Pakistan Microfinance Network

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MicroNOTE

UNLOCKING SYNERGIES:
A Case Study on United Bank Limited's (UBL) acquisition of Khushhali Bank Limited (KBL)

By ALI BASHARAT and AMMAR ARSHAD

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INTRODUCTION

On June 4, 2012, the acquisition process of Khushhali Bank Limited (KBL) was complete. The microfinance bank was acquired by a United Bank Limited (UBL) led consortium, which consisted of four international players, and was the first transaction of its nature in Pakistan. The sale of KBL was to become a trendsetter in the industry - the transaction caught the attention of local and international stakeholders, resulting in the acquisition of other microfinance banks (MFBs) (as per TABLE 1). Moreover, the interest generated was attestation of the fact that the microfinance industry in Pakistan had become a definite feature on the financial landscape of the country.

TABLE 1: Acquisition of MFBs recently

MFB	Acquired By	Year
Rozgar Microfinance Bank	Pakistan Telecom Mobile Limited	2012
Kashf Microfinance Bank	FINCA	2013

History

United Bank Limited (UBL) is one of the leading commercial banks in the country with an asset base of over USD 9.6 billion and 1282 branches. Founded in 1959, the bank has fostered a culture of innovation. It was the first bank in Pakistan to open an overseas branch in 1963 and to launch a credit card in 1971. The bank was nationalized in 1974 by the Government of Pakistan as part of an overall move to nationalize industry and business in the country. With a shift in policy towards financial liberalization and promotion of private sector, the government laid out a plan to privatize UBL in the 1990s. The bank was finally privatized in 2002, bought by a consortium of Bestway Group and Abu Dhabi Group.

Over the years UBL has gradually been transforming itself into a financial services group, with branches across four continents. The bank ventured into branchless banking through its 'Omni' platform in 2010. In addition, UBL has diversified into insurance and wealth management by launching UBL Insurers and UBL Fund Managers respectively.

PMN thanks its donors for their continued support

Khushhali Bank Limited (KBL) was established in the year 2000 under the Microfinance Sector Development Program (MSDP) and Poverty Reduction Strategy of Government of Pakistan. MSDP was developed under with the assistance of Asian Development Bank (ADB). KBL was the first major government initiative to bridge the demand for microfinance in the country through a regulated financial institution. However, since there was no regulatory framework for microfinance in Pakistan at the time, KBL was created and regulated by the State Bank of Pakistan under its own separate legal framework, the Khushhali Bank Ordinance 2000. The government requested leading commercial banks to contribute towards its creation, making fifteen banks as its shareholders. The bank initially operated on a community-based service delivery mechanism and formed client clusters to reduce transactional costs. However, as it expanded into urban areas KBL also started individual lending. Initially, it focused on extending micro-credit but currently provides not only lending products but also savings, remittances and insurance.

KBL remains one of the largest players in the microfinance industry in the country in terms of outreach and a branch network across the country.

Shareholders

On June 4, 2012, a consortium led by United Bank Limited and comprising ASN-NOVIB Microkredietfonds (Triple Jump B.V), Credit Suisse Microfinance Fund Management Company (ResponAbility Global Microfinance Fund), Rural impulse Fund II S.A. SICAV-FIS (Incofin Investment Management Comm, VA) and ShoreCap II Limited (Equator Capital Partners LLC) acquired 67.4% equity stake in Khushhali Bank Ltd (KBL) from a selling consortium comprising of eleven shareholders - National Bank of Pakistan, MCB Bank, Allied Bank, Standard Chartered Bank (Pakistan), Askari Bank, Citibank N.A, Habib Metropolitan Bank, Faysal Bank, KASB Bank, Silk Bank and Summit Bank sold their stakes while Habib Bank, Bank Al Habib and Soneri Bank continue to

