MicroRating International

rating of a microfinance bank

JSC "Bank Constanta"

Joint Stock Company, first rating

Tbilisi, Georgia

Report, June 2008

Contacts

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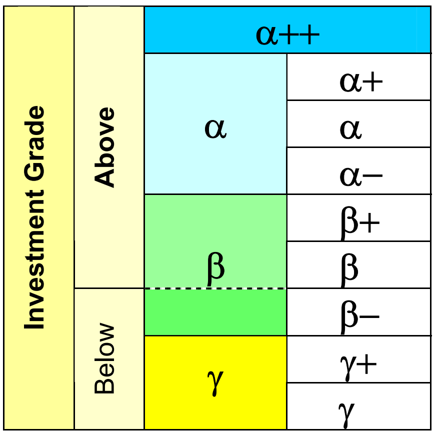
CREDIT RATING	β+
RATING OUTLOOK*	*neutral***

*M-CRIL's viewpoint (positive, neutral or negative) of the future prospects of the organisation
** The present uncertain political and military situation makes the outlook neutral

Date of visit **23-27 June 2008**



Main Performance Indicators

	Dec-06	Dec-07
Gross Portfolio (GEL million.)	34.7	42.9
(US$ million)	24.5	30.2
Number of active borrowers	19,621	14,653
RoA	2.2%	-2.5%
Portfolio yield	37.5%	33.8%
Portfolio at $Risk_{30}$	0.6%	0.4%
Operating expense ratio	26.4%	30.3%
Average loan o/s (GEL)	1,783	2,960
Borrowers per field staff	166	100

US$1= GEL1.42 (2006 and 2007)

Synopsis

Constanta – a Joint Stock Company – has more than a decade's experience and has adapted well to the changing market scenarios with the help of a professional and experienced Board, management and staff. Its transformation to a bank is a good step in this direction. However, its margins have reduced on account of a shift in its strategy in order to cope with fierce competition and due to increased expenses to prepare it for operation as a bank. The low staff productivity is also a cause of concern.

The bigger challenge that Constanta faces now is the high country risk resulting from the Russian invasion which could not only have an adverse impact on its fund mobilisation plans but also affect its portfolio quality due the enormous damage to life and property in Georgia.

In M-CRIL's view, on account of having received a banking license and having a comfortable capital adequacy position, Constanta can absorb significant loan funds from commercial sources for on-lending to its borrowers if peace returns to Georgia in the near future.

A rating update after one year is suggested to ascertain changes in the creditworthiness and absorptive potential of the institution. This rating is valid, subject to no other substantial inflows of loan funds into the organisation beyond the limits specified here and to no other significant changes in the organisational structure and external operating environment.

Highlights

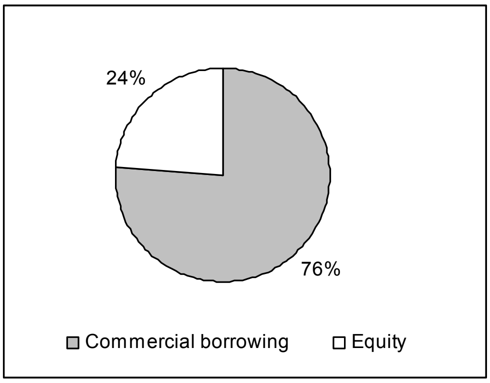
Positive

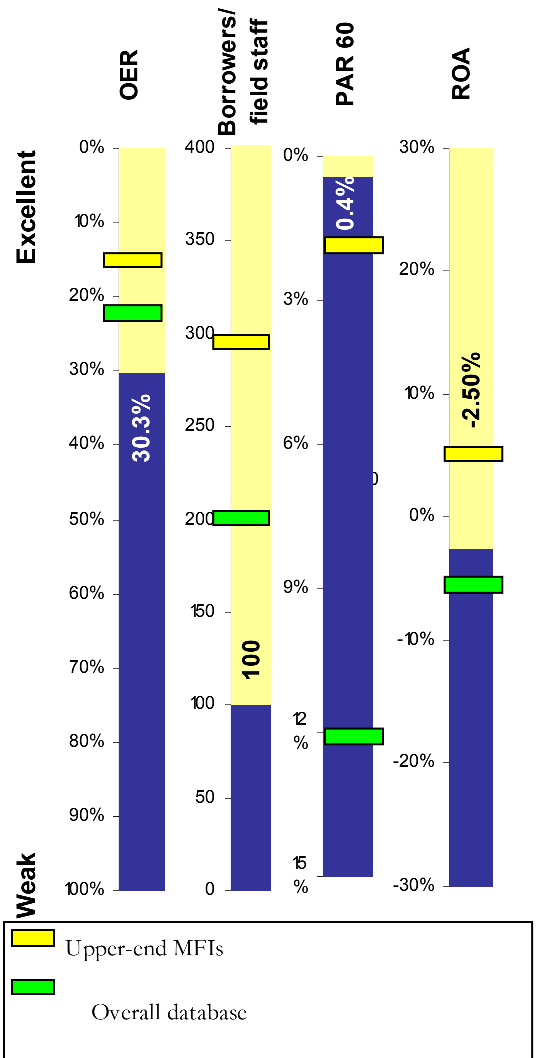
- Transformation to a bank
- Strong second line and staff
- Strong internal audit and control systems
- Good portfolio quality

Negative

- High country risk
- Stiff competition
- Small board
- Paucity of funds
- Low staff productivity
- Reducing margins

Sources of Funding





Note: Constanta figures as on 31st December 2007.

Comparison of Constanta's performance with MFIs rated by M-CRIL

Rating Rationale

Transformation of legal entity: The banking license will enable Constanta to widen the spectrum of its operations and products and provide it with a comparative advantage vis-a-vis MFOs. Yet, Constanta faces the serious challenge of adjusting to the regulatory and reporting requirements of its new institutional form.

Strong second line and professional staff: The second line of management has a professional background with relevant experience and staff at all levels is qualified and experienced.

Strong internal control and audit mechanism: A strong internal control environment is maintained by way of reports, loan utilisation and collateral checks and visits by supervisory staff and the internal audit team.

Good portfolio quality: Constanta has maintained good portfolio quality. However the considerable damage to life and property occurring in recent weeks poses a huge risk to portfolio quality and dilutes the risk mitigating collateral requirements of the bank.

Small Board: Constanta has a highly experienced and professional Board though it is quite small. Adding more members from diverse professional backgrounds would be a benefit.

Stiff competition: Constanta faces stiff competition from various MFOs and banks operating in Georgia and had to change its strategy in the past to cope with competition. Being a new entrant in the banking sector, it now faces tough competition from banks with respect to non-loan products as well.

Country risk: Despite a wide base of lenders, Constanta experienced a major fund shortage in 2008 on account of a high risk perception, unstable political environment in the country and uncertainty regarding the transformation process leading to a downward revision in its business plan. This has been aggravated recently by the conflict with Russia.

Low staff productivity: Staff productivity is declining and has reached very low levels. Consequently, a lot of non-performing staff were fired in 2007 and 2008.

Reducing margins: Operating margins have been reducing due to lowering yield on account of discontinuation of the group loan product and increasing costs on account of increasing salaries and renovation of branches. Since most of the expenses related to the transformation process have already been incurred, margins are expected to improve now with lower OER.

Performance Highlights

Rating Grades

Category	Rating grade
Governance & strategic positioning	β+
Organisation & Management	α–
Financial performance	β
Overall	β+

Select indicators/ratios

Main Indicators	31 Dec-04	31 Dec-05	31 Dec-06	31 Dec-07	30 June-08
Gross Loan Portfolio (GEL million)	9.9	14.1	34.7	42.9	54.1
(US$ million)	7.0	9.9	24.5	30.2	38.1
Number of Active Borrowers	18,657	16,578	19,621	14,653	14,037
Risk Weighted Capital Adequacy ratio	100.5%	67.3%	36.4%	30.0%	19.9%
Asset Quality					
Portfolio at Risk (>30 days)/Gross Loan Port.	19.4%	1.3%	0.6%	0.4%	0.3%
Loan Loss Reserve/Gross Portfolio	15.6%	2.9%	2.7%	2.0%	2.1%
Efficiency and Productivity					
Operating Expenses/Avg. Gross Loan Portfolio*	52.7%	43.7%	26.4%	30.3%	26.3%
Cost per Borrower (GEL)*	221	274	302	769	916
Average Outstanding Loan Size (GEL)	533	969	1,783	2,960	3,856
(US$)	375	682	1,256	2,084	2,715
Number of Borrowers/Field staff	225	207	166	100	108
/Total staff	81	69	73	42	41

*: Ratios for June 2008 is calculated on the basis of unaudited statements and annualised where ever required.
Exchange rate: US$1=GEL1.42 for all the years

Country overview

Georgia is a small transition economy sharing borders with Russia, Azerbaijan, Armenia and Turkey. Georgia is divided into 9 regions and has 69 districts. Georgians form 83.8% of the current population of which 51% is urban.

