

GIRAFE

Rating

A+
A
A-
B+
B
B-
C+
C
C-
D
E

Good: Procedures are well developed, effective, and incorporate a long-term perspective. Some improvements could be made. Long-term risks are identified in the strategic plan.

Trend

Positive
Stable
Uncertain
Negative

Due to the uncertainty about the impact of the new law on microfinance and the success of the merger and transformation processes.

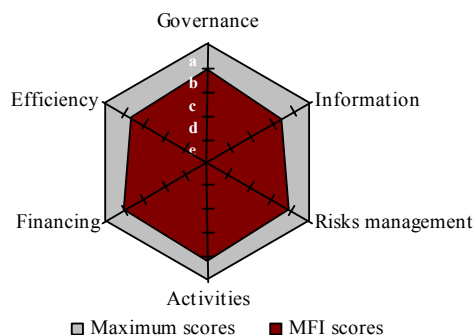
Performance indicators

(K EUR, unless otherwise indicated)

	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
ACTIVITY				
Total number of staff	48	49	47	57
Assets	5,496	6,687	9,208	11,280
Assets (K BAM)	10,748	13,079	18,010	22,062
Loan portfolio (EUR)	4,148	4,784	6,867	8,751
Active borrowers	3,579	3,833	5,096	6,322
APR	35.1%	35.1%	33.2%	32.3%
PAR 31-365	0.4%	0.7%	0.8%	1.0%
PAR > 365	0.0%	0.0%	0.0%	0.0%
Write-off ratio	1.3%	0.8%	0.2%	0.2%
Risk coverage ratio	812.8%	276.2%	256.7%	294.6%
PERFORMANCE				
ROE	4.3%	7.7%	9.3%	27.8%
Liabilities / Equity	360.9%	426.3%	569.3%	559.7%
ROA	0.8%	1.6%	1.5%	4.2%
OSS	103.1%	106.5%	107.2%	120.2%
FSS	81.9%	92.6%	96.1%	108.6%
Portfolio Yield	35.1%	34.6%	31.8%	31.4%
Operating expense ratio	32.3%	27.5%	22.3%	17.9%
Staff productivity	75	78	108	111
Funding expense ratio	5.4%	6.0%	7.2%	7.1%
GROWTH				
Portfolio growth	3.7%	15.3%	43.5%	27.4%
Asset growth	5.5%	21.7%	37.7%	22.5%
EUR/BAM	1.96	1.96	1.96	1.96

LOK micro, BiH

November 2005



Description of the institution

LOK micro was created in 1997 as a “citizens association” in the city of Sarajevo. In February 2001 it transformed into a Micro Credit Organization (MCO) in accordance with the Law for Micro Credit Organizations. As of October 2005, LOK micro served 6,322 clients through a network of 16 satellite offices and 6 Regional Offices concentrated in the Federation of Bosnia and Herzegovina. The institution has a loan portfolio of 8.8 M EUR (17.1 M BAM) and offers four loan products for production, trade, services and agriculture, mainly through individual loans (some solidarity loans).

Rating summary

The MFI has been assigned a global rating of B+. This grade is based on an innovative approach to product diversification and design, on a dynamic financing strategy and on a proactive attitude towards the imminent consolidation of the sector. This rating also reflects LOK micro’s relative weaker operational and financial track record compared to the top performing MFIs in BiH and the execution risks associated with the planned merger with Sinergija Plus. Additionally, LOK micro needs to continue improving its financial performance while assessing its interest rates, which are among the highest in the industry, in the highly competitive market context of BiH. MIS is another area for attention as LOK micro is developing a new integrated software.

This grade has been given with an **Uncertain** trend. This trend is based on the regulatory uncertainty associated with the new law to be adopted in June 2006 and with the upcoming merger with Sinergija Plus and the transformation into a for-profit company.

Financing needs

LOK micro anticipates funding needs of 5.4 M BAM (2.7 M EUR) in its 2006 Operational Plan in order to reach its portfolio growth objectives. Planet Rating believes that LOK micro is able to absorb this debt given its excellent track record with commercial banks, the improving trend of its operations and the potential capitalization of its concessional liabilities in 2006. The merger with Sinergija Plus, if successful, will provide a better platform to compete and to handle additional leverage.