TABLE 2: Shareholding pattern of KBL before and after its acquisiton

Shareholding pattern of KBL	2012		2011	
	Rupees	Percentage	Rupees	Percentage
United Bank Limited	506,285,280	29.7%	200,000,000	11.7%
Rural Impulse Fund II S.A. SICAV-FIS	298,496,310	17.5%	-	0.0%
ShoreCap II Limited	243,568,080	14.3%	-	0.0%
ASN-NOVIB Microkredietfonds	168,795,020	9.9%	-	0.0%
Credit Suisse Microfinance	132,855,310	7.8%	-	0.0%
Habib Bank Limited	300,000,000	17.6%	300,000,000	17.6%
Bank Al Habib Limited	30,000,000	1.8%	30,000,000	1.8%
Soneri Bank Limited	25,000,000	1.5%	25,000,000	1.5%
National Bank of Pakistan	-	0.0%	400,000,000	23.5%
MCB Bank Limited	-	0.0%	300,000,000	17.6%
Allied Bank Limited	-	0.0%	200,000,000	11.7%
Standard Chartered Bank (Pakistan) Limited	-	0.0%	80,000,000	4.7%
Askari Bank Limited	-	0.0%	50,000,000	2.9%
Citibank N.A	-	0.0%	50,000,000	2.9%
Habib Metropolitan Bank Limited	-	0.0%	25,000,000	1.5%
Faysal Bank Limited	-	0.0%	15,000,000	0.9%
KASB Bank Limited	-	0.0%	10,000,000	0.6%
Silk Bank Limited	-	0.0%	10,000,000	0.6%
Summit Bank	-	0.0%	10,000,000	0.6%
Total	1,705,000,000	100%	1,705,000,0	100%

hold their stakes in KBL. In view of the changes in the shareholding, a new microfinance banking license was issued to KBL on November 19, 2012 by SBP. Prior to the acquisition, UBL alone held 11.74% shares of KBL, whereas, the acquisition has increased the cumulative holding of UBL to 29.69%. TABLE 2 exhibits the shareholding pattern of KBL before and after the acquisition.

Governance

The consortium has reconstituted the board of directors of KBL which brings in diversified international experience in the field of microfinance, banking operations and corporate governance. Mr. Rayomond Kotwal replaced Mr. Qamar Hussain as the chairman of KBL, whereas Mr. Syed Javed, Ms. Lisa Gayle Thomas, Mr. Greet Peetermans and Mr. Erik Peter Geurts have been constituted as the new directors of the bank. Mr. Raymond (Chairman KBL) is also currently serving as the Chief Financial Officer of UBL and carries over sixteen years of rich banking experience. Mr. Raymond has formerly held the position of CFO Citigroup and CFO Citibank Pakistan. TABLE 3 highlights the change in the composition of board of directors of KBL as a result of the acquisition.

TABLE 3: Change in the composition of of BoD of KBL as a result of its acquisition

2012		2011	
Chairman/Director	Raymond H. Kotwal	**Chairman**	Qamar Hussain
President/Director	Ghalib Nishtar	**President**	Ghalib Nishtar
Director	Zakir Mehmood	**Director**	Zakir Mehmood
Director	Syed Javed	**Director**	M.R Mehkari
Director	Lisa Gayle Thomas	**Director**	M.U.A Usmani
Director	Geert Peetermans	**Director**	Rashid Akhtar Chugtai
Director	Erik Peter Geurts		

Board Committees

With the change in board of directors, two additional board committees have been formulated in addition to the audit committee – Human Resource & Compensation Committee and Risk Management & Credit Committee (TABLE 4).

TABLE 4: Change in the Board Committees of KBL as a result of its acquisition

2012	2011
Human Resource & Compensation Committee	N/A
Risk Management & Credit Committee	N/A
Audit Committee	Audit Committee

It is important to note here that the introduction of new board committees (Human Resource & Compensation Committee and Risk Management & Credit Committee) by the reconstituted board highlights the boards desire to strengthen the organization by means of an improved governance structure. Prior to the acquisition, the board had only set up an audit committee, which is a statutory requirement, while no emphasis was given to the development of other committees.

The formation of Human Resource & Compensation Committee depicts the board's interest towards development of staff capabilities. The primary goal of the Committee is to design and oversee initiatives in the organization that foster executive and employee development and retention, with emphasis on leadership development, management capabilities and succession plans. Likewise, the Risk Management & Credit Committee has been set up to assist the board in assessing the different types of risks to which KBL is exposed. The committee oversees the organizations risk management infrastructure and advises the board on strategies to counter potential risks. The chair of the Risk Management & Credit Committee, Mr. Syed Javed, is also serving as a Senior Executive Vice President at UBL and is heading the strategic business planning division of UBL.