Indicators	2004	2005	2006	2007	2008
Population (in million)	4.31	4.32	4.40	4.37	4.33
GDP growth, %	5.8	9.6	9.3	12.4	9.0
Inflation, % (year end)	4.8	5.5	8.2	10.0	11.0
Current account balance, % GDP	-8.9	-11.9	-15.9	-19.7	-16.6
Balance of trade (US$ billion)	-1.2	-1.6	-2.7	-3.9	N.A
Exchange rate (US$/GEL)	1.9	1.8	1.7	1.6	1.4

Georgia has a history of wars, invasions and political instability. Shortly before the collapse of USSR, Georgia declared independence and elected its first president who was deposed within a year. This was followed by civil unrest until 1995. At the same time, two regions of Georgia, Abkhazia and South Ossetia, quickly became embroiled in disputes with local separatists. Georgian politics has always witnessed political upheavals including allegations of ballot fraud on the Parliament in 2003, the unnatural death of the Prime Minister due to apparent gas leak in 2005, resignation of the President on charges of corruption and of the Prime Minister due to poor health conditions in 2007. The country had both Parliament and Presidential elections in 2008.

Presently Georgia maintains diplomatic relations with Azerbaijan, Armenia and Turkey; however an increasing alliance of Georgia with the US and EU in its effort to become a full member of NATO has strained Georgia's relations with Russia. The tension escalated well beyond the dispute over South Ossetia leading to invasion by Russia in August 2008 resulting in widespread loss of life and property in Georgia. A NATO meeting in September 2008 will be seen as a crucial test of the West's resolve to confront Russia's drive to extend its influence in the former Soviet Republics including Georgia.

Since the fall of the USSR, Georgia embarked on a major structural reform designed to transition to a free market economy. However, under the impact of civil wars and the loss of both preferential access to former Soviet Union markets and large budget transfers, output fell by 70% and exports by 90%. The World Bank and the International Monetary Fund were the first ones to offer financial help by granting a credit of US$206 million in 1995.

Since the early 2000s some visible positive developments have been observed in the Georgian economy. In 2006, real GDP growth rate reached 9.3%, making it one of the fastest growing economies in Eastern Europe. Georgia's ranking improved from 112th to 18th in 2008 in terms of ease of doing business. However, the country is still battling with a high unemployment rate and has fairly low median income compared to European countries.

Due to the country's climate and topography, agriculture and tourism have been the principal sectors of the economy. However agriculture is now replaced by services which form 54.8% of GDP, while the share of agriculture is currently 17.7% of GDP. Its imports and exports accounted for 10% and 18% of GDP respectively in 2006. Georgia is developing into an international transport and oil pipeline corridor on account of its strategic location. However tensions with Russia have led to an economic embargo and simultaneous discontinuation of financial links which acts as a major external impediment for Georgia's economy.

The economic collapse and increasing unemployment post-dissolution has resulted in citizens engaging increasingly in micro and small business activities. In 2006, the micro business sector grew by 55%. This subsequently created a market for the emerging microfinance (MF) industry. Until recently the Georgian MF sector was dominated by several non-profit MFOs (Microfinance Organisation). Constanta was the leader having a 43.1% share in terms of volume followed by FINCA (22.5%) in December 2007 ahead of Credo, JSC MFO Crystal and Lazika Capital. In September 2007, the Georgian commercial banking sector had 19 banks with total assets of GEL6.7 billion (US$4.7 billion).

The potential of the MSME sector as well as growing demand led to commercial banks pursuing a downscaling strategy. ProCredit Bank, especially established to serve this sector, leads the MF market with a share of 45% followed by the Bank of Georgia (26%). Other players include TBC Bank, VTB and Bank Republic.

In July 2006, the Government of Georgia framed a special law on MFOs which provided the NGO MFOs a much needed legal framework. The law required all existing MFOs to be registered at the National Bank of Georgia to transform either into a joint stock or a limited liability company until the end of 2007.

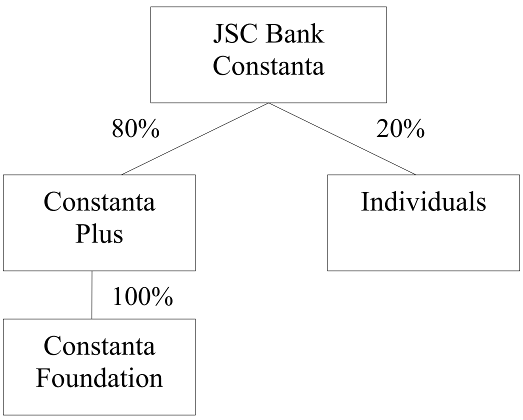
Competition in the Georgian microfinance sector is expected to be fiercer in future. However, the latest events, the Russian invasion as well as the worsening situation in world financial markets could result in higher risks for the Georgian financial sector as well as limited resources for Georgian banks which would slow down current market growth despite huge demand.

Sources
www.worldbank.org
www.indexmundi.com/georgia
CIA World Factbook
World Economic Outlook Database 2008

Organisation Profile

JSC Bank Constanta (henceforth called Constanta) was promoted in October 1997 by Ms Tamar Lebanidze as Constanta Foundation, a not-for-profit organisation, to provide high quality microfinance services to micro and small businesses. The foundation started its operations with grant support from UNHCR through the Save the Children Fund, which was later supplemented by grant funding from USAID. Since then, Constanta Foundation has been associated with CARE, USAID, CGAP, Mercy Corps and DFID for various projects involving the provision of micro-loans to farm and off-farm businesses.

In order to comply with the requirement of the Law on Microfinance Organisations in Georgia which was adopted in July 2006 and amended in July 2007, Constanta started its operations as a Joint Stock Company (JSC) and transferred these to the newly established company by 31 December 2007. However as the law did not permit NGOs to be directly involved in any entrepreneurial activity, Constanta Plus, a limited liability company was formed. LLC Constanta Plus is a 100% subsidiary of Constanta Foundation and owns 80% of the shares of JSC Constanta. The remaining 20% of shares are owned by 7 individuals including the management and Board members of Constanta Foundation. The organization was subject to Civil Code and tax regulations until June 2008. Since receiving the bank licence from the National Bank of Georgia in July 2008, it is also subject to banking supervision.



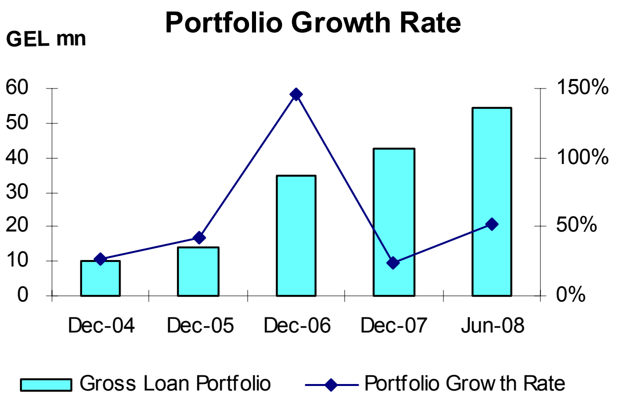
Constanta serves more than 14,000 clients with the credit portfolio exceeding GEL50 million in June 2008. All of its branches are located in cities; but its operations extend to semi-urban and rural areas also. Currently, Constanta operates through 21 branches in the Adjara, Shida Kartli, Kakheti, Imereti, Samegrelo, Kvemo kartli and Samtskhe Javakheti regions of Georgia. Six of these branches are located in Tbilisi, the capital city.

● Existing branches of Constanta

Constanta started micro-credit with lending to groups in urban areas. It diversified to individual lending at the end of 2001 in order to imitate the lending methodology of ProCredit Bank, the first commercial bank and a microfinance market leader. In 2003, the organisation expanded its operations in rural areas when it launched an agricultural product. In addition to the wide range of loan products, Constanta also provides foreign exchange facilities; this is the only non-loan product so far.

The highest authority of Constanta is the Shareholders Meeting which appoints the members of the Supervisory Board. Constanta is governed by a three member supervisory Board consisting of Tamar Lebanidze, also Executive Director (ED) of the Association of Georgian Microfinance institutions (AGMO), Giorgi Loladze, Chairman of the Georgian stock exchange and Murtaz Kikoria, an ex-senior banker at EBRD. The management is led by the General Director of the JSC who joined as Program Manager in 2000 and became ED in 2004. He supervises the functioning of the key departments including Marketing, HR, IT, Legal, Management Support. The departments supervise the work of smaller units called Divisions. The General Director and Director for Operations and Finance form the Executive Board. The heads of department with the Executive Board form the Management Board which meets weekly to discuss current issues and results. Each branch is staffed by Loan Officers (LO), Loan Managers (LM), and Cashier and is headed by a Branch Director who reports to the Executive Board. The Loan Managers report to the Branch Director. The total staff strength of Constanta is 344 out of which 95 are based in the head office (HO).

