

# **REVIEW OF THE FINANCIAL PERFORMANCE OF ACCESSBANK, AZERBAIJAN**

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## **Introduction**

With the full support of multilateral and bilateral agencies, some of whom are the bank's shareholders and lenders, AccessBank of Azerbaijan has grown in the spotlight as a shining example of a successful emerging market financial institution. Its assets have risen from just over USD 20 million at the end of 2005 to more than USD 350 million today. Client accounts increased from less than 7,000 at the end of 2005 to more than 100,000 today. Fitch has given the bank the highest rating of any private bank in Azerbaijan, indeed the highest possible rating for Azerbaijan, matching the country ceiling of BB+. The bank completed its debut bond issue in February 2008. This was the first bond issue on international capital markets by an Azerbaijani company, raising USD 25 million. Since its opening, the bank has expanded its services to include new savings products, loans money transfer services for businesses and individuals, electronic payment cards and an ATM and POS network. In general, it has been viewed as a success story not only in the microfinance industry but also in the wider arena of emerging market banking.

This article provides an overall analysis of the bank, from its creation by international financial institutions (IFI) to the equity involvement of AccessHolding Microfinance AG of Germany to its financial performance through the current financial crisis to its challenges ahead.

## **Background**

AccessBank was created under a joint effort by the European Bank for Reconstruction and Development (EBRD), KfW Development Bank, International Finance Corporation (IFC), Black Sea Trade and Development Bank (BSTDB) and LFS Financial Systems (LFS). The creation of the bank can be seen as part of a wider program by these International Financial Institutions (IFI). EBRD has been involved in 18 microfinance institutions throughout the territory of its operations. Seventeen of these have been greenfield operations in which a bank was created from the ground up. In such operations, EBRD first assesses the market for suitable partners and if there are none, it works with other IFIs to establish a bank. Recent projects include the Belarus Small Business Bank that was established in 2008 and has met with success in 2009 even during the financial crisis. AccessBank Tajikistan, a sister bank of the Azerbaijan bank, is expected to open its doors in the next few months. The establishment of KMB Bank in Russia in the wake of the 1998 financial crisis set a precedent for similar transactions in the region. KMB Bank was subsequently bought by Italy's Banca Intesa and now has assets of more than USD 1 billion. Other activities in the sector include 13 banks in the

Western Balkans under the ProCredit Holdings Company as well as ProCredit in Ukraine and Xacbank in Mongolia.

In the case of Azerbaijan, EBRD conducted its feasibility study in 2001 and the Micro Finance Bank of Azerbaijan was established in October 2002. With the IFIs as shareholders, the new bank needed a management team. Through an international competitive procurement, LFS Financial Systems GmbH was chosen. LFS is a German consulting and management company that specializes in microfinance. Initially, LFS supplied nearly the entire management team but now only one expatriate remains in bank management. LFS also took an equity stake in the bank.

In 2006, LFS established AccessHolding Microfinance AG along with other international investors. With AccessHolding, LFS is able to expand its role beyond providing consulting services to taking equity stakes in microfinance institutions. In April 2007, AccessHolding took nearly a 10 percent stake in AccessBank of Azerbaijan which increased to a little more than 16.5 percent in December 2007. AccessHolding's other investments include microfinance banks in Africa (Liberia, Madagascar, Nigeria and Tanzania) and a new project under development with EBRD – AccessBank of Tajikistan. The current shareholders of AccessBank of Azerbaijan are EBRD (20 percent), IFC (20 percent), BSTDB (20 percent), KfW (20 percent), AccessHolding (16.53 percent) and LFS Financial Systems GmbH (3.47 percent).

The participation of AccessHolding as an equity investor led the bank to change its name from Micro Finance Bank of Azerbaijan to AccessBank. The rebranding of the bank along with the name change has attracted additional customers. As Chikako Kuno, Director of EBRD's Small Business Finance team, reports, "Many businesses in Azerbaijan don't think of themselves as micro or small and are not likely to approach a microfinance bank for lending. The name change helped to attract these customers."

Technical Assistance from the European Commission and later KfW accompanied the equity investments by the IFIs. AccessBank has had a demonstration effect in Azerbaijan, showing the profitability of lending to small businesses and entrepreneurs. EBRD is now engaged with seven other banks and six nonbank financial institutions (NBFIs) in Azerbaijan, providing technical assistance and loans to support microfinance.

