MIS specialist and accountant and reconciliation of information from loan tracking and accounting system conducted frequently.

The **system of audit reporting presents some room for improvement**. In fact, mainly due to the English language barrier, the compliance manager reports to the SC through the CEO. The compliance manager does not usually participate in SC meetings. Besides, although the audit function is supported by adequate monthly plans, an annual plan, agreed with the Supervisory Council, is not currently in place.

The degree of formalization of procedures is considered adequate to the stage of development of the organization; however, the audit manual does not include guidelines for the financial risks management.

⁹ E.g. the position of compliance manager remained vacant for 8 months due to the lack of human resources. During that period, the function was covered by the CEO and the branch managers.

¹⁰ Planned or surprise visits to clients to check for irregularities, compliance with procedures and clients satisfaction.

¹¹ e.g. the staff involved in the disbursement process includes: LO, cashier, accountant, MIS officer

Accounting and external audit

An audit of ASM financial statements (FS) was conducted by a local company for the period **March - July 2006**¹², although the final version is not available yet. Regarding the FS of **SC/US**, the **last audit** was performed over the period **June 2000 – June 2003**. Besides, the fact that there is no financial audit available for the period July 2003 February 2006, the difficulties in separating the microfinance program from the other activities of SC/US from an accounting point of view **limit the reliability of the microfinance program FS prior to the spin off** (equity composition in particular).

In the spin-off process (March 2006), the **functional currency** of ASM was changed from US\$ to AZN. The current treatment of items denominated in **foreign currency** presents some **inaccuracies**¹³ and the **exchange rate gains** originated by the US\$ denominated loan **are not registered** (while the exchange rate losses generated by a current account in US\$ are included in the income statement).

The limited reliability of the recent SC/US FS (2004 and 2005), the partial compliance of the ASM FS to the IAS (starting from 2006) and the change in the functional currency represent **difficulties** for **external actors** willing to make **financial trend analysis**. The audited financial statements, still in draft format, presents **some differences** with ASM internal ones, in terms of smaller provision expenses and accrual of some future expenses (profit taxes and some administrative expenses). Overall the **internal financial statements give a more prudential picture of ASM operations**.

Management Information System

The **MIS department** includes 3 employees: the manager, located in Barda, and one MIS specialist for each of the two branches. The MIS manager has responsibilities of software development and monitoring, IT support, reporting and data entry. The MIS in Azeri Star is composed of **two programs**, an **internally produced loan tracking system**, built with Visual Basic on SQL Server and an English accounting software, **SAGE**, donated by Save the Children at the beginning of 2006. The two software are **not integrated** and data on accounting and portfolio are reconciled and integrated on a daily basis, thus involving a significant amount of manual work.. The portfolio tracking system presents some issues for what concerns the **access to historical data** due to the fact that amounts included in the database prior to the beginning of 2006 were expressed in the former currency (AZM). Therefore, in order to retrieve historical information and elaborate it in proper reports MIS staff have to access to **back up files**, thus making **ad-hoc queries on past data rather complex and time consuming**. Nevertheless, MIS staff are already working on this issue, which should be solved by the first quarter of 2007. Besides, the fact that **only MIS staff are allowed to access the portfolio tracking system** raises some concerns, as credit and branch manager, as well as loan officers, have to systematically refer to MIS specialists in order to obtain information essential for their daily activities. Although at the moment the **reports** provided to credit staff seem **adequate**¹⁴, this policy could trigger, along with the growth in the organizational structure, bottlenecks and an insufficient flow of credit information. On the positive side, the **portfolio tracking system shows significant flexibility** in terms of reporting and it is **rather solid for what concerns security**, with proper layers of authorization in place and adequate passwords policy.

In regards to the **accounting software**, SAGE has been installed in all branches and allows accountants to perform quite effectively daily financial operations. However, **accounting data** sent monthly to the Financial Manager by the branches are **manually entered** into the accounting software installed **at central level** and consolidated into excel files, with significant manual work which brings about the **implicit risk of human mistakes**.

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.

¹² ASM became operational in March 2006.

¹³ The US\$ denominated loan (borrowed from Caucasus Credit) is not converted in the AZN equivalent using the official exchange rate of the end of each period; the AZN amount reported at the end March is the same reported at the end of the subsequent months.

¹⁴ MIS specialists provide branch and credit manager with daily reports on arrears and bimonthly repayments schedules.

3. Lending operations

Financial products

ASM operates mainly in **rural areas**, being Ganja and Mingachevir the only urban centres in the areas served. Loans are issued through group methodology¹⁵ and start-up businesses are not financed. ASM has designed **three group loan products** (business, livestock, graduated) and an individual one. However, due to the **shortage of funds**, the **delivery of individual loans** (started in 2002) is currently **suspended**. Loans offered have a defined maximum amount available for each loan cycle, and the increase in size of subsequent loans is subject to the client repayment history. **Graduated loans**, larger in size, are available to groups who successfully completed the last cycle of business and livestock loans. **Interest**

rates are rather rigid and not sensitive to the clients' credit history. Besides, due to the shortage of funds, loans issued are often not large enough to meet clients' needs.

As a general rule, **prepayments** are not allowed; however, in special cases, clients can prepay few days before the scheduled date¹⁶; prepayments represent a marginal phenomenon in ASM.

Azeri Star Microfinance **product diversification is improvable**, and the **overall marketing function is not developed yet**. The top management is aware of the need to develop marketing capacity within the organization and is **planning to adopt a promotional strategy** proportionate to the size of operations. Future plans include the introduction in 2007 of the **consumer** loan product, for which there is a large demand unmet, and the revision of interest rate levels when economies of scale will be reached.

Lending procedures

The **lending process is well structured** in several phases, including orientation meetings with clients and field visits prior to the disbursement, as well as frequent monitoring of active borrowers. Group loans applications are approved by LOs and the credit manager, with the support of the branch manager, while individual loans require the involvement of a credit committee. In principle,

Credit methodology

	Credit products			
	Group Business	Group Livestock	Group Graduated	Individual
<i>Currency of the credit</i>	AZN	AZN	AZN	AZN
<i>Type of interest</i>	Flat	Flat	Declining balance	Declining balance
<i>Min. interest rate (%)</i>	3.5%	3.5%	4.0%	4.0%
<i>Max. interest rate (%)</i>	4.0%	3.5%	4.0%	4.0%
<i>Average interest rate (%)</i>	3.6%	3.5%	4.0%	4.0%
<i>Description of commissions</i>	-	-	-	-
<i>Min. credit amount (US\$)*</i>	170	170	442	340
<i>Max. credit amount (US\$)*</i>	374	374	613	2,269
<i>Max credit amount for the first loan (US\$)*</i>	170	170	442	1,134
<i>Average credit amount (US\$)*</i>	270	250	459	1,475
<i>Min. loan maturity (months)</i>	4	6	6	4
<i>Max. loan maturity (months)</i>	6	8	8	12
<i>Average loan maturity (months)</i>	5.7	7.8	7.4	12.0
<i>Periodicity of interests payments</i>	4 weeks	4 weeks	4 weeks	4 weeks
<i>Periodicity of principal payments</i>	4 weeks	4 weeks	4 weeks	4 weeks
<i>Grace period (months)</i>	0	2	0	0
<i>Collaterals / guarantees</i>	Group guarantee	Group guarantee	Group guarantee	Physical Collateral

*Loan disbursed

¹⁵ Between 7 and 15 members, belonging to the same gender.