Constanta's growth has been impressive in view of the stiff competition in the country. As the figure below shows, Constanta's portfolio shot up by 146% in 2006 to roughly GEL35 million (US$24.6 million) due to increased focus on individual lending rather than group lending. As shown in the figure below, in the subsequent year its growth slowed down and the portfolio was GEL50 million (US$35.2 million) in December 2007 and GEL54 million (US$38.0 million) in June 2008. Growth has been restricted due to the inadequate mobilisation of funds. In the future also, growth in Constanta's portfolio is likely largely to depend on its capacity to attract funds.



Constanta's client numbers have decreased since 2005 except in 2006 when they increased by 18.3% to 19,621 clients. The decline in client numbers can be attributed to the shift of Constanta's group clients to become individual loan clients of competing banks. In order to retain its clients, the organisation introduced an 'express loan' in July 2007 which arrested the decline. It improved from -25.3% in December 2007 to -4.2% in June 2008. The number of borrowers is expected to rise as additional products are offered as a result of the banking licence.

Microfinance policies

Constanta lends to both women and men. Locations and areas are identified on the basis of market studies. Attractive markets are those with unmet demand or those partly covered by other microfinance service providers. The Loan Officer verifies the business of the applicant and then collects documents like profit and loss account, balance sheet and cash flow. Detailed cash flow analysis may be required only in cases of higher loan size or seasonal loans. This is followed by valuation and appraisal of collateral by the Branch Manager and Loan Manager who have sanctioning authority for loans up to GEL20,000 (US$14,085). Applications for larger loans are forwarded to the credit committee at the HO for approval. The disbursements are made in cash at the branch. The process of loan application to disbursement takes 2-15 days. Repayment is on a monthly basis and is in cash at the branches.

Loan products

Constanta has a wide array of loan products. It started by offering group loans as its first loan product in 1997. However, in recent years competitors started offering individual loans without any collateral to the group clients of the Constanta. Consequently, Constanta introduced express loan/fast loan and have now discontinued group loans.

Product Category	Amount (30 June 2008)		Share of Portfolio	
	GEL million	US$ million	31 Dec 2007	30 June 2008
Group loan	0.29	0.20	6.8%	0.5%
Individual loan (old)	1.33	0.93	17.3%	2.5%
Express loan	29.59	20.84	41.5%	54.7%
Business loan	12.28	8.64	20.3%	22.7%
Agro loan	6.00	4.22	8.2%	11.1%
Seasonal loan	0.63	0.45	1.0%	1.2%
Family loan	0.19	0.13	0.3%	0.4%
Parallel loan	0.25	0.18	0.3%	0.5%
Consumer loan	0.35	0.25	0.0%	0.7%
Staff loan	3.15	2.22	4.4%	5.8%
Total Portfolio	**54.12**	**38.11**	**100%**	**100%**

Exchange rate: US$1=GEL1.42

As the above table shows, the share of the express loan product is growing and increased from 41.5% in December 2007 to 54.7% in June 2008 with a related decrease in the share of the group loan product from 6.8% to 0.5% over this period. The share of the old individual product has also considerably reduced since it has been discontinued.

Express loan: This type of loan is disbursed to owners of micro and small enterprises with at least three months of business experience and who urgently need unsecured funds to expand their business activities. Express loans are intended to increase working capital or purchase fixed assets and ranges from GEL100 to 10,000 or US$50 to $6,000. For a loan up to GEL6,000 and US$3,500 no collateral is required. Third party guarantees are required for loans of US$3,500-6,000.

The interest rate ranges from 31%-42% on loans disbursed in GEL for term of 3-18 months and from 25%-36% when in USD in a term of 3-36 months. Express loans are confirmed within 1-2 business days.

Business loan: Business owners searching for ways to increase working capital, purchase fixed assets and further expand their business activities find this type of loan very helpful. The amount varies from GEL2,500-100,000 and US$1,500-60,000 and can be borrowed for 3-18 and 3-60 months at an interest rate of 19-34% and 18-26% respectively. Business loans are secured and therefore movable as well as immovable property is accepted as security for the loan. Under certain circumstances a 6-month grace period may also be given. Further, borrowers with a good business loan repayment history may be eligible for renewed loans, parallel loans and short term overdrafts. Business loans are confirmed within 3-5 days.

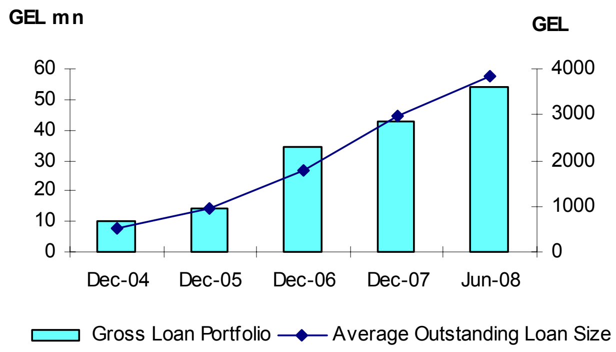
Agriculture loan: This type of loan is designed for those with a minimum of two years of experience. The loan amount varies from GEL500-100,000 at 23-42% and from US$300-60,000 at 20-42%. Agricultural loans are for tenure of 3-18 months and 3-60 months respectively and are usually confirmed within 3-5 days. Repayment is flexible with grace period and equal or unequal installments. Third party guarantees and movable property as well as real estate are accepted as loan security.

Seasonal Loan: These are specially meant for tourism businesses and wishing to expand their activities. The seasonal loan enables customers to enjoy flexible payment options and a grace period dependent on the seasonality of the tourism business. The loan amount ranges from GEL1,000-100,000 at 23-36% and US$500-60,000 at 18-32%. Third party guarantees, movable as well as real estate can be accepted as loan security.

Family Loan: This is designed for small and medium entrepreneurs who wish to buy new consumer goods for their own use, mainly home appliances and furniture. The loan amount for this loan is GEL200-5,000 for a term of 3-18 months. However the term is 6 months in case of cell phone purchase and 24 months in case of furniture. Family loans are issued either in the branches or at the shop premises. This product is offered only in seven of the branches.

There has been a sustained increase in the average outstanding loan size primarily due to a decrease in the number of clients. The average outstanding loan size significantly increased from GEL533 (US$375) in December 2004 to GEL3,856 (US$2,715) in June 2008 with an average growth of 66% per annum. The average outstanding loan size is expected to stabilise now until Constanta launches a new product with a higher loan size.

Portfolio and Ave. Out. Loan Size



<u>Deposit products</u>

Constanta does not yet have a deposit product. However with its transformation to a bank, Constanta would be allowed to accept deposits by the end of 2008 after the Supervisory Agency has assessed the quality of its assets. According to the licence granted, Constanta is prohibited from accepting term and demand deposits from individuals unless the Finance Supervisory Agency of Georgia specifically permits it. The bank can attract all kinds of deposits from companies; however it is relatively complicated at present.

Governance and strategic positioning

Constanta has reasonable performance on governance with a rating grade of β+. A highly experienced and professional Board, strong second line, good vision and strategy to cope with competition and transformation to a bank has resulted in this performance. However, a high country risk is the major challenge now for the bank.

<u>Governance structure</u>

Constanta has a highly experienced and professional Board. However, the size of the Board is small consisting of three members. Ms Tamar Lebanidze, the promoter of Constanta Foundation and current Executive Director of AGMO heads the Board. Other members of the Board are Mr Giorgi Loladze, Chairman of the Supervisory Board of Georgian Stock Exchange and Mr. Murtaz Kikoria, an ex-senior banker at EBRD and ex-head of Banking Supervision and Regulation Department of the National Bank of Georgia. The current Board was constituted in November 2007. The Board is required to meet quarterly. On an average the Board meets twice a month to discuss strategic as well as operational issues. The members of the Board are from diverse professions and have rich experience of their respective fields. However, the board could benefit by adding more members from diverse professional backgrounds.

In view of the recently obtained banking license, Constanta needs to have an Audit Committee, Asset-Liability Committee and a Human Resource Committee in the Board. Thus, it plans to add at least two members to the Board. When it mobilises equity, it may also have one or more representatives of equity investors on the Board. The addition of members on the Board will make strategic decision making more varied and democratic and ensure the strengthening of systems and processes of the organisation.