AccessBank was ranked 11<sup>th</sup> out of the country's 46 banks in terms of assets with two percent of total banking sector assets and was ranked 10<sup>th</sup> in terms of sector loan portfolio, with 2.3 percent of the sector loan portfolio at the end of 2008. Today its rank has increased to 6<sup>th</sup> in terms of both assets and loans. It is one of the few 100 percent foreign-owned banks in Azerbaijan. Among the leading microfinance institutions (including 12 banks and 20 NBFIs) tracked by the Azerbaijan Micro Finance Association, AccessBank held a 38 percent market share in 2008, up from 30 percent in 2007. Finca trails a distant second at 12 percent. Fitch Ratings awarded AccessBank the highest rating for a private bank in Azerbaijan, BB+, matching the country ceiling in 2009.

## Macroeconomic Environment

Azerbaijan is an oil-exporting country which distinguishes it from some of its neighbors in the Caucasus and Central Asia region. The economy received a major boost when the Baku-Tbilisi-Ceyhan pipeline opened in June 2006. GDP growth was higher than 35 percent in 2006, 24 percent in 2007 and 11 percent in 2008. Oil and gas comprised 62 percent of GDP in 2008, the same year in which Azerbaijan reached a USD 40 billion trade surplus.

High growth and the trade surplus has led to currency appreciation and inflation. The local currency, the manat, appreciated five percent against the US dollar in 2006, three percent in 2007 and five percent again in 2008. (The Azeri Manat (AZM) was replaced by the Azeri New Manat (AZN) with an exchange of 5,000:1 in 2006.) Official inflation was 16.7 percent in 2007 and 21 percent in 2008, slowing toward the end of the year as oil prices dropped.

## Azerbaijan Banking Sector

The banking sector in Azerbaijan is dominated by the International Bank of Azerbaijan (IBA) and by Kapital Bank. IBA's share of total banking assets stood at 47 percent in 2006 and 39 percent in 2007 and then rose to 43 percent at the end of 2008 as a result of the global financial crisis.

At the time of AccessBank's creation, EBRD's strategy included increasing diversity in the banking sector to provide alternatives to the state-owned bank. At the time of its intervention, the banking sector was characterized by low capitalization and limited transparency. EBRD's strategy also included a focus on small business and microfinance. "The loan/GDP ratio is low for the region, never mind comparisons to Western Europe or the US. There is a lot of room for financial intermediation," says EBRD's Kuno.

The current financial crisis has led some Azerbaijan banks to halt their lending activities and many banks had to repay loans since they could not find additional funds for refinancing. The Central bank of Azerbaijan reacted by eliminating the five percent reserve requirement on foreign borrowings, reducing the required deposit reserve from 12 to half a percent and extending loans to certain banks. In general, however, Azerbaijan has fared much better than other countries, particularly emerging markets, in the financial crisis. The table below shows some key banking sector indicators.

<b>Banking Sector Indicators</b>			
	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>Banking Sector Assets (AZN bn)</b>			
AZN bn	3.78	6.73	10.30
% of GDP	n.a.	27	27
<b>Banking Sector Loan Portfolio (net of loans to</b>			

<b>FIIs)</b>			
AZN bn	2.1	4.4	6.8
% of GDP	n.a.	18	18
<b>Customer Deposits</b>			
AZN bn	2.12	3.44	4.10
% of GDP	n.a.	<14	11
<i>Source: AccessBank Annual Reports</i>			

## AccessBank's Financial Performance

In general, AccessBank's financial performance has been impressive. With the full support of multilateral and bilateral agencies, some of whom are the bank's shareholders and lenders, AccessBank has grown in the spotlight as a shining example of a successful emerging market financial institution. Total assets grew more than 153 percent in 2006, 140 percent in 2007 and 81 percent in 2008. In the same years, customer deposits increased by more than 483 percent, 282 percent and 90 percent, respectively. The number of deposit accounts increased from 1,336 in 2005 to 28,158 in 2008. In comparison, operating expenses increased by only 155 percent in 2006, then less than 90 percent in both 2007 and 2008. Shareholder equity increased by nearly 140 percent in 2007 and 154 percent in 2008.