Planet Rating

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■ Microfinance sector

The microfinance sector in Bosnia and Herzegovina (BiH), launched after the end of war in 1997, is highly developed with continued support from the World Bank and international NGOs. The bulk of startup funds for the sector have been channeled through the WB-financed Local Initiatives Project (LIP). Numerous international donors have funded microfinance organizations (MFIs) and provided valuable technical assistance. The 10 largest MFIs, having adopted many industry best practices, are among the strongest MFIs in Eastern Europe. There is a pressure to consolidate the 46 registered MFIs into 4-5 strong players mirroring the parallel trend in the general banking sector. Although talks about takeovers and mergers are getting louder, there is not yet an industry-wide sense of urgency to translate words into actions. The MFIs have yet to experience the “real pain” (e.g. slow growth, deteriorating portfolio quality) that would trigger serious merger/takeover talks. One of the biggest obstacles to industry consolidation is that top MFI management are used to managing their own MFIs in their own manner; it is difficult for them to consider potentially different or reduced roles in larger merged MFIs.

The next big event on the BiH industry calendar is the new microfinance law expected to be adopted in June 2006 after much delay. The new law will provide existing MFIs two choices: non-profit foundation status or for-profit shareholder company status. Both options would disallow the mobilization of deposits, an activity reserved for banks. This proposed law, despite a lack of clarity regarding the ultimate ownership of MFIs’ donated equity, will open the way for foreign and domestic equity investment and thus will further push the industry down the commercialization path. Since the beginning of 2005, the level of competition has heated up considerably between MFIs, but also with some of local banks “downscaling” into top-tier MFI markets (see Activities section for more details). Most banks, led by Raiffeisen Bank BiH and with the notable exception of ProCredit bank BiH, have chosen to get involved in the microfinance sector indirectly through financing MFI portfolio growth. As of September 30th, 2005, local banks and insurance firms provided about 51 of the 97,3 million BAM in outstanding exposure on commercial terms to BiH MFIs.

■ Political and economical environment

It has been ten years since the Dayton Agreement was signed by all parties ending the war in BiH. BiH’s national government is charged with conducting foreign, economic

and fiscal policies with a second tier of governments organized along ethnic lines: the Federation of Bosnia and Herzegovina and the Bosnian Serb-led Republika Srpska with each having substantial legislative powers. BiH is burdened by these many overlapping levels of government, whose expense represents an important share of GDP.

There are ongoing efforts to streamline government functions and transfer some key powers to the national level as evidenced by the creation of a single Ministry of Defense and soon a single national police. On November 22, 2005, leaders of all major Bosnian ethnic groups signed a unity agreement in Washington D.C. seeking to overhaul their constitutional and governmental systems. The BiH government will eventually have only one president, with a strong prime minister and parliament, in order to lead the country forward more effectively.

Ranked 66 (out of 175 countries) in the UNDP 2004 Human Development Report, BiH is a post-conflict country transitioning to a free market economy. BiH Central Bank forecasted a 6% real GDP growth in 2005 fueled by strong foreign direct investment (FDI), especially in the manufacturing area. On October 21, 2005, the European Commission opened negotiations with BiH on a Stabilization and Association Agreement which is the first major step in the European integration process.

- Macroeconomic conditions are stable; industrial production recorded rapid growth in 2005, particularly in the mining and processing sectors; unemployment remains over 40%.
- The Central Bank of BiH has kept inflation low and the national currency (BAM) firmly pegged to the EUR for the past few years. Inflation now runs around 2.5% mainly due to increased fuel costs.
- This favourable economic climate and renewed trust in the national currency have resulted in strong growth of deposits in domestic banks (+20%) and of bank credit (+26%) to private companies and households.
- The informal economy (gray or black) is estimated by various sources to be as high as 40% of the overall economy
- The Central Bank regulates banks and other financial companies, but does not yet regulate MFIs, which are currently overseen by entity governments.