Operational and growth strategy

Constanta's growth strategy has always been in response to the prevailing situation. It adopted the group lending model but discontinued it in order to cope with growing competition from commercial banks. Over the years Constanta has diversified its product offerings and is now planning to focus on consumer loans as such lending is booming in Georgia. It was also planning to launch a mortgage loan but wisely decided to postpone the launch due to the paucity of funds coupled with the sub-prime crisis in USA and its effects across the world. The Board and management needs to be cautious about experimenting with any such new products in future.

With the licence to operate as a bank, Constanta plans to continue to be microfinance focussed. However it plans to widen its spectrum by venturing into SME and corporate banking; albeit with an initial nominal exposure to this sector. Savings as a product for the lower segment of the society would be difficult initially and therefore the management plans to introduce money transfers both internal and international. Establishment of ATMs (Automated Teller Machines) is expected to happen over the next 6-8 months.

Constanta does not plan to expand until it has considerably improved its productivity. However in the short term, it plans to expand geographically and, after some time, would go for vertical expansion by adding more branches in a region. Due to the weak presence of commercial banks in the rural areas, Constanta plans to intensify its rural operations. In order to support its portfolio growth Constanta plans to mobilise funds by issuing bonds or an IPO apart from immediate additional sourcing measures such as raising deposits.

Fund mobilisation

Constanta has always had a wide base of lenders and donors including Oikocredit, Credit Suisse, Triodos, GMF, Dexia/Blue Orchard and Calvert. Despite this wide base, Constanta experienced a shortage of funds in 2008 on account of insufficient liquidity in the financial market, high country risk perception, unstable political environment and uncertainty regarding the transformation process. In 2007 it could mobilise US$14 million from international funders and the funds crisis aggravated in 2008, due to which the organisation had to revise its business plan. Currently Constanta is in discussions with Microvest, Impulse Microfinance Investment Fund and Deutsche Bank Flexi Fund.

Another assured source of debt funds is Bank Republic which is its only domestic lender. In pursuance of the downscaling strategy by the commercial banks, since 2006 the banks in Georgia have become competitors of Constanta targeting the same segment of people. However, Constanta's dependence on debt funds is expected to go down on account of its licence to mobilise deposits though it would take some time to popularise the deposit product amongst its existing clients.

In addition to debt and deposits, Constanta plans to invite equity capital and is in negotiations with some international financial institutions. It plans to convert into an open company with dilution of own shareholding by increasing its capital by 30% in 2008, and management hope that this will result in an inflow of roughly GEL6 million (US$4.2 million). The crucial factors in mobilising equity investment relate to the purchase consideration, extent of control and the exit route. The equity mobilisation would increase the organisation's leveraging capacity. Constanta is also exploring the issue of bonds. Presently Bank of Georgia and ProCredit Bank have issued bonds as a pilot and these were oversubscribed. This has instilled confidence in the management of Constanta for its own issue. This may be followed by an IPO in the medium term.

Second line of leadership

Constanta has a strong second line of leadership with considerable experience in the banking sector. The Directors of various departments have years of relevant experience and have the skills to carry out their jobs efficiently and effectively.

Competition

Constanta faces stiff competition from various MFIs and banks operating in Georgia. The big non-bank players other than Constanta are FINCA, JSC MFO Crystal, VF Credo and Lazika Capital. In terms of share of clients, Constanta is the second biggest player amongst the non-bank MFIs, while with respect to the outstanding portfolio it is the market leader with roughly 43% share. Constanta ranks third amongst the bank and non-bank MFIs together in terms of share of clients; however due to comparatively high loan size offered by the banks, most of the banks are much ahead of Constanta in terms of volume. Competition with banks started when they started pursuing a downscaling strategy in 2007. Consequently the Bank of Georgia, VTB, Bank Republic emerged in the microfinance market. Amongst the banks the main competition is from ProCredit Bank, the first commercial bank being especially established to serve the MSME sector. It was in response to this competition that Constanta had to discontinue its group loan product and start individual lending. Today the SME sector is among the top priorities of the bank's credit and growth strategy. Price wars, changes in loan size and variations in collateral requirements have now become a regular feature of the Georgian microfinance sector.

Constanta's core competence lies in its understanding of microlending on account of its 10 years of experience. Additionally promptness of services, client friendly approach, flexible and convenient terms and conditions are its strengths. Strong marketing and good positioning also helps the organisation to deal with the fierce competition. With the banking licence, Constanta would be better placed in the future vis-à-vis MFOs. However for the same reason, it faces tough competition from banks with respect to savings mobilisation and other non-loan banking products in which it is a new entrant.

Organisation and management

Constanta has good management performance with a grade of α-. This is on account of its professional and experienced staff, strong internal control systems and mechanism for tracking overdues. However the low productivity level of staff is a major cause of concern.

Human resource quality & management

Constanta has qualified and experienced staff in its management cadre. Most of the department heads have experience of working in major commercial banks of Georgia. In 2007, the management hired roughly 25 staff with banking experience in its effort to prepare itself for the new entity post transformation.

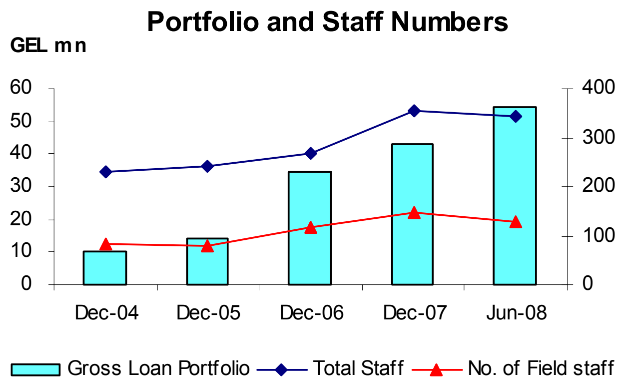
Human resource management is formalised and the HR team consists of three members. Short listed job applicants are invited for a written test which includes professional, IQ and IT test followed by an interview. For top management positions, only an interview is conducted. Probation for various positions ranges from two to six months. LOs have to undergo two months of on-the-job training followed by two weeks of classroom training. They prefer fresh recruits at the LO level and its own staff at the middle level.

Constanta has an in-house training team. Staff is regularly trained so as to equip them to meet the changes in the organisation; however most of the specialised trainings are conducted by an external agency. Few of the staff have made exposure visits. As the staff base is expanding, it would be wise to further develop the training team to cater to the future capacity building requirements of the organisation, especially in a competitive market of Georgia.

The motivation level of the staff has increased since the salary hike in 2007 which brought salaries up to par with the commercial banks. Attractive compensation by competitors was one of the main reasons for staff attrition in 2007. The organisation also fired 41 staff in 2007 and 43 in 2008 mainly due to non-performance.

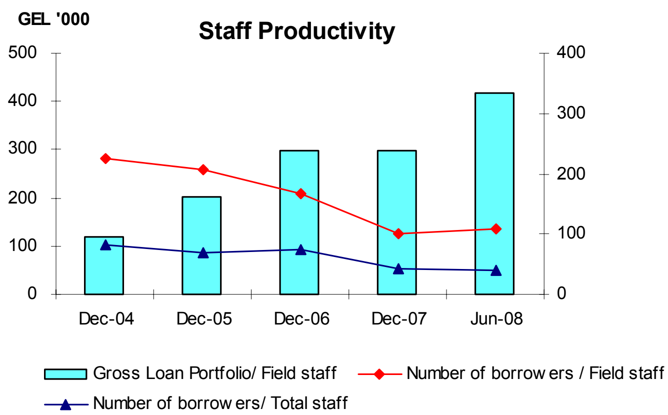
A bonus of GEL100 (US$70.4) is given to all staff at the beginning of the year. The staff are also provided a range of financial benefits up to GEL300 (US$ 211.3) for marriage, child birth or death of a close family member. Other initiatives to boost employee morale include training and promotion. Constanta also has a penalty in the form of no incentive for two months or no promotion for 4-8 months. Penalty is imposed on LO, LM and BM for weak portfolio quality. For other staff, it is in the form of restrictions on salary increments and promotions. Performance appraisal is not very systematic and regular. However performance of the staff on parameters like numbers of clients, old and new clients, portfolio growth, portfolio at risk is assessed. There is no policy on regular transfer and transfers are usually made to fill up vacant positions.

The field and total staff of Constanta increased with growth in its portfolio. The field staff considerably increased from 80 in December 2005 to 118 in December 2006 and further increased in 2007; however without a proportionate increase in the portfolio in the latter case. Field staff to total staff ratio declined from 44% in December 2006 to 38% in June 2008, partly as a result of the high administrative and support staff in the branches and partly due to the large numbers based at HO. Despite major attrition and firing in 2007, the total staff is roughly at the same level in 2008. This is on account of the hiring of people with banking experience in 2007 and 2008.