Portfolio at Risk (30 days) peaked at 0.56 percent in 2008. This was due to the fact that the bank had not written off any loans since 2006 and that some of its borrowers were facing financial difficulties. The key results of the bank's performance are shown in the table below.

<b>AccessBank Key Results</b>				
<b>(USD 000s)</b>				
<b>Source:</b>	2006 AR	2007AR	2008AR	2008AR
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>BALANCE SHEET</b>				
Total Assets	21,844	55,406	133,250	242,091
Liquid Assets	3,086	6,229	16,579	29,167
Total Loan Portfolio	17,137	46,658	114,537	208,154
Business Loan Portfolio	16,926	44,124	101,251	191,303
Micro Loans	6,648	18,302	43,374	87,883
Trust and Small Loans	8,662	19,269	36,478	68,522
Medium-sized Loans	1,809	6,553	21,399	34,898
Consumer Loan Portfolio	0	1,866	11,427	12,219
Other Loans	211	668	1,859	4,633
Accrued Interest and Disbursement Fee	192	83	-1,013	1,315
Loan Loss Reserve	0	0	2,350	5,138
Net Loan Portfolio	17,333	46,741	111,175	204,331
Fixed and Other Assets	1,430	2,436	5,495	8,593
Customer Deposits	644	3,757	14,355	27,281
Borrowings	14,250	44,779	101,704	170,090
Shareholders' Equity	6,750	6,837	16,378	41,572

<b>PROFIT AND LOSS ACCOUNT</b>				
Operating Income	2,763	6,232	17,588	39,223
Operating Expense	2,542	6,471	11,895	22,478
Profit Before Tax	221	-239	5,693	16,745
Profit After Tax	147	-279	4,258	13,052
<b>RATIOS</b>				
Return on Equity (end of year - FX adjusted)	8.80%	-4.00%	26.00%	31.40%
Return on Average Assets (FX adjusted)	3.80%	-0.70%	4.50%	6.80%
Cost/Income Ratio (FX adjusted)	81.50%	103.80%	67.60%	57.30%
Capital Adequacy (FX adjusted)	33.00%	13.30%	20.40%	24.60%
<b>MISCELLANEOUS</b>				
Number of Outstanding Loans	5,724	16,719	47,638	71,148
Number of Business Loans	n.a.	n.a.	30,262	47,753
Number of Micro Loans	n.a.	n.a.	28,710	45,017
Average Micro Loan Size (disbursed)	n.a.	n.a.	2,089	2,712
Number of Trust, Small and Medium Loans	n.a.	n.a.	1,552	2,736
Average Trust, Small, and Medium Loan size (disbursed)	n.a.	n.a.	47,357	46,937
Number of Agro Loans	n.a.	n.a.	2,137	10,013
Average Agro Loan Size (disbursed)	n.a.	n.a.	1,692	2,207
Number of Deposit Accounts	1,336	5,538	11,864	28,158
Number of Branches	7	10	14	20
Number of Staff	213	458	612	863
Portfolio at Risk (30 days)	0.40%	0.46%	0.05%	0.56%

AccessBank provided some loan data as of end-October 2009:

- The overall average loan size is USD 3.600
- 95 percent of loans are less than USD 10,000 and of those, the average is less than USD 3,000
- 3.4 percent are small loans of USD 20,000-100,000 with an average of USD 40,000
- Some loans are medium-sized, but these are very few and limited.

AccessBank was rated at BB+ by Fitch Ratings. This is the highest rating for a private bank in Azerbaijan<sup>1</sup> and indeed the highest possible rating since it matches the country ceiling. Very few banks in Azerbaijan have ratings and, of those, most are rated B-. “This provides a lot of confidence to investors,” notes Walid Fayad, a Banker with EBRD who works directly with AccessBank.