	Dec.02	Dec.03	Dec.04	Oct.05
GDP per cap. (EUR)	1,556	1,611	1,681	1,763
Inflation	0.3%	0.2%	0.9%	1.7%
Moody’s rating BiH				B3
COFACE				D

Source: CBBH, Moody’s, COFACE

▪ Institutional presentation

Networks

LOK micro is a member of AMFI (the local association of MFIs in BiH). LOK micro CEO is the current President of AMFI.

Ownership

As a local non-profit MCO, LOK micro has no owners. The founders are individuals who started microfinance activities with the help of the World Bank.

The Board of Directors (BoD) is composed of four members with banking, commercial and teaching backgrounds. Per LIP request, it also includes an Odraz Foundation (institution that implements LIP in the Federation) and a Raiffeissen Bank representative as associate members without voting rights. As the governing body, the BoD validates annual reports, budgets, operational plans and all strategic decisions (appointment of managers, approval of loans, adoption of new procedures).

Name of BoD members	Profession	Position in BoD	Date of entry
Enver Beganović, B sci ecc	Retired/ Former banker	President	2001
PH D Drago Radić	Professor on the Law faculty Mostar	Member	2001
Faruk Brkanić, B sci ecc	Private entrepreneur	Member	2001
Halil Mešan B sci ecc	Director of Žitozajednica	Member	2001

Two other committees complement the work of the BoD: the Audit Committee (for internal audit issues) and the Compensation Committee (for discussions on salary increases).

Management team

The LOK micro management team is particularly complete for the size of the institution with four managers (CEO, Financial Manager, Executive Credit Manager, Executive Operations Manager), two heads of departments (Head of IT Department and Head of Financial Department) and an Internal Auditor. It includes experienced staff that has worked for the institution since its beginning (CEO, Financial Manager, Head of IT Department) and younger and dynamic staff that has been hired as the institution has grown. There are also six Regional Managers that manage the six Regional Offices.

The CEO, Mr. Nusret Čaušević, is a Member of the Parliament of the Federation¹ with previous experience in the field of civil service (Ministry of Urban Planning, Stari

Grad Municipality) and Civil Society. He created LOK micro, first as a Citizen's Association, together with other individuals and with the support of the World Bank. As most practitioners of microfinance in BiH, he has received trainings organized by LIP.

Donations

LOK micro has capitalized 662,186 EUR (1,295,124 BAM) from the absorption of the equity of three smaller MFIs: Blue Bridge, Business Center and NBR Modriča. This equity includes grants received by these institutions but also their own retained earnings. LOK micro has not yet capitalized part of the subordinated LIP loans, although this is expected to happen in the following months (see "F").

Legal form, supervision and audit

LOK micro started its microfinance operations in 1997 as a "citizen's association" (non-profit organization). In February 2001 it was transformed into a Micro Credit Organization (MCO) in accordance with the Law on Micro Credit Organizations, and registered with the Federation Ministry of Social Welfare, Displaced Persons, and Refugees. It also registered offices in Republika Srpska with the RS Ministry of Finance (Modriča, Lukavica, Prijedor) LOK micro is not subject to any banking supervision but LIP conducts its own supervision that includes monitoring visits and the remission of financial and portfolio information on a monthly basis for monitoring and benchmarking purposes.

The financial statements of LOK micro, prepared in accordance with IFRS and IASB, have been audited by Deloitte d.o.o. Sarajevo since its registration as a MCO. This firm has auditing experience with many other MFIs in BiH, has been in communications with World Bank actors on microfinance issues and applies the CGAP audit guidelines. The auditors have always certified the accounts without qualifications. The financial statements as of 31st July 2005 were also audited in order to prepare for the potential capitalization of LIP funds (see F).

Organization

- The headquarters (HQ) in Sarajevo centralize all management and administrative staff (general management, accounting and finance, credit management, operation management, internal audit).
- Operations are managed from Regional Offices led by a Branch Manager. Each Branch Manager is responsible for either one or several satellite offices depending on the portfolio size, and is in charge of the general portfolio management: loan validation process, monitoring of portfolio performance and Loan Officer (LO) work and market evaluations. Loans up to 12,000 BAM are validated by field staff in a credit committee that includes

¹ "Citizens Party", a center party of the opposition.