Staff productivity

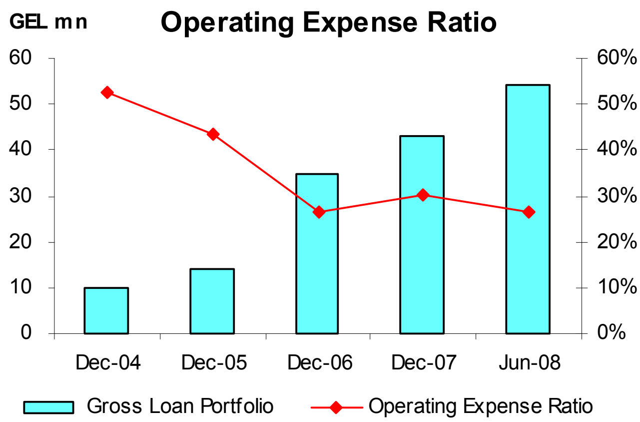
The staff productivity of Constanta is very low and is on a decreasing trend in terms of number of borrowers. The number of borrowers per field staff reduced from 225 in December 2004 to 108 in June 2008. The total staff productivity in June 2008 was just 41. However with respect to average portfolio outstanding per field staff, the productivity increased from GEL120,000 (US$84,507) in 2004 to GEL294,000 (US$209,155) in 2007 and considerably to GEL416,000 (US$292,958) in 2008.



The prime factor for the low client productivity of staff is the staff policy of posting 4-6 LOs even in newly established branches. The average field staff per branch was 7 in December 2007 which reduced to 6 in June 2008 resulting in a slight increase in field staff productivity. In addition to this, a high number of administrative and support staff at every branch resulted in low productivity. To deal with the existing low levels of productivity, the management fired non-performing staff in 2007 and 2008. According to the management the ideal productivity of LO in terms of clients is 200 and in terms of portfolio is GEL 700,000 (US$492,958).

Operating efficiency

The OER was very high at 52.7% in 2004 but since then has declined to 26.3% in June 2008. However, operating expenses in absolute terms have shot up sharply. Rise in operating expenses in 2007 was observed to be by 90% due to a sharp rise in total number of staff, higher salary levels and huge depreciation charged to the newly renovated branches. Personnel expenses increased by roughly 48% and depreciation by 171% in 2007. All these expenses were made to prepare to operate as a bank. The massive rise in operating expenses has been offset by an increase in portfolio resulting in declining OER.



With the hiring of new staff and renovation of branches being complete, operating expenses are expected to stabilise. As a result OER is expected to decline further at a higher rate. This is reflected by a falling trend in personnel expenses from April 2008 to June 2008 and total expenses during the same periods.

Accounting and MIS

Accounting was centralised in 2007 and uses Delphi software. The software is not equipped to generate basic reports such as income statements or balance sheets and can only record every transaction of each branch in the form of trial balance. Presently, monthly statements are prepared by downloading data from the software and transferring it to MS-Excel. This allows scope for human error and is a time taking process.

All income and expenses are recorded on accrual basis. Loan loss reserve is created on the basis of ageing analysis. Depreciation is accounted on a monthly basis on the written down value method. Loans are written off at branches when unpaid for more than 180 days. The branches are treated as profit centres and daily accounting of branches is done. However till the time of the rating visit, branch-wise income and expenditure statements were prepared and profitability analysis was done without accounting for the HO administrative costs and cost of funds. Consequently most of the branches show profits whereas they are actually making losses. Performance of the branches is carefully analysed in quarterly management reports.

'Visual Studio' software is used for the MIS which is on a real time basis. Until 2006, 'Fox Pro' was used which was not on-line. The new software stores the entire credit information and the administrator has the right to add products and make any other changes if required. The new software has quite successfully fulfilled their needs by generating reports, automating processes and systems and presenting information on a real time basis. The quality of MIS reporting is good.

The branches are on-line connected with a centralised SQL server at HO. There are two servers at HO and on failure of one of the server; the branches automatically get connected to the second server. Branches are well connected by fibre channel, DSL and wireless. However occasional cases of connectivity breakdown are observed in the branches which rely on wireless connection. Mobile connectivity is used as a back up in such a situation. Back up of data is automatically stored in the server on a daily basis and also in a tape drive. Constanta is planning to have a credit disaster recovery site by 2009.

Reporting is done from the perspective of income tax, management accounting and financial analysis. The financial statements and other financial information are required to be submitted to National Bank of Georgia on a daily, biweekly, monthly, quarterly, semi-annually and annual basis. Tax declarations are made to the government tax department on a monthly and annual basis. Other information is prepared for lenders and vendors and submitted to them as per their request. On a monthly basis variance reports are prepared and sent to branches and on a quarterly basis the financial statements of the branches are discussed with the BM. along with reports on liquidity, capital adequacy data is prepared for the purpose of management accounting.

<u>Tracking system for overdues</u>

The tracking system of overdues is good. Any loan overdue by more than 3 days is monitored by the credit head. In case of non-repayment, on the 3rd day from the due date an official note is sent asking the client to visit the branch. After 15 days of non-repayment from the due date the case is forwarded to the Problem LO who exclusively handles clients' overdues and gets commission on overdues collected.

The last resort is to file a legal suit against such clients. However the legal process may extend up to six months. Constanta has so far not lost any case against its clients. In most of the cases collateral is not liquidated and the client pays the settlement amount including the outstanding loan amount, interest on overdues, taxes and penalty in cash.

Constanta has a six member controlling team established specially for the purpose of control of portfolio at risk. Regular visits 2-3 times a year are made to the branches which are of 2 weeks duration. The visiting team consists of 2-4 members and at least 30% of overdue clients are visited. Assessment of LO's capability and integrity is also done. The Report is sent to the BM and subsequently to the credit head. The report is finally submitted to the Supervisory Board. Special visits by the controlling team are conducted if any serious issues are observed by the internal audit team.

<u>Internal control systems</u>

Constanta faced a case of fraud in 2004 in one of its branches which led to a major write off in 2005. Since then has strengthened its internal control systems. Control is exercised in the organisation by way of constant reporting and visits. The size of the audit team seems to be adequate for the existing branches.

Internal audit (IA) in the organisation is formalised with a 5 member team. However three of the members including the head of the internal audit team have less than one year of requisite experience. The management is planning to add 1-2 members with banking experience keeping in mind the transformed entity of Constanta. IA has a designed format which includes policy, operational and financial compliance in addition to collateral and loan utilisation checks. Fixed assets and inventory purchases as well as cash audit are also included in these visits. The audit is conducted on sample basis and covers roughly 10% of the portfolio and 5% of the total clients in a branch. The duration of the visit is usually 2 weeks by 2-4 persons depending upon the size of the branch. Branches and HO are audited at least on an annual basis. The report comprising of observations and recommendations is initially sent to the branch and then submitted to the Supervisory Board followed by the Board of Directors.

<u>Financial planning</u>

Constanta has prepared a five year strategic Business Plan for the period 2008-2012 which explicitly states deliverables for every department. The plan is quite rigorous and shows the projected growth of the organisation in terms of operational area, portfolio and clients. The plan is revised every year in November based on market forces and competitive analysis. A master budget is prepared annually on a bottom to top approach on the basis of the business plan.

Request for funds by branches are sent in the morning to the Treasury Manager (TM). Funds are electronically transferred by HO to branches. Until Constanta received the bank license, each branch had an account in Bank Republic or Bank of Georgia. The latter charges for online transactions on a monthly basis whereas Bank Republic charges per transaction. Sometimes Constanta also avails the service of private security companies for physical transfer of cash to branches and is charged on the basis of amount transferred.

Branches have limits with respect to cash, liquidity and treasury and the Treasury department monitors compliance with these limits by branches. The limits assigned are different for every branch and revised from time to time. Such a system ensures strong financial planning. Any idle cash at HO is put in deposit, but Constanta now plans to invest surplus cash more productively.

Quality of clients/member groups

Based on the client visits, the quality of clients seemed to be reasonable in terms of awareness and repayment performance. The level of satisfaction amongst the client seems to be high mainly due to the quality of service and personal approach of the staff. Despite stiff competition, duplication is avoided due to information sharing through the credit bureau.

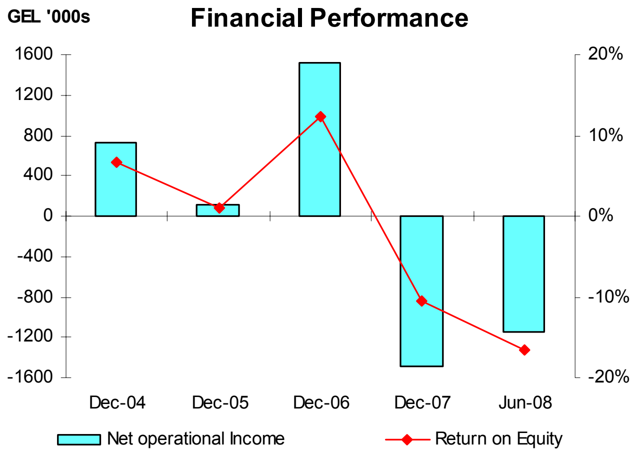
Infrastructure

Constanta has adequate infrastructure for its operations. Fixed assets mainly include, computers, office equipment, furniture and fixtures, vehicle, automobiles. The HO as well as all the branches operate from their own premises. In its preparation to operate as a bank, 19 branches were renovated in 2007 and 2008. Cash safes and security measures have been installed as per the statutory requirement.