The bank completed its debut bond issue in February 2008. This was the first bond issue on international capital markets by an Azerbaijani company, raising USD 25 million through a Luxembourg-based Special Purpose Vehicle. In November 2008, the EBRD arranged the bank’s first syndicated loan, raising another USD 28 million. Since its opening, the bank has expanded its services to include new savings products, loans money transfer services for businesses and individuals, electronic payment cards and an

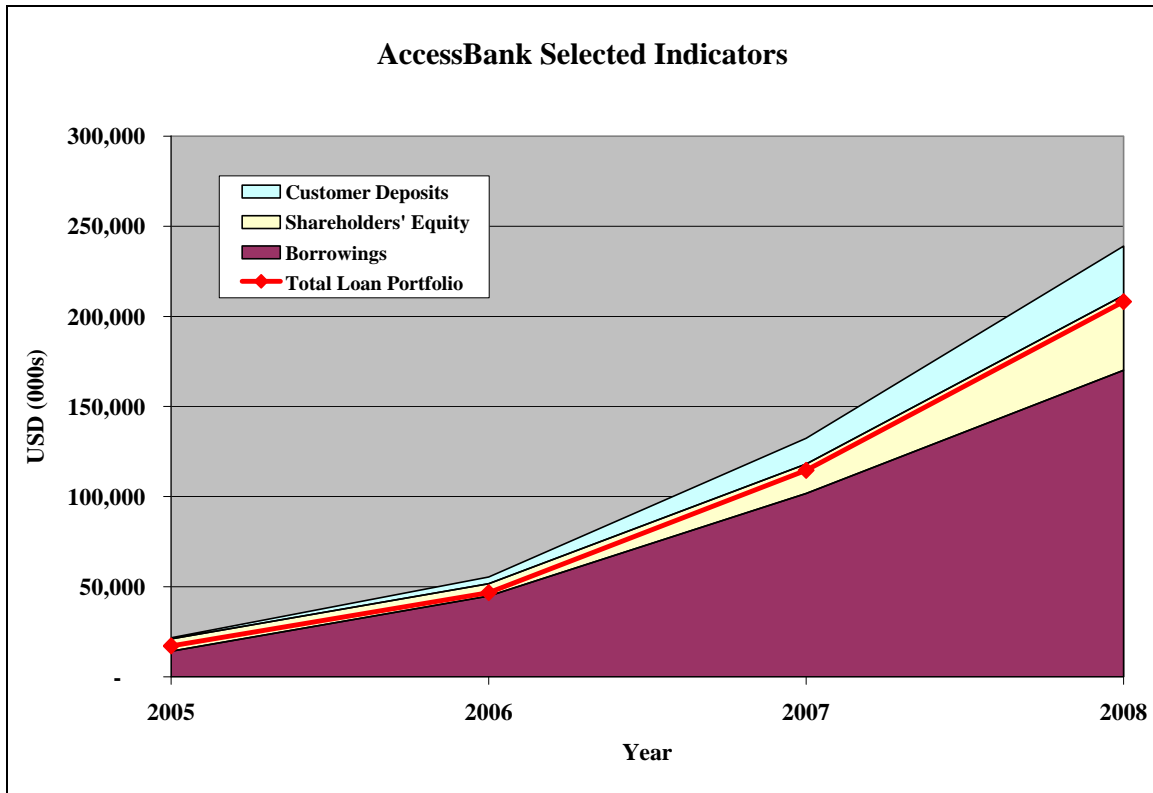
<sup>1</sup> International Bank of Azerbaijan also has a BB+ rating.

ATM and POS network. In general, it has been viewed as a success story not only in the microfinance industry but also in the wider arena of emerging market banking.

While the bank's performance has been impressive, there are some areas of concern. One of them is the bank's source of funds for lending. Traditional banks receive deposits and then on-lend them to other customers, channeling money from savers to investors. AccessBank's model is to borrow money internationally, combine it with equity from international investors (many of them lenders as well – approximately 17 percent of borrowings come from shareholders) then to on-lend it domestically. This is clear from the graph below. The bank's total loan portfolio as a percentage of international borrowing plus equity increased from 81.6 percent in 2005 to 98.3 percent in 2008. Meanwhile, the ratio of lending to customer deposits has decreased from more than 26 in 2005 to 7.6 in 2008.

From a long-term sustainability perspective, it would be desirable for this last figure to continue to fall so AccessBank could become a true bank, independent of international financing and serving the fundamental banking role of channeling domestic savings into investments. "The bank currently has a deposit to loan ratio of twenty-seven percent," notes Oksana Pak, Senior Banker with EBRD, "its sustainability requires a higher level."