¹⁶ With the approval of Credit Manager and Branch Manager.

loans larger than US\$ 20,000 are to be approved by the SC, even if such cases are not present at the moment. The same tool is used for the business analysis of all group loans, while a specific format has been developed for the individual loans. However, within the assessment of the repayment capacity for group graduated and individual loans, the cash flow projection is not analysed over the entire loan period. More generally, the scarce details included in the business analysis do not always guarantee an accurate calculation of the repayment capacity.

The approval process normally takes 10 days for new groups and 3 days for repeated loans; however, in August 2006, the liquidity crisis (see chapter 4) created one month waiting lists.

The follow-up of late loans is adequate, based on close monitoring. ASM does not have any restructuring policy.

Collaterals and accessibility

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

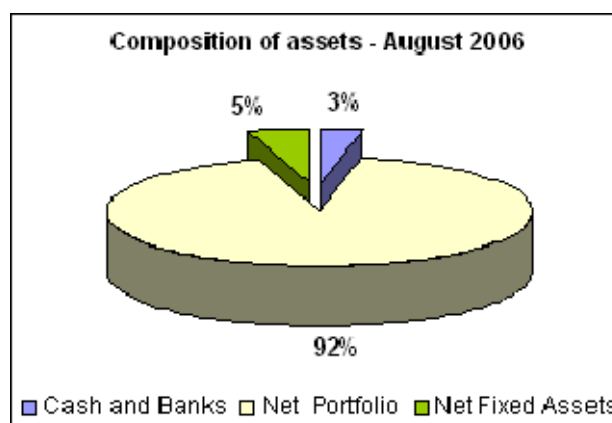
4. Assets structure and quality

Assets structure

The **concentration of resources into the core business is good**, with net portfolio accounting for **92%** of total assets as of August 2006 (88% on average over the period September 2005 - August 2006). Net fixed assets account for 5% of total assets. During 2005 the share of **liquidity** over total assets was highly variable, while after the spin-off it stabilized around **3%** (the average for the period September 2005 - August 2006 is equal to 7%).

It is worth mentioning the **funding resources crisis** that affected the CBL project in **2005**:

since the microfinance operations were part of the SC/US and the availability of cash for loan disbursement was unclear, in August the project was required to **return to SC/US** about **US\$ 270,000** that were withdrawn in the 2nd quarter of 2005. The issue was raised by SC/US in May but it took about two months to clearly identify the amount and the time when the funds had to be returned by the CBL project; thus, starting from May the portfolio started decreasing and a large amount of resources was kept liquid until August 2005 (40% of total assets on average in June-July). This shock in funding resources availability entailed the interruption of disbursements for more than one month and an overall **slowdown of portfolio growth in 2005**.



Portfolio structure

As of August 2006, out of the **total outstanding portfolio, worth US\$ 785,507**, more than **40%** is represented by **group livestock** loans, while group business and group graduated account respectively for 33% and 25% of portfolio. As a result of the **shortage of funds**, the **individual** portfolio has been **reducing** in 2005 and 2006, and is currently negligible. As soon as new funding resources will be attracted, ASM plans to significantly increase the individual loan portfolio.

Portfolio features	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Sep05-Aug06
Gross outstanding portfolio (US\$)	400,247	525,229	621,575	785,507
Group Business	169,896	224,629	222,572	263,007
Group Livestock	208,775	268,719	299,145	323,357
Group Graduated	0	2,040	89,433	198,991
Individual	21,576	29,841	10,425	151
Gross outstanding portfolio (AZN)	394,084	515,040	570,979	692,424
Growth of active gross portfolio	na	30.7%	10.9%	21.3%
Average disbursed loan amount (US\$)	166	188	228	272
Av. disbursed loan size on per capita GDP	19%	18%	15%	13%
Average residual maturity (months)	5.7	6.5	6.4	6.7
Number of active borrowers	3,196	3,755	3,815	4,102
% of active borrowers women	28.4%	40.3%	48.9%	51.9%
Drop-out ratio	59.2%	64.4%	88.1%	59.2%

na: not available

After the slowdown of portfolio growth in 2005, the increase achieved in the first 8 months of 2006 is remarkable (68% annualized), resulting in an improved growth pace over the period September 2005 – August 2006 (**21%**).

The **outreach** of ASM is **very deep**, as shown by the **average loan size on per capita GDP**, equal to **13%**, and by the percentage of **female active borrowers (52%)**, relatively high considering the rural areas of operations. The **average size of loans** disbursed has progressively **increased** along the years, reaching **US\$ 272** in the last period of analysis, even if, due to the large expansion of the Azeri economy, the loan size on per capita GDP follows a negative trend. The **increase in the loan size**, together with the **slow growth of active clients** (6% in the period

September 2005 – August 2006) is the result of the ASM strategy adopted to face the **shortage of funds** focused on retaining repeated clients. Despite the efforts of the organization, the client **drop-out rate** is high, equal to **59%**, and the main reason for it is the **inadequacy of the loan size** to the financial needs of the clientele. In addition to this, the **absence of consumer loans** among the products offered pushes some clients to move to ASM competitors, especially in Ganja. The **peak in drop-out rate** registered in **2005 (88%)** was due to the **funding crisis** faced in the second half of 2005, which stressed the shortage of funds already affecting the financial structure of the microfinance programme.

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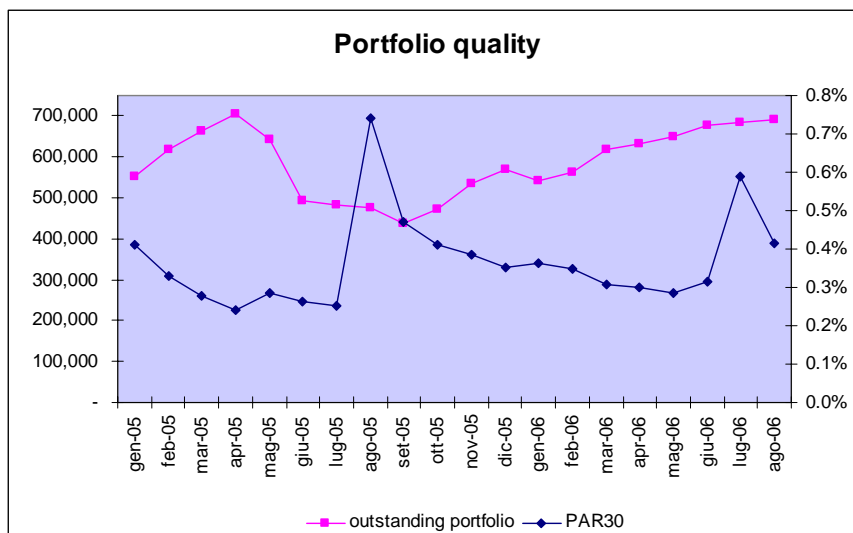
Branch	outstanding portfolio (US\$)	% of outst. portfolio	% number of borrowers	PAR > 30 days	PAR > 30 weighted
Barda	469,242	59.7%	56.8%	0.4%	0.2%
Ganja	316,264	40.3%	43.2%	0.4%	0.2%
TOTAL	785,507	100%	100%		0.4%

The MIS has recently started producing the information about the drop-out rate and the management is monitoring its evolution, even if it is not supported yet by systematic reporting. Exit surveys are conducted to investigate the clients' reasons for leaving the organization.