The fixed assets contributed 11.4% of the total asset base on 31 December 2004. This figure fell to 3.3% of total assets on 31 December 2006 due to a massive increase in share of fixed deposits. In order to develop branch infrastructure with the best standards of a commercial bank and with a common brand, Constanta made heavy investments in fixed assets in 2007. The total was significantly increased by 326% from GEL1.7 million (US$1.2 million) in December 2006 to GEL7.4 million (US$5.2 million) in December 2007 with a share of 11.8% of total assets. The total of fixed assets in June 2008 has further risen to GEL8.4 million (US$5.9 million). The share of fixed assets is expected to decline now with the completion of the branch and IT infrastructure development plan.

Financial profile

Constanta's performance on financial parameters is weak with a rating grade of **β**. The relatively low grade is due to the declining profitability and capital adequacy position of the organisation. However Constanta has been able to maintain its capital adequacy ratio above the statutory requirement. It has also maintained its portfolio quality and improved operating efficiency.



As is apparent from the above figure, since 2007 Constanta has been unprofitable and registered a net operational deficit of GEL1.4 million (US$0.98 million) in December 2007 at a ROE of -10.5%. The reason for the loss can be attributed to declining yield and rising expenses.

Yield reduced from 76.7% in 2005 to 33.8% in 2007 due to the change in composition of the portfolio. The group loan product had a high yield and formed 34% of the total portfolio in 2006. The reduction in the share of the group loan product sharply reduced profitability as the change in the portfolio mix was coupled with price wars waged by Constanta's competitors forcing the organisation to lower its own lending rate of interest.

Simultaneously a major increase in operating expenses took place due to reasons mentioned in the 'operating efficiency' sub-section. An upward swing in interest income seems to have begun with an increase in the overall portfolio, interest income has started rising from GEL1.06 million (US$0.75 million)in April 2008 to GEL1.16 million (US$0.82 million) in May and GEL1.21 million (US$0.85 million) in June 2008. The operating expenses have also stabilised now and therefore the profitability position is expected to improve from here.

Financial Ratios	31 Dec 04	31 Dec 05	31 Dec 06	31 Dec 07	30 June 08
Capital Adequacy					
Risk Weighted Capital Adequacy ratio	100.5%	67.3%	36.4%	30.0%	19.9%
Asset Quality					
Portfolio at Risk (>30 days)/ Gross Loan Portfolio	19.4%	1.3%	0.6%	0.4%	0.3%
Loan Loss Reserve/Gross Portfolio	15.6%	2.9%	2.7%	2.0%	2.1%
Management					
Operating Expenses/Average Gross Loan Portfolio*	52.7%	43.7%	26.4%	30.3%	26.3%
Number of Borrowers/Total field staff	225	207	166	100	108
Number of Borrowers/Total staff	81	69	73	42	41
Earnings*					
Net operating income/Average Equity (ROE)	6.7%	1.0%	12.3%	-10.5%	-16.5%
Net operating income/Average Assets (ROA)	6.7%	0.9%	2.2%	-2.5%	-3.5%
Portfolio Yield	76.7%	46.2%	37.5%	33.8%	26.4%
Financial Cost Ratio	0.0%	2.1%	10.6%	13.2%	10.0%
Interest and fee expense/Average funding liabilities	0.0%	10.9%	10.9%	11.3%	9.6%
Liquidity					
Cash & Liquid Assets/Total Assets	9.5%	1.4%	0.4%	2.9%	1.8%

*: Ratios for June 2008 is calculated on the basis of unaudited statements and annualised where ever required.
Exchange rate: US$1=GEL1.42 for all the years

Credit performance and portfolio quality

The portfolio quality of Constanta was found to be good with PAR_{30} at 0.34% on 30 June 2008, a marginal reduction from 0.42% on 31 December 2007. Constanta has strengthened its internal control mechanism on account of the fraud at one of its branches in 2004 and now monitors its portfolio well.

As on 30 June 2008

Product	PAR>0	PAR>30
Individual loan (old)	7.92%	5.23%
Group loan	3.26%	2.42%
Agro loan	1.21%	1.14%
Express loan	0.29%	0.09%
Business loan	0.17%	0.08%

PAR_{30} was highest in the old individual loan product at 5.23% in June 2008 due to mostly overdue loans remaining in its portfolio. PAR is expected to reduce with the share of the group loan product reducing to zero in the near future. To avoid default in the agro loan product, Constanta lends to only those farmers who have crop insurance. With respect to branches, PAR_{30} was highest in the Didube branch at 8.25% in June 2008 on account of default on a single loan of US$54,500 due to the business failure of a client coupled with his ill-health.

As on 30 June 2008

Activities	Amount		Share of Portfolio
	GEL mln	US$ mln	
Trade	31.0	21.9	57%
Agriculture	6.0	4.2	11%
Production	4.6	3.3	9%
Service	4.8	3.4	9%
Other	7.6	5.3	14%

The portfolio of the organisation is reasonably diversified as can be seen from the above table. The share of portfolio in trade slightly reduced from 60.8% as on 31 December 2007. Portfolio in trade has shifted from street vendors to owners of small shops subsequent to the government law against street vendors. The share of agriculture has increased from 8.2% in December 2007 to 11.1% in June 2008. Considering Constanta's plans to intensify its operations in rural areas where banks are usually not present, the share of agriculture loans in the total portfolio is expected to rise further. A similar trend can be seen with the share of clients in various activities.

In addition to the diversification, the organisation also reduces portfolio risk by accepting collateral. Roughly 61% of the portfolio is secured by third party guarantees, while 31% is collateralised by property. However, with the rapid increase in the share of the express loan in total portfolio, which is provided without any collateral, the portfolio risk will tend to increase. The organisation needs to strengthen the appraisal process focussing more on existing and projected cash flows of the express loan clients and his/her repayment capacity to avoid any potential risk to portfolio. Additionally, considerable damage to life and property occurring due to the volatile situation in the country poses a huge risk to portfolio quality and also dilutes the risk mitigating collateral requirement policy of Constanta.

Mobilisation of funds, liability & equity composition

Constanta has always had wide base of lenders and donors as can be seen below in the table. Despite the wide base, Constanta experienced a major shortage of funds in 2008 on account of insufficient liquidity in the financial market, high risk perception, the unstable political environment in the country and uncertainty regarding the transformation process leading to downward revision of its business plan. In 2008, till the time of the rating visit it had been able to mobilise US$9.5 million. The table below presents details of Constanta's borrowings.

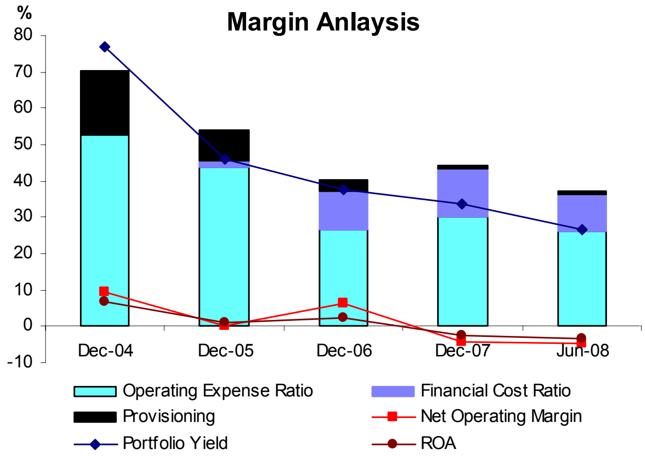
Lender	Total Borrowing (in $ '000)	O/s on June-08 (in $ '000)	Interest rate
OikoCredit	5,852	4,602.4	6.9%-12.0%
Incofin	900	Nil	8.5%
Triodos	1,315	1,315	Min 8.5%
Microvest	1,400	Nil	12.0%
Credit Suisse	3,000	2,000	9.5%
GMF	2,100	1,500	9.0%
Dexia	750	Nil	6MLIBOR+6%
GCMC	4,000	4,000	10.4%
Novib	2,064	2,064	10.0%
EBRD	3,500	3,500	LIBOR+5.7%
Blue Orchard	4,000	4,000	9.0%
DWM	4,000	4,000	8.7%
Dual Return	1,000	1,000	9.5%
Finethic	1,000	1,000	9.5%
Bistum Essen	2,000	2,000	9.0%
Calvert	500	500	8.3%
Bank Republic	30.257.6	7,184.7	6.0%-16.0%
Total	**67,638.6**	**38,666.1**	

The capital adequacy of the organisation has been decreasing since 2004. With no debt funds in 2004, CAR was exceptionally high at 100.5% but it reduced to 30.0% in December 2007 and further to 19.9% in June 2008 due to the current year's deficit. However the CAR is still more than the statutory requirement of 12%, which puts Constanta in a comfortable position to leverage commercial funds in the future.