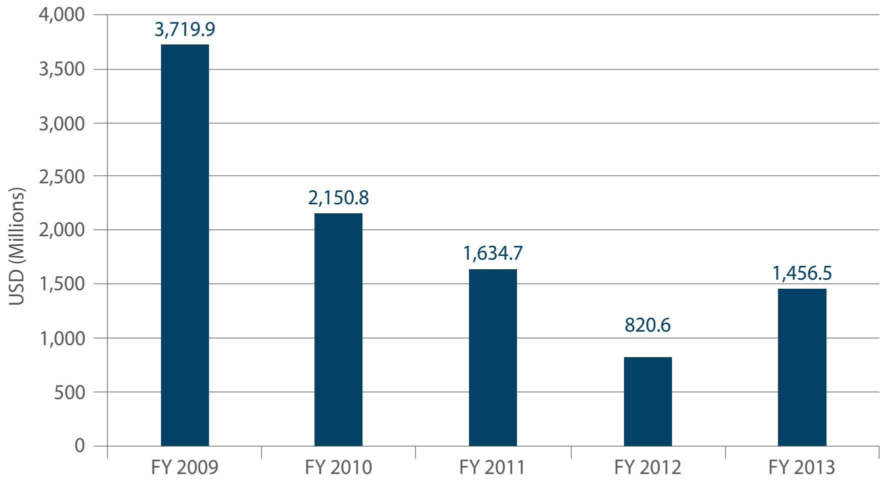
The new board has also transformed the composition of the audit committee – Mr. Geert Peetermans has replaced Mr. M. R. Mehkari as the chairman of the audit committee. Mr. Mehkari had carried with him more than forty years of experience in domestic and international banking and was the former president of Askari Bank Limited. The current chairman of the audit committee, Mr. Geert, is a graduate from Harvard Business School and currently holds the position of chief investment officer at Incofin Investment Management.

MOTIVATION OF CONSORTIUM

As mentioned earlier, the consortium led by UBL consists of four renowned international players; Triple Jump B.V, Credit Suisse Microfinance, Incofin Investment Management and Equator Capital Partners LLC. In order to bring the aforementioned players together, ShoreBank International (hired as a financial advisor for the deal) had facilitated UBL in developing linkages among the consortium partners.

It is pertinent to mention here that the foreign investors were willing to invest in Pakistan at a time when total foreign direct investment (FDI) had declined to its lowest (in fiscal year 2012) as exhibited in EXHIBIT 1. Despite the deteriorating macroeconomic situation of Pakistan, which hampered the flow of foreign investment into the country, the following favorable factors had encouraged the international players to be a part of the consortium and hence, invest in Pakistan:

EXHIBIT 1: Foreign direct investment



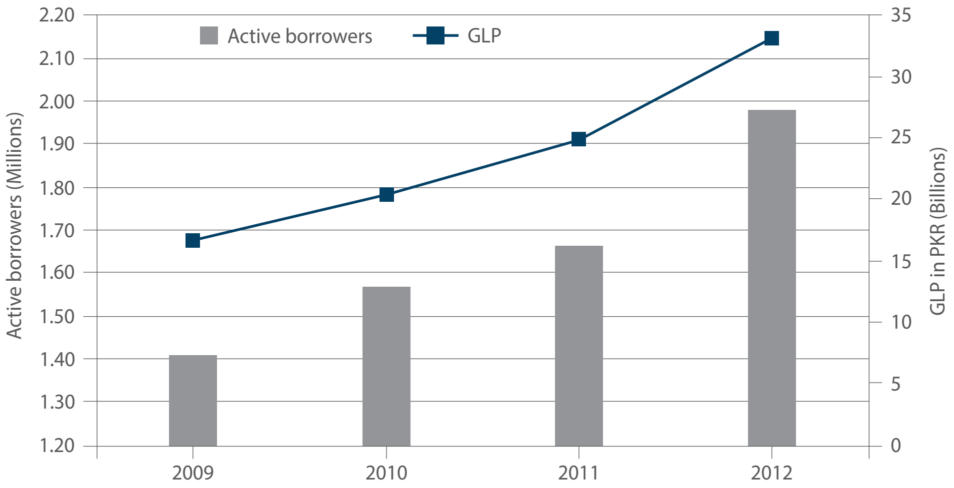
Source: *State Bank of Pakistan*

I. Growth in the Microfinance Sector

The Pakistan microfinance sector has been growing significantly over the last couple of years – from the period 2009 to 2012, the number of active borrowers grew by 40%, whereas, the total gross loan portfolio (GLP) witnessed a staggering growth of 98% (EXHIBIT 2). The growth in the sector came on the back of various initiatives and developments; primarily due to the entrance of new players, branchless banking initiatives, product innovation and access to guarantee funds (MCGF and PRISM). These developments have stimulated growth by enhancing the outreach and penetrating deeper into existing markets.