The **breakdown by branch** shows a **balanced** structure, with **60%** of portfolio allocated to **Barda** and **40%** to **Ganja**. This structure will change in the medium term: in the second quarter of 2007 a new branch will be opened (either in Agdash or in Mingachevir, upgrading the existing service point) and in 2008 the lending operations conducted from the Baku office, which will start as HQs basis, will intensify.

Loan portfolio quality

Portfolio Quality Indicators	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Sep05-Aug06
Consolidated PAR30	0.2%	0.4%	0.3%	0.4%
31-60	0.0%	0.0%	0.0%	0.0%
61-90	0.0%	0.0%	0.0%	0.0%
91-180	0.2%	0.4%	0.3%	0.4%
181-365	0.0%	0.0%	0.0%	0.0%
>365	0.0%	0.0%	0.0%	0.0%
Arrears rate (> 1 day)	0.3%	0.5%	0.3%	0.4%
Restructured portfolio	0.0%	0.0%	0.0%	0.0%
Provision expense ratio	6.9%	1.4%	1.7%	5.9%
Loan loss reserve ratio	4.0%	4.0%	4.0%	4.0%
Risk coverage ratio (30 days)	2313.0%	975.8%	1147.7%	967.4%
Write off ratio	16.4%	0.3%	0.2%	0.2%



With **PAR30** equal to **0.4%** and write off ratio worth 0.2%, **ASM portfolio quality is very good**. The **write off policy is regularly applied**. The high write off ratio registered in 2003 was due to the delinquency crisis experienced in 2001-2002 due to the loose procedures in place at that time. Since then, the methodology and control system has been improved. The relatively large provision expense in the last period of analysis is exceptional, and originates

from the fact that after the spin-off the loan loss reserve of ASM was equal to zero. As of August 2006 the **risk coverage is abundant**, the relative ratio standing at 967%.

As shown by the portfolio quality graph, PAR30 has always maintained below 0.8%; however, two peaks were registered in August 2005 and July 2006, when it reached respectively 0.7% and 0.6%, due to the default of some groups.

More generally, the delinquency reasons are often linked to the poor performance of the clients'

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By amount (US\$)	outstanding portfolio (US\$)	% of outst. portfolio	% number of borrowers	PAR > 1 day	PAR > 1 weighted
113-283	249,308	31.7%	52.3%	1.1%	0.4%
284-397	337,057	42.9%	33.5%	0.8%	0.3%
398-578	198,991	25.3%	14.2%	0%	0%
> 578	151	0.02%	0.02%	0%	0%
TOTAL	785,507	100%	100%		0.7%

business, in turn related to a sometimes business adverse environment, and to the households' vulnerability to external shocks.

The **inverse relation between the loan disbursed size and the PAR1** can reflect ASM selection process of the

better risk repeated clients along with the progressive credit cycles (maximum loan amounts are fixed for each loan cycle).

The **higher risk** profile of loans financing **livestock** is clearly shown by the portfolio breakdown by sector: PAR1 is equal to 1.1% and its weighted impact is 0.5%. Despite the limited overall incidence of delinquency in

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By sector	outstanding portfolio (US\$)	% of outst. portfolio	% number of borrowers	PAR > 1 day	PAR > 1 weighted
<i>Agriculture</i>	19,649	2.5%	2.5%	0.0%	0.0%
<i>Livestock</i>	347,786	44.3%	48.7%	1.1%	0.5%
<i>Production</i>	62,379	7.9%	7.8%	0.6%	0.1%
<i>Service</i>	17,738	2.3%	2.4%	0.2%	0.0%
<i>Trade</i>	337,955	43.0%	38.7%	0.3%	0.1%
TOTAL	785,507	100%	100%		0.7%

absolute terms, the **concentration** of portfolio in this riskier category is **quite high (44%)** and should be closely monitored. However, the planned increase of lending operations in the Agdash and Baku areas, where the demand for business, individual and consumption loans is

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By original term (months)	outstanding portfolio (US\$)	% of outst. portfolio	% number of credits	PAR > 1 day	PAR > 1 weighted
4	28,597	3.6%	6.4%	0.6%	0.0%
6	309,731	39.4%	38.7%	0.4%	0.2%
8	447,030	56.9%	54.9%	0.9%	0.5%
>8	151	0.0%	0.0%	0.0%	0.0%
TOTAL	785,509	100%	100%		0.7%

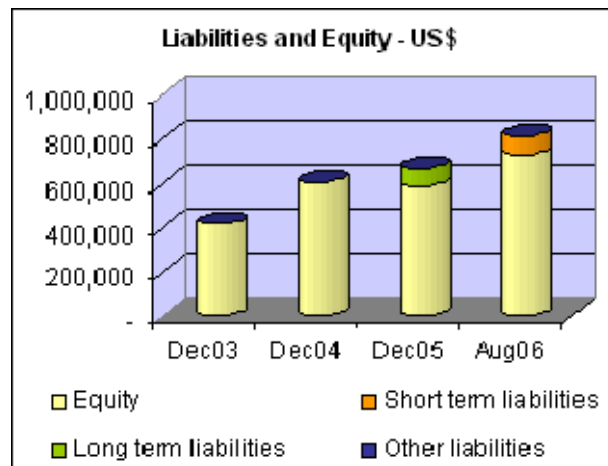
predominant, together with the expected access to funding resources, **will likely decrease in the short-medium term the share of portfolio financing livestock**

activities. The relatively higher risk of financing livestock is also reflected in the **concentration of PAR1 in the category of loans with 8 months maturity**: indeed, group livestock loans have associated an average maturity of 7.8 months.

5. Financial structure and ALM¹⁷

As of August 2006, Azeri Star Microfinance financial structure is **mainly composed of donated equity**, mostly channelled through Save the Children from the US Agency for International Development (USAID).