Asset composition

The gross loan portfolio was roughly 90% of the total asset base in December 2005 which reduced to 67.6% in December 2007. However the share of loan assets to total assets has improved in subsequent months and is at 77.8% in June 2008. This was due to the quite high share of fixed in total assets, roughly 12% both in December 2007 and June 2008 resulting from Constanta's preparation to become a bank. Cash and bank balances formed 3% of the total assets in December 2007 and was slightly reduced to 1.8% in June 2008.

Profitability and sustainability



Constanta has not been able to perform well on profitability and sustainability indicators due to the strategic change in the portfolio mix and planned heavy expenditure to enable it to operate as a bank. However improved portfolio quality is encouraging resulting in a decline in provisioning expenses.

Future plans and prospects

With the license to operate as a bank, Constanta plans to continue to be a Micro-finance bank. However it plans to widen its spectrum by venturing into SME and corporate banking; albeit with an initial marginal exposure to this sector.

Constanta does not plan to expand until it has considerably improved its productivity. However in the short term, it plans to expand geographically and then undertake vertical expansion by adding more branches in a region. Due to the weak presence of commercial banks in rural areas, Constanta plans to intensify its operations there. In order to support its portfolio growth Constanta plans to mobilise funds by issuing bonds or an IPO in the medium term apart from the immediate plan to raise deposits.

Financial statements of Constanta*

Balance sheets

In GEL thousands

31-Dec-04	31-Dec-05	31-Dec-06		31-Dec-07	30-June-08
			Assets		
			Current assets		
-	27	26	Cash in hand	159	800
1,046	188	212	Cash in bank	1,712	437
0	0	108	Net intangibles	267	290
0	0	55	Inventories and stock	182	189
90	358	154	Income Tax and other tax settlements in advance	702	98
0	0	0	Other receivables	1,270	734
225	37	210	Other current assets	304	536
9,937	*16,062*	*34,991*	*Gross loans outstanding*	*43,368*	*54,122*
0	*1,939*	*252*	Write off	*483*	*0*
9,937	*14,123*	*34,739*	Gross loans outstanding after write off	*42,885*	*54,122*
1,550	*469*	*957*	*(Loan loss reserve)*	*849*	*1,154*
8,387	13,654	33,782	Net loans outstanding	42,036	52,968
9,748	**14,264**	**34,547**	**Total current assets**	**46,632**	**56,052**
			Long term assets		
0	0	16,867	Fixed deposits and investments	9,309	5,087
1,259	1,409	1,756	Net fixed assets	7,484	8,453
1,259	**1,409**	**18,623**	**Total long term assets**	**16,793**	**13,540**
11,007	**15,673**	**53,170**	**Total assets**	**63,425**	**69,592**
			Liabilities and net worth		
			Current liabilities		
0	35	20	Accrued expenses	175	770
0	0	400	Accrued taxes	677	0
74	0	42	Other current liabilities	97	605
74	**35**	**462**	**Total current liabilities**	**949**	**1,375**
			Long term liabilities		
0	4,080	39,451	Bank loan	44,743	55,071
0	0	0	Other borrowings	2,762	164
0	**4,080**	**39,451**	**Total long term liabilities**	**47,505**	**55,235**
74	**4,115**	**39,913**	**Total liabilities**	**48,454**	**56,610**
			Net worth		
0	0	0	Equity Capital	0	15,676
0	0	0	Asset revaluation reserve	1,247	-
0	0	0	Minority interest	2,471	-
10,561	11,493	12,205	Retained net surplus/(deficit)	13,062	-1,230
372	65	1,052	Current net surplus/(deficit)	-1,809	-1,464
10,933	**11,558**	**13,257**	**Total net worth**	**14,971**	**12,982**
11,007	**15,673**	**53,170**	**Total liabilities and net worth**	**63,425**	**69,592**

*: Balance sheet for 2004, 2005, 2006 and 2007 are of Constanta Foundation. For June 2008, Balance sheet is for JSC Bank Constanta

Income statements

In GEL thousands

31-Dec-04	31-Dec-05	31-Dec-06		31-Dec-07	30-June-08
			Income		
6,006	4,796	8,419	Interest on loans	12,584	6,461
0	34	762	Interest on deposits and investments	1,465	213
229	781	1,168	Fee, commission and penalty income	822	1,262
0	0	0	Gain on sale/revaluation of assets	0	8
0	0	100	Foreign exchange gain	0	9
0	100	97	Bad debts recovered	124	0
0	21	29	Other income	29	5
6,235	**5,732**	**10,575**	**Total income**	**15,065**	**7,958**
			Financial costs		
0	169	2,263	Interest on borrowings	4,717	2,432
0	8	21	Interest on overdraft	19	0
0	45	92	Commission	173	21
6,235	**5,510**	**8,199**	**Gross financial margin**	**10,156**	**5,505**
1,375	-1,081	488	Provision for losses	-108	230
0	1,939	252	Write off	483	0
4,860	**4,652**	**7,459**	**Net financial margin**	**9,781**	**5,275**
			Operating expenses		
3,860	2,572	3,499	Personnel expenses	5,162	3,498
0	1,220	1,978	Administrative expenses	4,123	1,780
0	91	134	Travelling expenses	252	123
0	257	292	Depreciation	792	646
0	0	0	Loss on sale/revaluation of assets	250	0
268	16	0	Foreign exchange loss	308	0
0	380	29	Other expenses	379	383
4,128	**4,536**	**5,932**	**Total operating expenses**	**11,266**	**6,430**
732	**116**	**1,527**	**Net surplus/(deficit)**	**-1,485**	**-1,155**
0	0	0	Gain/loss on security trading	61	-85
732	**116**	**1,527**	**Profit before tax**	**-1,424**	**-1,240**
360	51	475	Tax expenses	585	224
372	**65**	**1,052**	**Profit after tax**	**-2,009**	**-1,464**
372	**65**	**1,052**	**Current surplus/(deficit) transferred to balance sheet**	**-2,009**	**-1,464**

*: Income statement for 2004, 2005, 2006 and 2007 are of Constanta Foundation. For June 2008, Income statement is for JSC Bank Constanta

Balance sheets in US$

In US$ thousands

31-Dec-04	31-Dec-05	31-Dec-06		31-Dec-07	30-June-08
			Assets		
			Current assets		
-	19	18	Cash in hand	112	563
737	132	149	Cash in bank	1,206	308
0	0	76	Net intangibles	188	204
0	0	39	Inventories and stock	128	133
63	252	108	Income Tax and other tax settlements in advance	494	69
0	0	0	Other receivables	894	517
158	26	148	Other current assets	214	377
6,998	*11,311*	*24,642*	*Gross loans outstanding*	*30,541*	*38,114*
0	1,365	177	Write off	340	0
6,998	9,946	24,464	Gross loans outstanding after write off	30,201	38,114
1,092	*330*	*674*	*(Loan loss reserve)*	*598*	*813*
5,906	9,615	23,790	Net loans outstanding	29,603	37,301
6,865	**10,045**	**24,329**	**Total current assets**	**32,839**	**39,473**
			Long term assets		
0	0	11,878	Fixed deposits and investments	6,556	3,582
887	992	1,237	Net fixed assets	5,270	5,953
887	**992**	**13,115**	**Total long term assets**	**11,826**	**9,535**
7,751	**11,037**	**37,444**	**Total assets**	**44,665**	**49,008**
			Liabilities and net worth		
			Current liabilities		
0	25	14	Accrued expenses	123	542
0	0	282	Accrued taxes	477	0
52	0	30	Other current liabilities	68	426
52	**25**	**325**	**Total current liabilities**	**668**	**968**
			Long term liabilities		
0	2,873	27,782	Bank loan	31,509	38,782
0	0	0	Other borrowings	1,945	115
0	**2,873**	**27,782**	**Total long term liabilities**	**33,454**	**38,898**
52	**2,898**	**28,108**	**Total liabilities**	**34,123**	**39,866**
			Net worth		
0	0	0	Equity Capital	0	11,039
0	0	0	Asset revaluation reserve	878	0
0	0	0	Minority interest	1,740	0
7,437	8,094	8,595	Retained net surplus/(deficit)	9,199	-866
262	46	741	Current net surplus/(deficit)	-1,274	-1,031
7,699	**8,139**	**9,336**	**Total net worth**	**10,543**	**9,142**
7,751	**11,037**	**37,444**	**Total liabilities and net worth**	**44,665**	**49,008**