LOs and the Regional Office Manager. Larger loans require HQ validation.

- All operations involving cash (disbursements, repayments) are made through local partner bank teller windows.
- Client, disbursement and repayment data is sent daily by LOs in auxiliary databases that are then entered at HQ in the loan tracking and accounting systems. Updated databases are sent every day back to Regional Offices by email. Regional Offices are aware of portfolio quality on a daily basis.

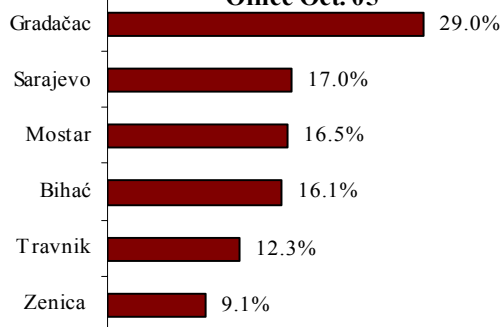
Market penetration

LOK micro operates through a network of six Regional Offices and 16 satellite offices (some satellite offices are located within the Regional Offices) located mainly in the Federation of BiH. LOK Micro was one of the first MFIs to operate in both entities: in 2001 it established a satellite office in Modriča, RS. In 2006, three new offices will be opened in RS (Visoko, Lukavica, Prijedor). The opening of Regional Offices has been initially based on external growth through the absorption of smaller MFIs.

LOK micro Regional Offices location



Outstanding portfolio per Regional Office Oct. 05



Products and services

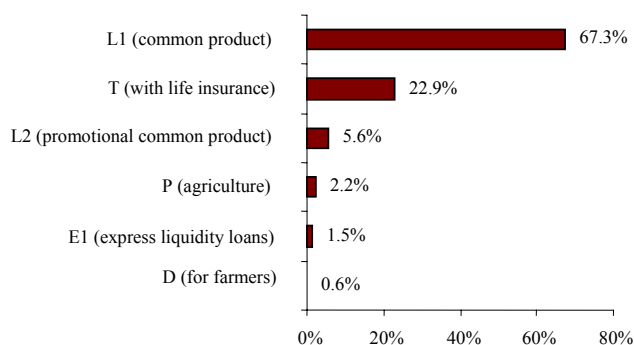
A detailed description of products is provided in appendix.

LOK micro has offered for many years a single product for all different purposes (trade, services, production, agriculture). In 2004 and 2005 it started a redefinition of its product offering in order to customize a product for each type of activity financed. This has led the institution to offer up to four permanent products and some short term products linked to promotional policies.

- Product L1 is the oldest product offered by LOK micro and it can be disbursed to any kind of formal or informal microenterprise. It is capped at 30,000 BAM (15,000 EUR), with an average disbursed amount of 3,347 BAM (1,670 EUR). Terms range from 1 to 36 months (most loans are below 12 months). Offered mainly with the individual methodology, this product can also be offered under the solidarity loan methodology. The APR is 35.1%.
- Product T was launched in 2004 in partnership with the insurance company Triglav. This product is given at a lower rate than L1 (APR is 26.0%) but the client is required to buy an insurance policy from Triglav that serves as a guarantee. These loans are financed by Triglav at a competitive interest rate (see "F" and appendix). They are capped at 30,000 BAM (15,000 EUR), with an average disbursed amount of 6,313 BAM (3,155 EUR). Terms range from 1 to 24 months, with an average loan length of 15 months.
- Product P for agriculture was launched in 2002. It is capped at 5,000 BAM (2,500 EUR), with an average disbursed amount of 4,356 BAM (2,175 EUR). Terms range from 1 to 24 months with a grace period of six months, and an average loan length of 22 months. The APR is 9.6%.
- Product E1 for short term liquidity needs was launched in 2004. It ranges from 500 BAM (250 EUR) to 2,000 BAM (1,000 EUR), with an average disbursed amount of 1,232 BAM (1,115 EUR). Terms range from 1 to 5 months, with an average loan length of 3 months. The APR is 40.1%.