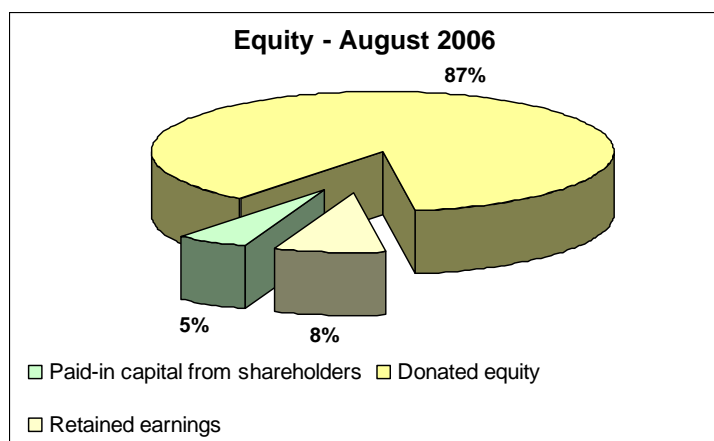
The institution has accessed its **first funding liability, disbursed by Caucasus Credit¹⁸**, in April 2005 and has not further leveraged its equity since then. **Debt/equity ratio** remains therefore at **extremely low levels**, amounting, as of August 2006, to 0.11, leaving rather wide room for significant increases in leverage. Future raising of funding liabilities might be facilitated by Azeri Star Microfinance recent institutional evolution towards a commercial legal status.



Liabilities and equity structure

At the moment Azeri Star Microfinance **funding liabilities** are composed of a **short term loan** denominated in US\$ from Caucasus Credit with an original amount of about US\$ 80,000, which will have to be totally repaid in May 2007. Azeri Star Microfinance legal status prior the transformation and scarce size and visibility have hampered so far its capacity to attract commercial funds, causing the institution to be almost completely reliant on grants channelled by Save the Children. This situation, as mentioned in the previous chapter, **has triggered in mid-2005 a sever liquidity crisis** with a consequent slow down in credit operations and potential negative impact on the institutional image. Following the transformation into a commercial entity Azeri Star is pursuing a **funding strategy** mainly based on attracting **social and commercial investors**, thus its leverage is likely to increase significantly in the near future.

As of August 2006 ASM **total equity** is worth **US\$ 734,715**, and it is mainly composed by donations received from USAID (US\$ 565,000), while paid-in capital from Save the Children, the only shareholder, accounts for 5% of the total. **Equity** has undergone a **brisk 28% drop** between June and August 2005, due to the already mentioned return to Save the Children of part of donated equity used by the program to feed loan portfolio, for then growing 18% over the following 12 months thanks to the 2006 positive net income and paid-in capital. Upon its transformation into LLC, equity has been deperated of the losses accumulated by the program since starting its operations as microfinance arm of Save the Children (about US\$ 360,000), and has started its new institutional life since February 28, 2006 without retained earnings/losses. Thus, as of August 2006 only a minor part of equity (7.7%) is represented by earnings.



¹⁷ 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.

¹⁸ 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

Azeri Star **monitors liquidity** at central level **once a month** and no sophisticated liquidity management is at the moment undertaken. The low level of debt financing justifies the **basic liquidity management**, although, with the perspective of a broader access to commercial funds, it needs to be strengthened. The **maturity structure** of ASM portfolio, which, due to the type of financial products offered, is **mostly composed** of loans due within **less than 6 months** and

ensures **rapid cash turnover**, facilitates liquidity administration and **minimizes the risk of maturity mismatch** below six months. Therefore, despite the short term nature of Azeri Star liabilities, the institution does not suffer from maturity gap risk, and the **current ratio** is equal to **9.4**.

For what **currency risk** is concerned, the institution presents a **negative net position** in US\$, which represents 11% of equity. This is due to the fact that all ASM portfolio is denominated in local currency and the only funding liability contracted has been disbursed in US\$. ASM still lacks skills in dealing with foreign currencies¹⁹. However, the positive economic conjuncture, with the New Manat appreciating against

the dollar, has prevented the institution from any loss for exchange rate. Nevertheless, the **prospective of an increase in funding** from international sources, the **unavailability of hedging tools** in the Country, and the fact that **Azeri Star does not have any policy to cope with financial risks**, are likely to **sensibly augment currency risk** in the next future.

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**.

As already mentioned, Azeri Star Microfinance still **lacks proper financial risks handling policies** and procedures and **financial department expertise** in recognizing and managing risks such as maturity risk, currency risk and interest risk **is to be developed yet**.

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US\$	US\$*	Local currency
Assets	1,003	848,018
Cash and banks	1,003	24,189
Portfolio		785,507
Fixed assets		38,322
Liabilities	82,886	0
Deposits		
Loans	82,886	
NET POSITION	-81,883	848,018

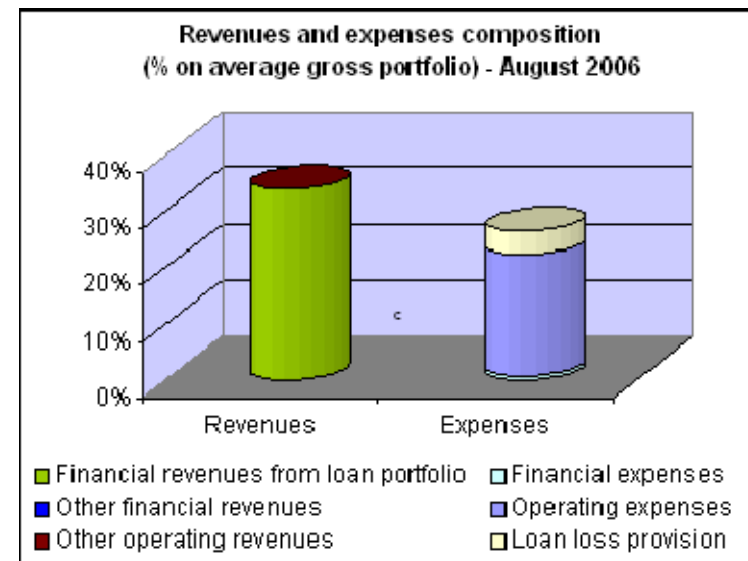
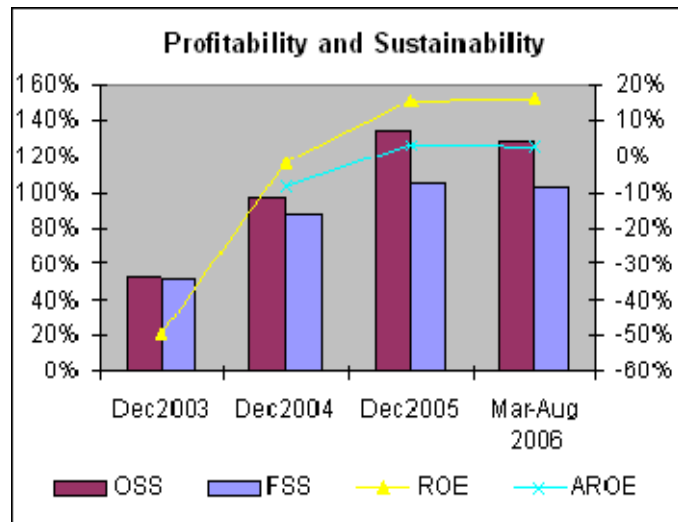
*Exchange rate AZN / US\$: 0.88

¹⁹ The exchange gains proceeding from the short position in US\$ have never been included in the Financial Statements.