However, having said this, the penetration rate of the microfinance sector stood at only 9%[1] by the end of 2012 – depicting potential for further growth in the sector.

EXHIBIT 2: Growth in number of active borrowers and GLP



Source: *Pakistan Microfinance Review*

II. Financial Inclusion

The financial sector in Pakistan remains highly restricted in its outreach, both, in terms of its depth and breadth. According to the Access to Finance Study of 2008[2], around 11 percent of the total population has access to a formal banking account and another 32 percent are informally served, whereas 56 percent of the adult population is totally excluded from the financial sector. The provinces of Baluchistan and Khyber-Pakhtunkhwa were found to be the most financially excluded with 84 percent and 60 percent respectively.

Keeping the aforementioned in view, immense opportunities exist to expand the financial services market in order to tap the unbanked and the underserved financial segment. Microfinance can play a major role in bridging the financial exclusion gap in the county by introducing a range of products (credit, savings and insurance) with innovative delivery channels (branchless banking).

III. Regulatory Environment

Pakistan's regulatory environment and regulatory framework for microfinance industry, continues to be recognized as one of the best globally. The Economist's Global Microscope on Microfinance Business Environment continues to rank Pakistan's legal and regulatory framework among the top 3 in the world and considers Pakistan as having one of the most enabling business environment for microfinance regionally and globally.

The report "Global Microscope on Microfinance Business Environment" highlights SBPs attempts to support the growth of the industry, while maintaining its stability. It commends the regulatory framework which allows MFBs to extend a range of microfinance services to poor and low-income customers through various arrangements, including mobilizing deposits. However, at the same time, the prudential regulations drafted for MFBs ensure that the institutions do not put consumers' money at risk and function with strength and stability.

Currently, only MFBs are regulated and supervised by the State Bank of Pakistan (SBP), whereas, Microfinance Institutes (MFI) and Rural Support Programs (RSPs) are not supervised by any regulatory body. However, the Pakistan Microfinance Network

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[1] The potential microfinance market is estimated to be approximately 27 million as per the PMN publication "Microwatch". As of December 2012, total active borrowers stood at 2.4 million which is approximately 9% of the potential market.

[2] The Access to Finance Survey (A2FS) was conducted in 2007/08 to capture the formal and informal financial services being provided in Pakistan. It was the first study of its kind in Pakistan which provides qualitative insights and empirical data covering over 10,000 respondents from the urban and rural areas of all the four provinces.

(PMN) is working closely with Securities and Exchange Commission of Pakistan (SECP), with the objective of developing a regulatory framework for the non-bank MFPs.

IV. Khushhali Bank Limited

Khushhali Bank is one of the largest microfinance providers in Pakistan, currently operating across 92 districts with a branch network of 110. During the period of the acquisition, KBL had a market share (active borrowers) of approximately 19% (highest in the industry) making it an attractive investment venture. The dominance in outreach is supported by sound financials of the Bank – its balance sheet stands at PKR 10 billion and has been in profit since 2005 (as highlighted in the Performance Evaluation section).

As mentioned earlier, KBL was the first licensed microfinance bank established in Pakistan (in the year 2000). Operating in the sector for more than a decade, KBL has developed a strong presence on the ground with a well-recognized brand name. The vast experience of the microfinance bank in the sector, coupled with an established brand name, encouraged the consortium to invest in KBL rather than initiating a greenfield investment.

V. United Bank Limited

As highlighted earlier in the report, UBL is one of the leading commercial banks in Pakistan with an international presence in more than ten countries – the global depository receipts (GDRs) of UBL are also listed on the London Stock Exchange.

Being part of a consortium that is led by a financially strong institution with impressive international credentials gave confidence to the participating institutions. The international players were also aware of the fact that UBL's interest in the acquisition is part of a long term strategy and the bank increased its shareholding as as strategic move and not just for short term benefits.

An organization of the scale of UBL has the technical and financial capacity to support and uplift the performance of KBL. UBLs existing experience of the credit market, especially in the agricultural sector, can be leveraged to provide managerial expertise to KBL in order to support their operations.