LOK micro has also launched a promotional product for good clients, taking advantage of an availability of resources in September 2005. This L2 product was offered at a lower interest rate than L1 (APR of 33.1%) and was promoted through letters sent to best clients. It is planned to launch other products of this type to enhance client retention. LOK micro also temporarily launched Product D for some farmers who were sub contractors of a local factory, with the same conditions than Product L1.

Outstanding portfolio per product Oct. 2005



■ Governance

Governance and Decision Making is rated “b”

LOK micro is currently registered as a not-for-profit microcredit organization, but is planning to merge with RS-based Sinergija Plus and to transform into a microcredit company with shareholders when the new microcredit law is enacted. This process will raise many ownership questions that are not taken into account in this report. The details of the merger and the transformation are not yet known and the new law has not yet been published. The key operational aspects of merger with Sinergija Plus are, however, treated throughout in the report.

Decision-making

LOK micro governance structure is efficient and follows best practice standards:

- The Board of Directors (BoD) gathers committed and independent members. They participate in almost all meetings and bring valuable comments and insights. Their former experience in the private and superior education sectors is instrumental to good decision making.
- All decisions are adequately formalized in minutes that keep track of the discussions held.
- As all MFIs working with LIP, governance bodies are strengthened by specialized committees, namely the Audit Committee and the Compensation Committee.

LOK micro has the classical decision making mechanism of an NGO; most decisions and initiatives stem from the Management Team, while the BoD mainly discusses and

validates management initiatives. Since Directors are not the owners of the institution, they do not have a financial relationship with the assets of the MFI. However, this structure has not prevented a healthy development of the NGO, thanks to a transparent, committed and professional Management Team.

The consequences of the merger between LOK micro and Sinergija Plus, that include the nomination of new BoD members representing the capital composition of the new company, have been fully considered and understood by the present BoD. The decision to merge has been made public and orientates the decision making of both institutions. The BoD of both institutions has approved it. Although the precise structure of the BoD of the company is not yet known and will depend on many factors (new law, participation of a third partner), the institution is ready to accept a dramatic change in its decision making process.

LOK micro management team and BoD receive complete management information regarding financial and portfolio performance. Information is presented in monthly reports that include standard financial and portfolio indicators as well as financial statements. Although comparisons with other MFIs and analyses and explanations of trends are frequently added, they are not systematically included despite their clear advantages for monitoring purposes.

Planning

LOK micro has conducted a thorough and participatory planning process that led to the writing of the 2004-2007 Strategic Plan and annual operational plans with concrete goals in terms of portfolio growth, HR, expansion and financial projections. Detailed budgets are produced on an annual basis and monitored monthly.

The strategic plan clearly states the rationale for a merger and transformation into a microcredit company.

- Given its size in the microfinance industry in BiH (7% of total portfolio, 5% of clients as of September 2005), a merger appears as a logical decision if the institution is to survive in a very competitive market. This decision is strengthened by the fact that both LOK micro and Sinergija Plus do not have international networks or NGOs that supported their initial development, making it more difficult to grow internally.
- LOK micro is characterized by a very “for profit” approach to microfinance, through external growth and innovation. It successfully took over three MFIs to penetrate the areas of Gradačac, Travnik and Bihać. A merger is therefore something LOK micro staff is not afraid of. Both MFIs have already started integration processes, such as common gatherings and common negotiation of loans.

- The selection of Sinergija Plus makes sense. It is a RS based MFI, which will therefore complement the current network of LOK micro. Sinergija Plus has also a similar target population than LOK micro: both institutions have the highest average loan size of the market². Finally, both have quite similar management cultures, with an interest in innovation and development of financial and non financial services for their clients.

However, the thinking on the practical issues of integrating LOK micro and Sinergija Plus has not yet been formalized. This is expected to be decided once the law is passed. But many aspects such as capital composition, organizational chart, products of the new company and interest rates could be discussed from now. The timing of the merger once the law is passed are still to be defined, although the announcement of the intention to merge was made two years ago. The financial projections for the new company are not yet available either.