6. Financial²⁰ and operational results

Azeri Star Microfinance presently shows **positive levels of financial performance** both in terms of profitability and sustainability, with a sharp upward trend over the period December 2003 – 2005, while remaining stable over the last 20 months, if not slightly declining. Nevertheless, the newly established LLC, because of its short institutional life, **does not enjoy yet a consolidated record of sustainability and positive financial performance**. The microfinance program financial performances have been in 2003 and 2004 **highly affected** by the cost of some **technical assistance** (about US\$ 82,000 for 2003 and US\$ 90,000 for 2004).

The period **March 2006 – August 2006**²¹ witnesses rather high profitability, with **ROE and ROA** standing respectively at 16.3% and 14.6%, somewhat **increasing compared to 2005** (15.3% and 14.3%). Such improvement is mainly to the slight decrease in the operating expenses on average portfolio, which counterbalances the **high cost of provisioning** for potential loan losses. It is important to notice that the **steep drop in the amount of equity and assets** during 2005 affects the consistency of the indicators based on averages. In presence of a sudden variation in BS values a more reliable indicator for understanding the trend for profitability and financial viability is the Operational Self Sufficiency, especially, as in the case of ASM, when taxes and extraordinary expenses and incomes are not included in the Financial Statements. **OSS**, although maintaining fairly high levels, follows a different pattern, **lower** over the period March – August 2006 than for the previous year (respectively 135% and 129%). OSS better shows the **relevant impact of provisioning** in 2006, which is however mitigated by ASM better performance in containing expenses.



Financial indicators for the period **September 2005 – August 2006**²² (ROE and OSS being respectively 14.22% and 125.65%), show a **noticeable drop** compared to January – December 2005, and even more, in terms of sustainability, to the first 8 months of 2005 (OSS is equal to 145%). The main reason for this trend, beside the high cost of provisioning, is the **prolonged impact of the slow down in credit operations** brought about by the shortage of funds, which was triggered by the already mentioned return to SC/US of about US\$ 270,000.

²⁰ 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.

²¹ The limited length of the period post spin-off under analysis limits the significance of financial indicators, as factors, such as seasonality, might not be taken into consideration.

²² Indicators for the period September 2005 – August 2006 are limited reliable due to the scarce consistency of the FS drafted prior the spin-off process (February 2006) and the ones presented afterwards.

In general, **adjusted indicators stands at significantly lower levels** mainly due to Azerbaijan macroeconomic performance, still experiencing rather **high levels of inflation**, although in a **decreasing trend** over the last 2 years. Over the period March – August 2006 FSS stands slightly above 100%, at 104%, while **AROE and AROA** amount respectively to 2.5% and 2.8%. Adjusted indicators follow the same trend of unadjusted ones, albeit **FSS decline from 2005 is less noticeable**, due to the decrease in the average inflation (11.8% in 2005, 7.3% over the period March – August 2006). It is important to highlight that from year 2006 ASM will have to **pay profit taxes** due to its legal status transformation, thus **adding a further component of cost** to its expense structure which might reduce profitability if not counterbalanced by a decrease in operational costs.

Financial Indicators	Jan04-Dec04	Jan05-Dec05	Sep05-Aug06	Mar06-Aug06
Operating expenses ratio (aver. gross portf.)	68.2%	48.6%	47.1%	42.7%
Staff allocation ratio	39.5%	38.5%	28.9%	28.9%
Staff productivity (borrowers)	99	98	108	108
Loan officer productivity (borrowers)	250	254	373	373
Loan officer productivity (amount)	35,015	41,438	71,410	71,410
Cost per loan lent	40	35	34	na
Cost per borrower	84	71	78	77
Funding expense ratio**	0.0%	0.5%	1.2%	1.4%
Provision expense ratio	1.4%	1.6%	6.1%	8.4%
Portfolio yield (gross portfolio)	67.9%	68.4%	68.4%	67.7%

Portfolio yield has remained **rather stable** over the last 2 years, only **slightly decreasing** from 68.4% for the period January – December 2005 to 67.7% for March – August 2006 mostly due to the increasingly larger share represented by graduated loans, which bear lower interest rates. As of August 2006, for the period starting from March, ASM still enjoys more than **15% profit margin**, also thanks to the high level of interest rates and the low funding expenses, without however taking into consideration the cost of inflation. **Inflation adjustments sensibly erode the margin**, which for the same period shrinks to only 2.5%, leaving limited room for covering the likely decrease in interest rates triggered by competitive pressures, the raises in cost due to the augment in commercial fund borrowed to foster future growth and payments of taxes.

In terms of **efficiency**, Azeri Star Microfinance is suffering from a rather high operating expenses ratio, which stands, for the period March – August 2006 at 42.7%, although in an important improving trend from the 48.6% of 2005 and the much higher 68% of 2004. The drop in operating expenses is also triggered by the diminishment in personnel costs, with total ASM staff which have decreased in number in the second half of 2005.

As of August 2006 the **staff allocation ratio** stands at a **quite low 29%**, especially due to a 40% decrease in the number of loan officers since the first half of 2005, who have not been replaced yet due to the scarcity of funds available for disbursement. The ratio, when deputed of support staff, reaches a less worrying 39%, which however leaves significant room for improvement.

ASM current **productivity** results **are improvable** and still highly affected by the shortage of funds. While **loan officer productivity** in terms of **borrowers** is at **rather good levels** (373 as of August 2006) although with margin for further increase, their productivity **by amount** is **significantly low**, also due to the previous bonus system, which did not take into consideration portfolio amount within its criteria. Besides, the positive trend for loan officer productivity is accentuated by the almost 30% decrease in the number of credit staff.

Overall **Azeri Star Microfinance** shows **positive levels of profitability and sustainability**, albeit it still has to **prove its ability** to maintain and enhance financial performance in the **long term**, especially considering competitive pressures on active interest rates and the likely increase in cost of funds. **Efficiency, and to a lesser extent productivity, leave wide room for improvement**, as ASM rather heavy operational structure is not yet fully exploited, also due to the lack of adequate funds for fostering the much needed growth.

7. Strategic objectives and financial needs

Strategic objectives and strategies

All Azeri Star Microfinance efforts in terms of **strategy** have been in 2005 **focused on the transformation into a Limited Liabilities Company**, through the spin-off from Save the Children, which now owns the totality of the newly born microfinance institution. Although Save the Children still runs 3 programs in Azerbaijan, and its permanence for other 1-2 years in the country should be ensured, there remains the **issue of the exit strategy** of the international NGO when it will decide to withdraw from Azerbaijan. This especially considering that microfinance is not to be considered Save the Children core business and it will probably be one of the activities to be firstly affected by the diminished effort in the country. The main option which Save the Children is at the moment taking into consideration is the opportunity to **merge Azeri Star with other Azeri microfinance institution**. In 2007 a survey by Save the Children specialists will be carried out in order to properly assess this possibility, which will also depend on the funding situation of Azeri Star, the willingness of staff and management to undergo such process, and the capacity of the governance to agree the merger with institutions with similar mission and organizational structure. In the case such option will prove not to be feasible, the international NGO is also assessing other options, including transferring the ownership to the employees²³

Azeri Star has recently produced a 3-year **Strategic Business Plan for the period 2006-2008**. This exhaustive and well designed document precisely delineates the main strategic and operational objectives for the last months of 2006 and the following two years, and the activities to be undertaken in order to fulfill them. According to the strategic business plan the main objectives for the period 2006-2008 are:

- **Fundraising.** Azeri Star will spend a lot of efforts in fundraising in order to be able to foster the planned growth in terms of portfolio, operational structure and geographical expansion.
- **Geographical expansion.** By the end of 2008 Azeri Star is planning to have 4 branches, establishing an office either in Agdash or in Mingechevir and transferring the Head Office, which will also function as branch, to Baku. Through its enhanced branch network the institution is planning to significantly increase its outreach²⁴, serving the districts of Goychay, Gabala, Shamkir, Baku and the Absheron peninsula.
- **Enhancement of its structure and operations**, introducing new products (consumer and staff loans), establishing new positions (e.g. operational manager, human resource officer) and increasing overall efficiency through a review of the systems in place.
- Conducting a **study on merger possibilities** with other similar MFIs and assess the impact on Azeri Star.
- **Increase visibility** through enhancing marketing and moving the headquarters to Baku.