SYNERGIES

The acquisition of KBL was more than just another revenue stream for UBL; the synergetic values attached to the acquisition are highly significant and were the driving force behind the acquisition. As per definition, the word synergy can be defined as *the concept that the value and performance of two companies combined will be greater than the sum of the separate individual part*. Keeping this in view, both organizations are expected to capitalize on the potential synergies, which in turn, will have a positive impact on the financial results of KBL and UBL. Based on the organizational structures and business models, UBL and KBL are expected to benefit from the following synergies:

I. New Market Segment

During the period of the acquisition (the third quarter of 2012), KBL was catering to approximately 465,000 micro borrowers – making it the highest market share holder (19%) in terms of borrowers. This was achieved through a branch network of 107 branches in over 70 districts across Pakistan. Keeping this in view, the ownership of KBL has provided UBL access to a major chunk of the microfinance market. Prior to the deal, UBL's asset portfolio did not accommodate this lower end of the credit market, hence making it an entirely new segment for the commercial bank and preventing any overlapping of market segments.

II. Platform for OMNI

UBL was the first commercial bank in Pakistan to launch its branchless banking service, UBL Omni in 2010. Since its inception, UBL Omni has built a reputation as one of the pioneering players of Pakistan's branchless banking sector. In Pakistan, the conventional banking sector serves less than 20% of the population. It is with this in mind that UBL developed Omni, to provide basic banking services to the masses through retail agents. Unlike its predecessor, Easypaisa (a product of Telenor and Tameer Bank), UBL Omni is an in-house product, solely owned by UBL.

Omni is involved in providing a vast range of services which include G2P disbursements, loan repayments, corporate cash collections, salary disbursements, money transfer and bill payment services. It also facilitates government and international donor agencies for cash grant disbursements for the underprivileged segment.

As mentioned earlier, the acquisition of KBL has paved way for UBL to enter the microfinance segment, and with the branchless banking platform already in hand, UBL can leverage the client base of KBL to provide credit and deposit financial services to an entirely new segment of the unbanked and under banked market. The provision of credit and deposit products via Omni platform will decrease the transaction costs of KBL, as well as, enhance outreach with minimum additional costs. A number of MFBs have adopted branchless banking systems by teaming up with MNO's to expand into this field.

UBL Omni platform provided an ideal match for KBL to expand into branchless banking arena at a fraction of cost. Moreover, in house technology platforms and software developed by UBL can be utilized by KBL to upgrade their ERP and MIS.

III. Ownership and Governance

KBL was formed with leading commercial banks being its main shareholders but lacked a majority shareholder. The stake of these individual institutions was insignificant and so was the return on their investment. This resulted in a fragmented and disinterested ownership. In addition, none of the shareholders had any expertise relating to either the microfinance industry or had any interest in expanding into this particular market segment.

Acquisition by the UBL led consortium has provided KBL with not just strong and focused governance but also with expertise related to microfinance though microfinance investment funds which are part of the consortium.

Also, with financially strong owners, KBL will not just have easier access to funds in the future but it also provides the institution with a financial cushion[3]. Losses arising due to natural disasters point towards the need for financially strong parent organizations that can provide a financial cushion in such times.

PERFORMANCE EVALUATION

During fiscal year 2012, the bank continued to strengthen its balance sheet and income statement, while at the same time, sustaining remarkable growth in outreach. A change in board of directors of any organization has an impact on the overall performance of an organization; however, it is still too early to relate the current financial standing of KBL entirely on this transformation. As stated earlier, the new board carries extensive international experience in the fields of microfinance and banking, and the impact of the board's managerial expertise on financial performance will be

[3] In the absence of any sector level mechanism to cover losses from natural calamities or security related incidents, a financially strong parent organization can provide a financial cushion to microfinance organizations that work with vulnerable communities.

more evident by fiscal year 2013.

Nevertheless, the new board – during the seven months of ownership (Jun 12 – Dec 12) – has successfully maintained KBLs positive performance, showing growth on all fronts. TABLE 5 shows the performance of key indicators for the years 2011 and 2012.

TABLE 5: Performance of key indicators for the years 2011 and 2012

Indicators		2012	2011	% Change
Outreach				
Active Clients	Number	458,612	352,962	29.9%
Active Borrowers	Number	364,138	352,962	3.2%
Gross Loan Portfolio	PKR Millions	5,806	4,274	35.8%
Deposits	PKR Millions	4,041	1,677	141.0%
Financial Performance				
Total Revenue	PKR Millions	1,926	1,542	24.9%
Operating profit/(loss)	PKR Millions	(39)	(46)	15.2%
Profit after Tax	PKR Millions	168	152	10.5%
Investments	PKR Millions	1,044	945	10.5%
Total Assets	PKR Millions	9,954	8,221	21.1%
Borrowings	PKR Millions	3,010	3,958	-24.0%
Portfolio at Risk > 30	%	1.1%	4.4%	