The bank has benefited from some unique events of the past few years, mainly, the opening of the Baku-Tbilisi-Ceyhan pipeline and the depreciation of the US dollar. The pipeline provided a one-time (although certainly significant) boost to Azerbaijan's GDP. This growth has already cooled from 35 percent in 2006 to 11 percent in 2008 and is expected to cool further this year and next, to around 7.5 percent. The pipeline was opened at a good time for oil prices but those prices may not stay high forever and Azerbaijan's economy is highly dependent on those prices.



While the Azerbaijan manat has indeed appreciated against the US dollar, much of that can be attributed to the dollar's decline and not all of it to the manat's climb. This has provided extra comfort for AccessBank since a major share of its international borrowing is in US dollars. A falling dollar makes for easy repayment of dollar loans. A rising dollar would do just the opposite. This is again one reason for the bank to focus on increasing deposits, so it can source its liabilities in the same currency as its assets. The bank has moved to hedge its currency risk in its borrowing by sourcing two loans in the local currency – in November 2007 and August 2008. Still, it would seem that if the Azerbaijan economy were performing as well as the figures indicate, there should be sufficient depositors and savers interested in financial intermediation. The bank has also developed new products, namely term deposits, that should help to address this issue as well.

Another area for concern is the significant increase in impaired loans. These rose from approximately AZN 3.5 million in 2007 to AZN 12.0 million in 2008, or from 3.1 to 5.8 percent of the total loan portfolio. The bank reports that this change has come solely from accounting policy changes imposed by external auditors in response to the global crisis and is not a reflection of a deteriorating portfolio. The indication in the financial statements that these loans are fully collateralized by marketable real estate or 100% guarantees by AA rated banks does not provide much comfort with the effects of the US subprime crisis fresh in the minds of most analysts and investors. The bank should adjust its estimates of collateral coverage as real estate prices change. The financial statements indicate that these loans are not overdue or in arrears, but still this increase is significant

especially considering the slowing growth of the overall economy as well as the bank's major increases in lending fuelled by foreign borrowing during the past few years.

In general, term risk is not a major area for concern since most of the bank's loans (71 percent) carry terms of less than one year while most of its borrowings are in the range of three to six years. Interest rate risk is also not a major issue since the bank is borrowing at rates around 10 percent and lending at rates around 30 percent. However, looking forward to 2010, AccessBank has at least USD 43 million in principal due on its borrowings. An additional USD 128 million in principal is due in subsequent years with interest payments of USD 20 million per year. When added to the USD 43 million in principal payments over the coming year, that means that total debt service in 2010 is approximately USD 63 million. Should the bank's impaired loans deteriorate into Portfolio at Risk or worse, the bank may face cash flow challenges in 2010.

In response, AccessBank General Manager Andrew Pospelovsky explains, "We follow a very conservative liquidity and refinancing policy to ensure that we never have cash flow challenges. Today, we have over USD 60 million in liquid assets – fully covering all our principal and interest repayments over the next 12 months. We also have very good relations with our refinancing partners and have over USD 70 million in refinancing loans either signed or in process. Lastly, we now receive around USD 25 million in loan repayments every month – ensuring very strong cash flow. We take pride in the fact that throughout the crisis we have never stopped lending and our portfolio has grown every single month."

"The bank needs to follow a safe trajectory and make sure internal infrastructure keeps pace with the growth of its business," notes EBRD's Kuno. She says that the bank has been able to maintain portfolio quality in the past, even through the financial crisis, and it needs to ensure its ability to maintain that quality moving forward.

The EBRD's Fayad also notes the availability of qualified personnel as a challenge moving forward. "The best and brightest have been selected and put in senior management positions. As the bank grows, it needs to fill new positions in its ranks. Due to the rather limited availability of highly experienced bankers in Azerbaijan, the bank has focused on training and promoting from within."

As far as an exit strategy for the IFIs, EBRD says is interested in exiting its investment once the bank has matured to a suitable level. An example is KMB Bank in Russia which was sold to Italy's Banco Intesa and now has assets of more than USD 1 billion and continues to focus on small business lending.