²³ Constanta (Georgia), belonging to the SC network, underwent this process of ownership transfer to the employees. However, the Azeri regulation does not allow such possibility at the moment.

²⁴ By the end of 2008 the institution is planning to serve more than 9,000 clients.

The following table synthesizes the main results reported in Azeri Star financial projections:

AZERI STAR MICROFINANCE				
Projected key financial indicators	Actual 2005	2006	2007	2008
Oustandng portfolio (US\$)	621,575	1,109,541	1,513,005	2,112,168
Portfolio growth (AZN)	11%	77%	36%	40%
Number of loans	3,815	5,375	7,110	9,261
Equity (US\$)	592,663	858,403	1,120,053	1,526,497
Liabilities (US\$)	80,017	465,370	660,000	660,000
OSS	77%	149%	160%	171%
ROE	15.4%	21.3%	26.4%	30.7%
Operating expenses ratio	49%	46%	38%	35.0%

Source: 2006-2008 Strategic Business Plan

Financial projections within the Business Plan were drafted using Microfin, jointly by the CEO, the Financial Director and the MIS Manager with inputs from the credit and administrative staff. The projections also include a thorough analysis of the most important financial ratios for microfinance. Nevertheless, they **do not present different scenarios** (e.g. conservative, controlled and aggressive) contemplating for instance different assumptions with regards to access to commercial funds or future levels of active interest rates. The projections foresee a **strong portfolio growth** for the current year, which then stabilizes at slower but still satisfactory levels in 2007 and 2008 (respectively 36% and 40%). The expected growth, which will however heavily **depend on the capacity of Azeri Star to attract funding liabilities**, seems realistic especially when considering that the annualized increase of the outstanding loan portfolio over the period January-August 2006 was 68% and there is still high demand for credit in the areas the institution is currently covering and planning to reach in the next future. On the other hand, although **operating expenses** are forecasted to decrease from the current rather high level of 49% to 35% in 2008, also thanks to the planned increased size of operations they remain at **rather high levels**, and might bring about a squeeze in profit margins if increases in competition forced ASM to significantly lower interest rates.

Financial needs

According to the projections for 2007 and 2008 Azeri Star Microfinance would need a total of about **US\$ 1,500,000 for funding portfolio growth**. The institution is predicting to be able to generate approximately 60% of the needed amount with **retained earnings**, which are forecasted in a **significant increasing trend** (US\$ 462,000 in 2007 and US\$ 869,000 the following year). As far as **funding liabilities** are concerned, for the first two quarter of 2007 ASM is planning to attract around US\$ 150,000 in order to have enough funds to justify the opening of a new branch in the Adgash district, plus US\$ 450,000 for the remaining period planned expansion. Although ASM CEO has proceeded to **contact several potential investors**, all negotiations are still at an **early stage**, thus bringing about some concerns with regards to the institution's future capacity to fund its further development. Nevertheless, the **transformation** of the Microfinance Program into a Limited Liabilities Company will potentially make Azeri Star **more appealing** for investors and the top management is undertaking several steps in order to enhance the institution's visibility and transparency, such as **moving the headquarters to Baku** and carrying out independent external evaluations. Amongst the social and commercial investor already contacted by Azeri Star there are Blue Orchard, Deutsche Bank, Symbiotics, Triodos, EBRD and the Islamic Development Bank. In terms of **donations**, the institution does not foresee to receive any further funds from Save the Children, while contacts have been developed with British Petroleum for a potential grant.

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*	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 will be approved by the end of 2006.	The exemption from paying social taxes is temporary. A draft law for microfinance is under discussion in the parliament.
	<i>Lack of a credit bureau for microfinance institutions</i>	Medium-low	Informal exchange of information between MFIs and commercial banks.	A formal Credit Bureau for microfinance institution has not been set in place yet.
	<i>Growing competition</i>	Medium-low	–	Competition is gradually increasing in ASM areas of operation and especially in Ganja. The high portfolio yield is likely to experience downward pressure from competition in future.
Governance, management and operations	<i>Scarce Supervisory Council participation to ASM governance</i>	Medium	–	The Supervisory Council lacks finance background, formally meets once a year and has only recently started operating.
	<i>Staff turnover and lack of stable local human resources</i>	Medium-high	ASM is transferring the Head Office in Baku. Besides valid human resources have been found in Ganja, the second Azeri city in terms of dimension. There exist also the plan to introduce employee loans.	ASM location is not attractive for management and other staff and the institution lost several employees who wished to work in Baku. Location is also an issue in terms of commercial funds attraction and training provision to staff. Moreover a formal training needs assessment and training plan is not in place.
	<i>Improvable internal control function</i>	Medium-low	–	The compliance manager does not directly report to the Supervisory Council and has not prior experience in audit. The level of safety in terms of cash handling in Mingachevir is lower than in the branches.
	<i>Unreliable financial statements before spin off</i>	Medium-high	An audit has been performed for the period March-July 2006.	Before the spin-off the financial statements were not audited according to international accounting standards and there existed difficulties in separating the microfinance program from the other SC/US activities from an accounting point of view.
	<i>Shortcomings in some accounting procedures</i>	Medium	–	Donations and items denominated in foreign currency are not booked according to International Accounting Standards.
	<i>Shortcomings in the accounting software</i>	Medium	–	The financial department manually inputs and consolidates branches accounting information into the system at HQs level.