Financial Performance

In the year under review, KBL's net income from loan portfolio increased by 12% to reach PKR 1,146 M (EXHIBIT 3). The increase in fund based income was driven by growth in outreach, which in turn, gave rise to advances. More than 70% of KBL's total revenue is generated from interest income on loan portfolio while the remaining portion is generated from non-markup income – which primarily comprises of Fee & Commission income and Subsidies & Grants. The contribution of non-markup income to total income has increased significantly over the last year – by 55 % (EXHIBIT 4). This increase was driven by Fee & Commission income (which has been increasing in line with the loan portfolio) and recoveries, amounting to PKR 179 M, made against bad loans written off in earlier periods.

EXHIBIT 3: Net interest income

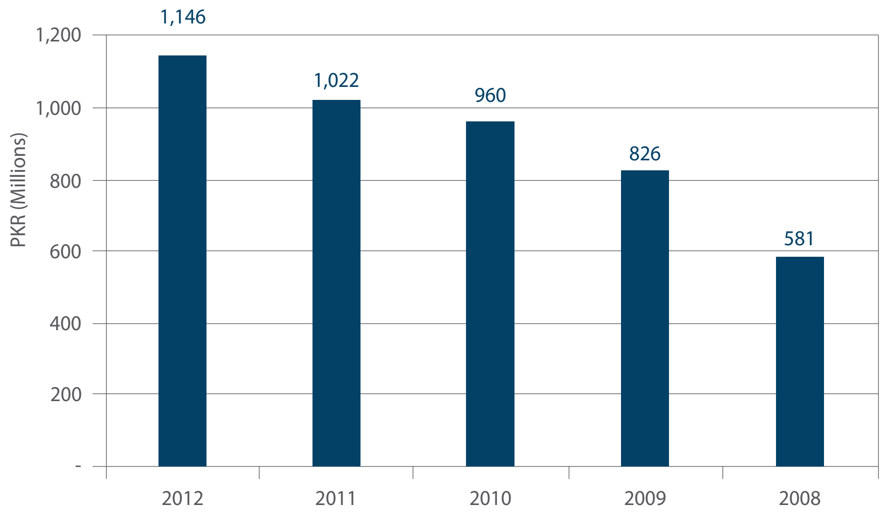
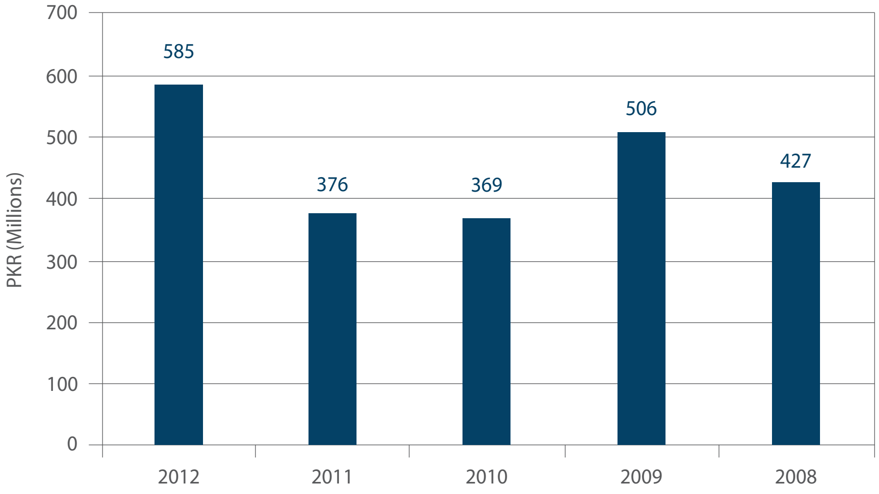


EXHIBIT 4: Non-interest income



On the expense side, KBLs non-interest expense witnessed a considerable increase of 18% in the year under review (EXHIBIT 5). This was primarily due to an increase in the salaries and benefits of permanent and contractual employees (207 new employees were added during the year). During the year, KBL also increased its marketing activities which had an impact on advertisement expenses. After accounting for the expenses, KBL closed its books with a profit after tax of PKR 168 M – an increase of 11% from previous year (EXHIBIT 6). The percentage growth in the net profit came on the back of improved interest based and non-interest based income generated in the year.