*: Balance sheet for 2004, 2005, 2006 and 2007 are of Constanta Foundation. For June 2008, Balance sheet is for JSC Bank Constanta
**: Exchange rates: US$1 = GEL1.42 for all the years

Income statements

In US$ thousands

31-Dec-04	31-Dec-05	31-Dec-06		31-Dec-07	30-June-08
			Income		
4,230	3,377	5,929	Interest on loans	8,862	4,550
0	24	537	Interest on deposits and investments	1,032	150
161	550	823	Fee, commission and penalty income	579	889
0	0	0	Gain on sale/revaluation of assets	0	6
0	0	70	Foreign exchange gain	0	6
0	70	68	Bad debts recovered	87	0
0	15	20	Other income	20	4
4,391	**4,037**	**7,447**	**Total income**	**10,609**	**5,604**
			Financial costs		
0	119	1,594	Interest on borrowings	3,322	1,713
0	6	15	Interest on overdraft	13	0
0	32	65	Commission	122	15
4,391	**3,880**	**5,774**	**Gross financial margin**	**7,152**	**3,877**
968	-761	344	Provision for losses	-76	162
0	1,365	177	Write off	340	0
3,423	**3,276**	**5,253**	**Net financial margin**	**6,888**	**3,715**
			Operating expenses		
2,718	1,811	2,464	Personnel expenses	3,635	2,463
0	859	1,393	Administrative expenses	2,904	1,254
0	64	94	Travelling expenses	177	87
0	181	206	Depreciation	558	455
0	0	0	Loss on sale/revaluation of assets	176	0
189	11	0	Foreign exchange loss	217	0
0	268	20	Other expenses	267	270
2,907	**3,194**	**4,177**	**Total operating expenses**	**7,934**	**4,528**
515	**82**	**1,075**	**Net surplus/(deficit)**	**-1,046**	**-813**
0	0	0	Gain/loss on security trading	43	-60
515	**82**	**1,075**	**Profit before tax**	**-1,003**	**-873**
254	36	335	Tax expenses	412	158
262	**46**	**741**	**Profit after tax**	**-1,415**	**-1,031**
262	**46**	**741**	**Current surplus/(deficit) transferred to balance sheet**	**-1,415**	**-1,031**

*: Income statement for 2004, 2005, 2006 and 2007 are of Constanta Foundation. For June 2008, Income statement is for JSC Bank Constanta.
** Exchange rates: US$1 = GEL1.42 for all the years

Notes to the financial statements

1. Constanta Foundation was registered as not for profit microfinance organisation on 31 January 1997. In November 2007, JSC Constanta was formed as a joint stock company. On 29 December 2007 the Foundation incorporated a limited liability company "Constanta Plus" which holds 80% of shares of JSC Constanta. The remaining 20% of shares of JSC Constanta are with seven individuals shown as 'minority interest'. On 8 July 2008, JSC Constanta received license from National Bank of Georgia to operate as a bank.
2. Financial statements for 2004, 2005 and 2006 are prepared for Constanta Foundation. Statements for 2007 are consolidated financial statements for Constanta Foundation, Constanta Plus and JSC Constanta. All significant intra-group transactions, balances, income and expenses are eliminated on consolidation. While statements for June 2008 represents statements of JSC Bank Constanta only. Based on agreement Constanta Foundation has sold all its assets and liabilities to JSC Constanta at book value.
3. Both income and expenses are recognised on an accrual basis.
4. 'Other receivables' on the assets side include receivable from sale of shares.
5. Intangibles include software, patent and licenses.
6. Cash at bank for 2004 also includes cash in hand.
7. LLR is created on the basis of ageing analysis. M-CRIL has not made any adjustments as LLR is appropriately created considering the good portfolio quality.
8. Loans are written off after 180 days.
9. Amortization of intangible assets and depreciation of fixed assets are calculated on straight-line basis at given rates: buildings (5%), furniture and equipment (20%), vehicles (20%), other (20%) and intangible assets (10%).
10. 'Other borrowings' include unsecured loan facility at 15% from an individual.
11. 'Retained surplus' includes grants/donated equity, donations and retained surplus of the year. Amount of GEL1,461,000 is deducted from 'Retained surplus' in 2007 towards 'discount adjustment at initial recognition of the capital contribution'.
12. GEL200,000 (share of minority interest in the current loss) is deducted from 'Current surplus' in 2007 and included in the 'Minority interest' while transferring to the balance sheet.
13. 'Equity capital' of JSC Bank Constanta shown in June 2008 is contributed by Constanta Foundation by contributing to its fixed assets, deposits in the bank and cash. It also includes minority interest.
14. Retained deficit of JSC Bank Constanta in June 2008 is mostly on account of loan loss provision expense for gross loan portfolio purchased from Constanta Foundation at the book value.

Glossary

1. Current repayment rate: Ratio of principal recovered (net of pre-payments) to the principal due for the last one year.
2. Portfolio at risk (PAR_{30}): Ratio of the principal balance outstanding on all loans with overdues greater than or equal to 30 days to the total loans outstanding on a given date.
3. Yield on portfolio: The interest income on loans divided by the average loan portfolio for the year.
4. Other income to average portfolio: Total income other than from the interest on loans divided by average portfolio.
5. Financial cost ratio: Total interest expense for the year divided by the average portfolio.
6. Loan loss provisioning ratio: Total loan loss provisioning expense for the year divided by the average portfolio.
7. Operating expense ratio: Ratio of salaries, travel, administrative costs and depreciation expenses to the average loan portfolio.
8. Net operating margin: Difference of (yield on portfolio+ yield on other income) and (financial cost ratio+ loan loss provisioning + interest loss provisioning) – also known as spread on portfolio
9. Average loan portfolio: This represents the average loan outstanding for the year computed on a monthly basis.
10. Average total assets: This represents the average total assets for the year calculated on an annual basis.
11. Operational Self-Sufficiency: Ratio of total income to total costs for the year.
12. Financial Self-Sufficiency: Ratio of total income to total adjusted expenses for the year. Adjustments have been made for subsidised cost of funds (w.r.t. market interest rate), equity (w.r.t. inflation) and in-kind donations.
13. Risk weighted capital adequacy ratio: Ratio of networth to risk weighted assets *M-CRIL Risk weights*: 100% for all assets except the following: fixed assets & interest bearing deposits: 50%; cash 0%.
14. Return on assets: Ratio of operational income/(loss) to average total assets
15. Return on equity: Ratio of operational income/(loss) to average net worth

Abbreviations

BM	Branch Manager
CAR	Capital Adequacy Ratio
CARE	Christian Action Research and Education
CGAP	Consultative Group to Assist the Poor
DFID	UK Department for International Development
DSL	Digital Subscriber Line
EBRD	European Bank for Reconstruction and Development
ED	Executive Director
EMI	Equated Monthly Instalment
EU	European Union
FCR	Financial Cost Ratio
FSS	Financial Self-Sufficiency
GEL	Georgian Lari
HO	Head Office
IA	Internal Audit
IDB	International Development Bank
IMF	International Monetary Fund
IPO	Initial Public Offer
IT	Information Technology
JSC	Joint Stock Company
LLC	Limited Liability Company
LLP	Loan Loss Provision
LLR	Loan Loss Reserve
LO	Loan officer
LM	Loan Manager
M-CRIL	Micro-Credit Ratings International Ltd
MFI	Micro Finance Institutions
MFO	Micro Finance Organisations
MIS	Management Information System
MSME	Micro, Small and Medium Enterprises
NATO	North Atlantic Treaty Organisation
NBFC	Non Bank Finance Company
NGO	Non Governmental Organisation
OECD	Organization for Economic Cooperation and Development
OER	Operating Expenses Ratio
OSS	Operational Self-Sufficiency
PAR_0	Portfolio at Risk (>=0 days)
ROA	Return on Assets
ROE	Return on Equity
TM	Treasury Manager
UNDP	United Nations Development Programme
US	United States
USAID	United States Agency for International Development

Validity This rating is valid till the next loan proposal made by the MFI to any financial institution or till any other significant change in the structure of the loan programme or in its external environment. A **rating update** (comprehensive repeat rating) is recommended whenever such changes take place or at the end of **one year** from the date of the initial assessment, whichever is earlier. Any substantial additional information that becomes available could also result in a rating update or a rating review (revision of rating grade based on a desk analysis).

Liability The rating assigned is a professional opinion of the assessors and M-CRIL does not guarantee the information and cannot accept any legal responsibility for actions arising out of the recommendations made.