* 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 ^a	Main measures implemented and/or to implement in the short term	Observations
Financial products and asset quality	Poor product diversification	Medium-low	ASM is planning to introduce consumer and employee loan products in the first quarter of 2007.	ASM product offer is limited. Individual loans supply has been suspended due to the shortage of funds
	High drop out rate	Medium-high	Management has recently started monitoring drop out.	The drop out rate is equal to 60% in the period Sept-Aug06 and to 88% in 2005, and it is especially concentrated in Ganja. Among the main reasons there is the shortage of funds.
	Portfolio concentration in the livestock sector	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	Shortage of funds	High	The Strategic and Business plan includes intense fundraising activity.	ASM is suffering from shortage of funds which hampers quicker portfolio and clients growth, territorial expansion and the further development of the organizational structure. ASM has not achieved yet the critical size to raise interest from a part of the specialized lenders.
	Lack of proper financial risk management	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.
	Currency Risk	Medium	No relevant losses have been registered so far as AZN is appreciating against the dollar.	The institution has a 11% negative net position on equity. Hedging instruments are not available in the country.
Financial and operational results	Improvable productivity and efficiency	Medium	ASM projections foresees productivity and efficiency to improve over the next two years.	Loan officer productivity is quite low compared to the best performing MFIs in the region. Staff allocation ratio stands at rather low levels also due to the shortage of funds. Operating costs are significantly high, at a 45% of average outstanding portfolio.
Strategic objectives and future evolutions	Lack of different scenarios analysis	Low	Different scenarios are developed internally.	The business plan is lacking projections presenting conservative, realistic and optimistic scenarios.
	Negotiations for funding still in early stage	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.
	Uncertainties about future ownership	Medium-low	Few possible outcomes are being considered, and a feasibility study on the possibility of merging with other Azeri MFIs is planned for the next year.	By the end of 2008 Save the Children is downsize te operations in the country.

^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.

Annex 1 - Financial statements

Azeri Star				
Balance sheet (US\$)	Dec03	Dec04	Dec05	Aug06
ASSETS				
<i>Cash and bank deposits</i>	23,686	67,039	38,368	25,192
<i>Short term financial assets</i>	-	-	-	-
<i>Net outstanding portfolio</i>	384,237	504,220	596,712	754,086
<i>Gross outstanding portfolio</i>	400,247	525,229	621,575	785,507
<i>Performing portfolio</i>	399,555	523,076	619,387	785,507
<i>Portfolio at risk > 30 days</i>	693	2,153	2,188	
<i>(Loan loss reserve)</i>	16,010	21,010	24,863	31,420
<i>Accrued interest</i>	-	-	-	-
<i>Other short term assets</i>	-	-	-	-
Total short term assets	407,923	571,258	635,080	779,279
<i>Long term financial assets</i>	-	-	-	-
<i>Net fixed assets</i>	11,449	40,111	37,600	38,321
<i>Other long term assets</i>	-	-	-	-
Total long term assets	11,449	40,111	37,600	38,321
Total assets	419,372	611,369	672,680	817,600
LIABILITIES and EQUITY				
LIABILITIES				
<i>Sight deposits</i>	-	-	-	-
<i>Short time deposits</i>	-	-	-	-
<i>Short term loans</i>	-	-	-	82,886
<i>Other short term liabilities</i>	-	-	-	-
Total short term liabilities	-	-	-	82,886
<i>Long term time deposits</i>				
<i>Long term loans</i>	-	-	80,017	-
<i>Other long term liabilities</i>	-	-	-	-
<i>Restricted funds</i>	-	-	-	-
Total Long term liabilities	-	-	80,017	-
Total liabilities	-	-	80,017	82,886
EQUITY				
<i>Paid-in capital from shareholders</i>				36,562
<i>Donated equity</i>	872,785	1,072,608	951,072	641,356
<i>Quasi-capital</i>				
<i>Reserves</i>				
Total retained earnings	- 453,412	- 461,238	- 358,410	56,798
<i>Net income, previous years</i>	- 325,091	- 453,483	- 464,182	-
<i>Net income, current year</i>	- 128,321	- 7,755	105,773	56,798
<i>Other equity accounts</i>				
Total equity	419,372	611,370	592,663	734,715
Total liabilities and equity	419,372	611,369	672,680	817,600

Except for the period March 2006 - July 2006 ASM financial statements have not been independently audited

Azeri Star				
Income Statement (US\$)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Mar06-Aug06
<i>Interest & commissions received on loans</i>	140,710	311,687	410,197	253,026
<i>Financial revenue from investment</i>				
<i>Other financial revenues</i>	-	-	-	-
A) Financial revenue	140,710	311,687	410,197	253,026
<i>Interest paid on borrowings</i>	-	-	2,872	5,174
<i>Interest paid on savings</i>	-	-	-	-
<i>Interest paid on mortgage</i>	-	-	-	-
<i>Other financial expenses</i>	-	-	-	34
<i>Inflation adjustment</i>	-	-	-	-
B) Financial expenses	-	-	2,872	5,208
Gross financial margin (A - B)	140,710	311,687	407,326	247,817
<i>Loan loss provision</i>	16,625	6,614	9,809	31,420
Net financial margin	124,086	305,073	397,516	216,397
<i>Other operating revenue</i>	407	-	-	-
<i>Personnel expenses</i>	114,766	151,739	204,611	107,071
<i>Administrative expenses</i>	138,048	161,088	87,132	52,529
C) Operating expenses	252,814	312,827	291,743	159,600
Net operating income	- 128,321	- 7,754	105,773	56,798
<i>Extraordinary revenue</i>	-	-	-	-
<i>Extraordinary expense</i>	-	-	-	-
Net income before donations, before tax	- 128,321	- 7,754	105,773	56,798
<i>Taxes</i>	-	-	-	-
Net income before donations	- 128,321	- 7,754	105,773	56,798
<i>Donations in cash</i>	-	-	-	-
<i>Revenue not from the operations</i>	-	-	-	-
<i>Expenses not from the operations</i>	-	-	-	-
Net income	- 128,321	- 7,754	105,773	56,798

Except for the period March 2006 - July 2006 ASM financial statements have not been independently audited.

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, and on the internal FS of ASM starting from March 2006. The last audit conducted in the period prior to the spin-off covered the period June 2000 – June 2003, while a draft version of the audited FS of ASM is available for the period March - August 2006.

Adjustments (US\$)	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Mar06-Aug06
Reversal of accrued interest on non-perf loans	-	-	-	-
Subsidized cost of fund adjustment	-	-	-	-
- Interest rate used (national currency)	11.6%	11.8%	12.8%	13.3%
- Interest rate used (foreign currency)	4.4%	5.1%	7.0%	8.4%
Inflation adjustment	5,444	33,295	77,381	47,506
- Inflation rate used	3.6%	10.4%	7.4%	2.5%
Loan loss provision adjustment	-	-	-	-
In-kind subsidy adjustment	1,341	2,500	8,884	-
Total variation of net income	6,785	35,795	86,265	47,506

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 kind²⁵ and soft loans²⁶)
- provisions are calculated with a standard formula²⁷
- 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 (especially in 2005), combined with the limited equity leverage, makes this adjustment accounting for 83% of the total variation of net income in the period September 2005 August 2006. The limited adjustments for the in kind subsidies received in the periods of analysis are mainly related to trainings and, in 2006, to the new SAGE software.

²⁵ Donations in kind are valorized and added to operational expenses.

²⁶ 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%.