EXHIBIT 5: Non-interest expense

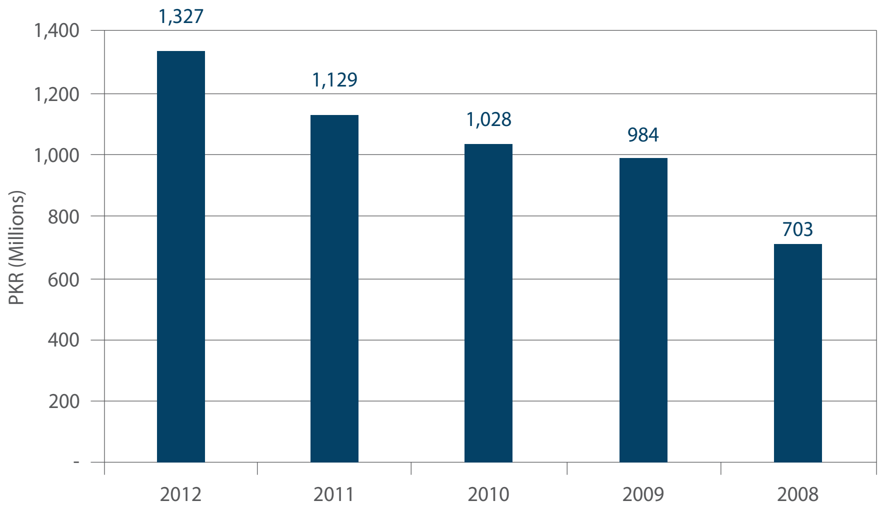
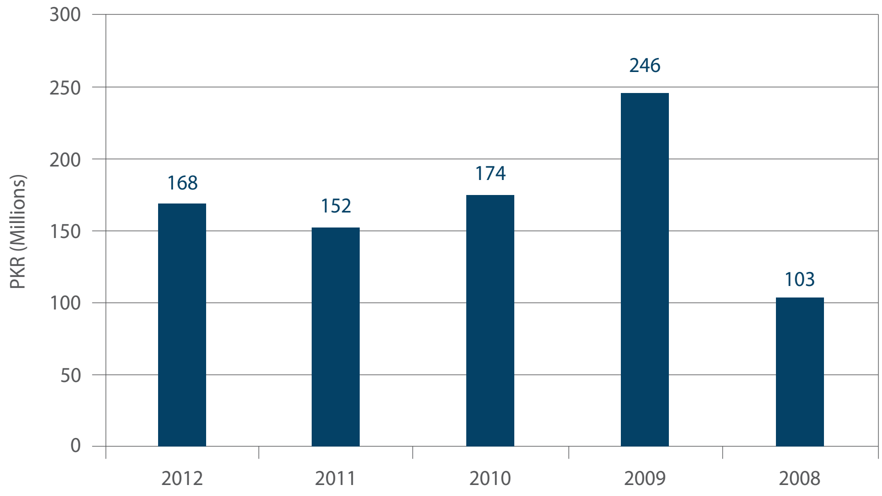


EXHIBIT 6: Profit after tax



The total assets of the company saw an increase of 21% in the current year to touch PKR 10 billion. The growth in assets was driven by an increase in the bank's core activity, advances, which saw an increase of 35% (EXHIBIT 7). During the year, KBL introduced its first secured loan product which attracted advances of worth PKR 670 million. KBL also witnessed an improvement in its liquid assets with an increase in investments in T-bills and cash balance with local banks. On the liabilities side, the deposits of KBL grew by a staggering 141% from PKR 1,677 million to PKR 4,041 million (EXHIBIT 8). The increase in the value of deposits was due to an increase in individual depositors from 300,762 in 2011 to 457,617 in 2012.