The other aspects of the strategic and operational plans are consistent with LOK micro current risks and market:

- Portfolio growth is expected to continue being dynamic, in order to allow for additional economies of scale. The average portfolio growth will pass from 40% in 2005 to almost 50% in 2006. As of October 2005, LOK micro had roughly respected its growth projections.
- The institution is committed to continue innovating in products and is already thinking about micro leasing and micro insurance once the new law authorizes it.
- It establishes also a proactive financing strategy that will rely in the capitalization of LIP funds (see “F”), in the strengthening of the already solid relations with commercial banks and in the search of new financing sources such as international funds and institutions that might be interested to buy into the capital base of the new company.
- Expansion to Eastern areas of the Federation is the new goal, together with the entrance in areas where financing for agriculture will be available through IFAD.
- Development of a new MIS that will be more user friendly and will allow an easier generation of reports is one of the keystones of LOK micro strategy. This process is already underway and the new software should be ready in 2006 (see “T”).

Management team

The Management Team is quite strong for the size of the institution (four managers, two heads of departments, an Internal Auditor, six Regional Managers), with skilled and multifaceted people. The CEO has a historical knowledge of the institution and has many external contacts that are of

much help in the financing process. The Finance Manager, who has been with the MFI since inception, knows all the financing partners and has a good view of the main strategic challenges. He can be considered as a real second-in-command person. Collective decision making at the management level through weekly meetings ensures the sharing of key information. The operating aspects are well known by the Credit and Operations Managers, so that they can face an unexpected departure from the CEO.

The appointment of well trained and experienced young managers is an adequate strategy for renewing staff and bringing new approaches. The Credit Manager, who graduated in Economics and Finance (2001), has worked in LOK Micro since 1999 (LO, Regional Manager, Credit Manager since 2001), gaining a deep knowledge of the institution. He has completed the three weeks Microfinance Training Program in Boulder, Colorado. The Operations Manager, who graduated as an engineer in 1999, worked in the private sector before joining LOK micro and has conducted consultancies for local and international firms. LOK micro is investing in them through the financing of their Masters degrees at local universities (in exchange they must commit not to leave the institution for the next two years).

The merger with Sinergija Plus will have an impact on the management team of the new company, since some members of the present management teams of both MFIs might have to leave or to redefine their responsibilities. However, the specifics about the integration of managers from Sinergija Plus have not yet been thought through sufficiently.

The recent redesign of the organizational chart is appropriate, especially in the face of the transformation into a private company. The Operations Manager position was created to concentrate the areas of MIS, product development and marketing. The Credit Manager is devoted to supervising portfolio quality but works closely with the Operations Manager in the development of new products and marketing. Some positions are not filled since they are not necessary for the present size of the institution (ie HR Manager, Marketing Service, PR Service) and will not be filled until transformation and merger. These positions are currently part of job descriptions of other work positions

Human resource management

LOK micro human resource management, although not led yet by a HR Manager, ensures motivation and good performance of staff. All HR procedures are formalized and respected. Training of staff is comprehensive: new LOs are trained through a standardized process that includes theoretical and field training with “mentors” (experienced

² Average loan size for LOK micro as of September 2005 is 3,167 BAM while it is 4,490 BAM for Sinergija Plus.

LOs). All staff also takes advantage of external trainings organized by LIP and other institutions. LOK micro establishes training programs every year for all staff. The financing of Master degrees for Managers and middle management ensures good skills and long term commitment with the MFI.

The salaries policy is adequate with an overall good level of salaries for the sector. LOs are motivated through a sophisticated bonus scheme that accounts for the quality and volume of the portfolio. The bonus scheme does not take into account number of clients, pushing the LOs to disburse ever higher loan amounts, capped by the credit procedures. Turnover has remained low despite the aggressive recruitment policy of other MFIs in BiH³. The 10% turn over in 2004 is linked to an unexpected departure of LOs for personal reasons.

The HR policy does not include, however, evaluations of staff that would focus on personal satisfaction and professional perspectives. This is particularly important as the institution grows and follow up of staff can not just be based on monthly financial bonuses.