²⁷ Provisions are calculated according to the following formula:

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

Annex 3 - Financial ratios

Azeri Star - AZN

Jan03-Dec03 **Jan04-Dec04** **Jan05-Dec05** **Mar06-Aug06**

PROFITABILITY

<i>Return on Equity (ROE)</i>	-49.5%	-1.5%	15.3%	16.3%
<i>Adjusted Return on Equity (AROE)</i>	nc	-8.4%	3.1%	2.8%
<i>Return on Assets (ROA)</i>	-49.5%	-1.5%	14.3%	14.6%
<i>Adjusted Return on Assets (AROA)</i>	nc	-8.4%	2.9%	2.5%
<i>Operational self-sufficiency (OSS)</i>	52.4%	97.6%	134.7%	128.9%
<i>Financial self-sufficiency (FSS)</i>	nc	87.7%	105.0%	103.8%
<i>Profit Margin</i>	-90.9%	-2.5%	25.8%	22.4%

LOAN PORTFOLIO QUALITY

<i>Portfolio at risk (PAR30)</i>	0.2%	0.4%	0.3%	0.4%
<i>Arrears rate (> 1 day)</i>	0.3%	0.5%	0.3%	0.0%
<i>Restructured loans</i>	0.0%	0.0%	0.0%	0.0%
<i>Provision expense ratio</i>	6.9%	1.4%	1.6%	8.4%
<i>Loan loss reserve ratio</i>	4.0%	4.0%	4.0%	4.0%
<i>Risk coverage ratio (30 days)</i>	2313.0%	975.8%	1147.7%	967.4%
<i>Write-off ratio</i>	16.4%	0.3%	0.2%	0.0%
<i>Adjusted write-off ratio</i>	19.7%	0.3%	0.2%	0.0%

EFFICIENCY AND PRODUCTIVITY

<i>Staff allocation ratio</i>	40.7%	39.5%	38.5%	28.9%
<i>Loan officer productivity (borrowers)</i>	291	250	254	373
<i>Loan officer productivity (amount)</i>	36,386	35,015	41,438	71,410
<i>Staff productivity (borrowers)</i>	118	99	98	108
<i>Staff productivity (amount)</i>	14,824	13,822	15,938	20,671
<i>Branch productivity (amount)</i>	400,247	525,229	310,788	392,753
<i>Operating expenses ratio (average gross portf.)</i>	105.3%	68.2%	48.6%	42.7%
<i>Operating expenses ratio (average assets)</i>	97.5%	59.6%	39.4%	41.0%
<i>Cost per loan lent</i>	43	40	35	38*
<i>Cost per borrower</i>	118	84	71	77
<i>Personnel expenses ratio (average gross portf.)</i>	47.8%	33.1%	34.1%	28.7%
<i>Admin. expenses ratio (average gross portfolio)</i>	57.5%	35.1%	14.5%	14.1%

ASSETS/LIABILITIES MANAGEMENT

<i>Portfolio yield (gross portfolio)</i>	58.6%	67.9%	68.4%	67.7%
<i>Portfolio yield (gross portfolio) - accrued</i>	58.6%	67.9%	68.4%	67.7%
<i>Funding expense ratio**</i>	0.0%	0.0%	0.5%	1.4%
<i>Cost of funds ratio**</i>	nc	nc	6.9%	11.8%
<i>Provision for inflation (average gross portfolio)</i>	0.0%	0.0%	0.0%	0.0%
<i>Adjusted provision for inflation (av. gross port.)</i>	2.3%	7.3%	12.9%	12.7%
<i>Current ratio</i>	nc	nc	nc	9.40
<i>Liquidity over total assets</i>	5.6%	11.0%	5.7%	3.1%
<i>Debt/equity ratio</i>	0.00	0.00	0.14	0.11
<i>Equity multiplier</i>	1.0	1.0	1.1	1.1
<i>Capital adequacy ratio</i>	100.0%	100.0%	88.1%	89.9%

* calculated for the period September - August 2006

nc: not computable

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

Except for the period March 2006 - July 2006 ASM financial statements have not been independently audited

Azeri Star - AZN

	Jan03-Dec03	Jan04-Dec04	Jan05-Dec05	Mar06-Aug06
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OUTREACH

<i>Average disbursed loan size</i>	166	188	228	272*
<i>Average outstanding balance</i>	125	140	163	191
<i>Average disbursed loan size on per-capita GDP</i>	18.9%	18.4%	14.9%	12.8%*
<i>Average outstanding balance on per-capita GDP</i>	14.3%	9.7%	10.6%	9.0%
<i>Percentage of active borrowers women</i>	28.4%	40.3%	48.9%	51.9%

GROWTH (amount in national currency)

<i>Growth of active gross portfolio</i>	nc	30.7%	10.9%	21.3%
<i>Growth of active borrowers</i>	nc	17.5%	1.6%	7.5%
<i>Growth of active loans</i>	nc	17.5%	1.6%	7.5%
<i>Growth of total assets</i>	nc	45.2%	3.1%	16.6%
<i>Growth of staff</i>	nc	40.7%	2.6%	-2.6%
<i>Growth of funding liabilities</i>	nc	nc	nc	-0.6%
<i>Growth of operating expenses**</i>	nc	23.2%	-12.6%	2.9%*
<i>Growth of equity</i>	nc	45.2%	-9.2%	19.0%

* calculated for the period September - August 2006

nc: not computable

** for August 2006 the growth has to be referred to December 2006

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 firstly audited this year for the period March - July 2006 by a local auditing company (TID Consulting), whose report is still in a draft version.

Loan loss provision and write-offs

The cost of provision, which is included in the income statement, is the difference between the loan loss reserve calculated at the beginning of the period and the loan loss reserve as it is at the end of the period deducting the write-offs. The cost of provision is recorded within the income statement

and it is cumulated as a loan loss reserve in the balance sheet as a negative item of the assets.

All or part of the outstanding amount of loans which have not received any payment for more than 180 days (6 months) for four-month loans, and 270 days (9 months) for six-month loans will be written off against the loan loss reserve every quarter.

Besides the ordinary reserve (equal to 4% of the monthly disbursements net of monthly principal repayments) a special reserve is created for late loans on a monthly basis according to the provisioning method shown in the table.

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 days	4%
1 - 30 days	10%
31 - 60 days	50%
61 - 90 days	75%
> 90 days	100%

Insider loans

Insider loans are not allowed in ASM.

Donations

Upon its spin-off the institution has inherited a US\$ 565,000 grant, which included part of the money coming from USAID and previously channelled by Save the Children into the microfinance program.

ASM records grants and donation for both operational expenses and loan capital in the income statement below the net income from operations.

Year	Amount	Destination	Source
2006	565,355	Grant for loan capital	USAID
TOTAL	565,355		

Details of funding liability

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Loans borrowed					
Source	Currency (in which the loan is due)	Outstanding Balance (US\$)	Outstanding Balance Short term (US\$)	Outstanding Balance Long term (US\$)	Agreement, kind of product and collateral
DRC (Caucas Credit)	US\$	82,886	82,886	0	Loan - 2 years grace period
TOTAL		82,886	82,886	0	

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Funding liabilities features						
Source	Loan amount (US\$)	Disbursement date	Maturity date	Principal repayments	Interest repayments	Interest rate
DRC (Caucas Credit)	82,886	April 2005	May 2007	At the end of the agreement	Monthly	1% per month

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.