EXHIBIT 7: Assets

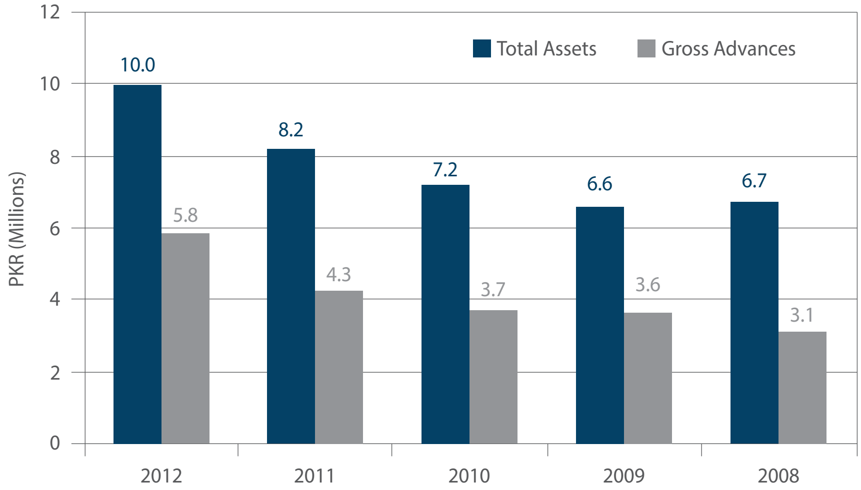
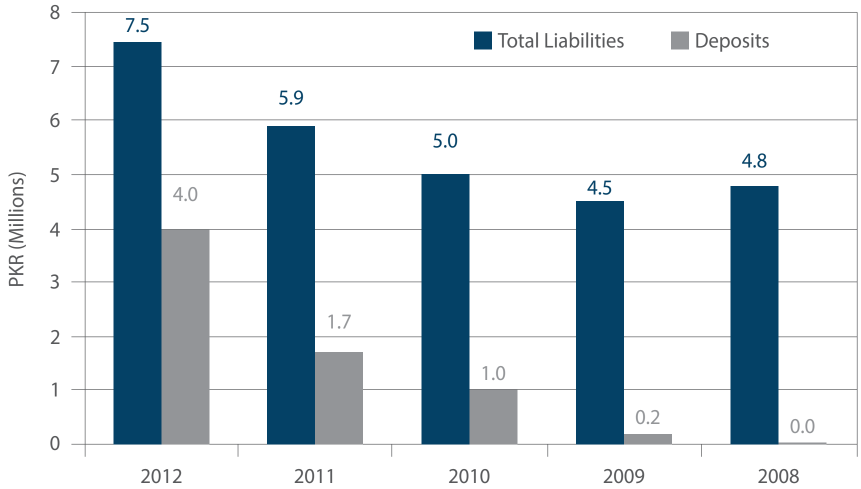


EXHIBIT 8: Liabilities



CONCLUSION

The acquisition of KBL was the first ever transaction in the sector involving a commercial bank which has expanded its horizons into the microfinance segment and hence, the double bottom line industry. A question that arises at this point is why did UBL acquire a microfinance bank instead of establishing its own microfinance department? One reason is that the outright acquisition of a microfinance bank, as in the case of UBL acquiring KBL, resulted in cost savings for the acquirer which would have otherwise not been possible in case of establishing a MFB from scratch. In order to move down the market to cater the microfinance clientage, it would have been necessary for UBL to establish separate functions and develop expertise in those areas since it represents an entirely new market segment.

Additionally, it would have been financially unfeasible to set up a microfinance unit as the revenues generated would have just been a tiny fraction of the bank's overall revenue and in turn would have required huge outlays in the form of human resource and infrastructure. In fact, the profit generated by KBL in 2012 (PKR 150 M) equals to a fraction of UBL's net income.

Adding on to the answer, KBL already had a well-developed infrastructure, an unparalleled branch network and an outreach across the country especially in the rural areas. Hence, it made much more sense to acquire KBL rather spending money and time on establishing a separate unit.

Having said this, another question that emerges is whether such acquisitions are beneficial for the Pakistan microfinance sector? As noted earlier in the study, the acquisition of KBL has given rise to significant synergetic values which provide an ideal platform to expand the microfinance outreach and cater to the under banked in a cost efficient manner. There is a huge unmet demand in the market for microfinance with enormous potential for growth and expansion. Moreover, with the dismal state of access to finance in the country, microfinance providers are ideally suited to reach out to the unbanked areas of the country.

The UBL led consortium can play a vital role in expanding KBL's existing outreach, by improving the governance structure, rolling out new business models and leveraging modern technologies to achieve scale and efficiency in distribution. The inclusion of international players has also paved way for knowledge transfer in terms of international expertise and best practices – the board of KBL mostly comprises of representatives of the international funds which carry extensive experience in microfinance.

In the end, we can conclude that such initiatives are crucial for the sector as long as the organizations can capitalize on the synergies which in turn will help foster innovation in products, technologies and management. It should also be noted that the business models of the MFBs have evolved over the years and have become sustainable. As a result, commercial investors can expect to generate positive financial, as well as, social returns by investing in microfinance banks.

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