	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
Total number of staff	48	49	47	57
% Credit officers	52%	51%	60%	63%
Turnover	2%	0%	10%	2%

Information

Information and equipment is rated “b”

Description of the MIS	
Equipment	<ul style="list-style-type: none"> ▪ 58 computers and seven laptops. Each Regional Office has 1 to 2 computers. ▪ Internet connections between HQ and Regional as well as satellite offices. ▪ All software is licensed.
Accounting	<ul style="list-style-type: none"> ▪ FINPOS: Bosnian accounting software. ▪ Centralized accounting process; daily reconciliation with bank statements and portfolio information. ▪ Monthly financial statements including amortization and provisions; no Regional Offices financial statements.
Portfolio information	<ul style="list-style-type: none"> ▪ KREDPOS: Internally developed, non integrated, loan tracking system, built on DOS language and DBF database. ▪ Regional Offices send client information and credit committee decisions through email to the HQ. ▪ Client, disbursements and repayment information entered and verified in HQ; information sent back to Regional Offices through email where it is integrated into their local databases.

Management Information System (MIS) and equipment
Hardware is sufficient for the institution and is adequately shared between HQ and Regional/satellite Offices. The

³ No LO from LOK micro has joined ProCredit Bank, which is one of the most aggressive institutions in hiring LOs.

existing information security policy could still be improved as backups of the main database are done in the hard drive on a daily basis but copies on CD Rom are only performed weekly. Additionally, there are almost no parameters in the loan tracking system (maximum amounts, interest rates, date of repayment) so that there is a risk of error when inputting the information (see “R”). The antivirus is updated automatically.

The loan tracking system, although well known by users and simple, is not very flexible. It has however responded so far to LOK micro needs, including the integration of new products. It does not allow for multiple levels of access according to the type of user. Its compatibility with other programs is not optimal (not possible to transfer information to Excel, to generate automatically contracts or other loan documents). The lack of integration between the loan tracking system and the accounting system generates additional work of information input and reconciliation. The system only includes the loan generation and repayment modules and does not allow for client evaluation, sector and client statistics, etc.

The accounting system is rather simple but responds to basic needs in terms of generation of financial statements. It does not include a financial analysis module. Therefore all ratios are calculated manually.

Being aware of these limitations, LOK micro is developing a new integrated MIS through a partnership with a local company. This initiative was discussed and approved by Sinergija Plus. This new MIS will be web based so that no actual transfer of databases will be involved and the input screens will be much more user friendly. The MIS will use a SQL database format and reports will be much more user friendly. The contract with the local software company is innovative: since the codes will belong to both institutions and their possible sell to other MFIs will generate income for both of them⁴. Development costs are also shared.

The MIS Head of Department is very experienced and has developed the current loan tracking system. He has worked with LOK micro almost from its beginnings and knows very well all the specificities of its products. He works alone, thus generating a key person risk. However, all loan tracking system procedures are documented.

Information on activities

Portfolio information is available on demand with a good level of detail at the HQ level. The loan tracking system

⁴ The MIS development team consists of two members from LOK micro (Head of IT Department and Operations Manager) and two from the local software development company. One additional IT specialist for network and hardware development has been hired.

generates all the necessary information for an appropriate tracking of portfolio information such as the number of clients, portfolio at risk by days of delinquency, written off loans, productivity per LO. Personalized reports can not be generated but the programmed reports are quite comprehensive. However, some information is not readily available and needs to be generated manually (ie write off per product/branch, rescheduled loans).

At the Regional Office level, the information available is sufficient for portfolio management (list of active clients with all necessary details, payments expected in the day, etc). Per management decision, Regional/satellite Offices only have at their disposal the local database, not allowing them to have a global view of the institution. However, the global view is available on a monthly basis through operational reports and competitions between LOs (LO of the month). Most reports on portfolio quality of the Regional Office can not be generated locally but must be requested from HQ and faxed (which is usually quick). Despite this, field staff is always aware of portfolio quality through frequent contact with clients and daily reception of payment slips from banks.

Financial and accounting information

Monthly financial statements with all accounting operations (depreciation, provisions) are quickly available. Information is reliable thanks to adequate and frequent reconciliations with banks and the loan tracking system performed daily at HQ.

All relevant financial ratios are included in the monthly operational report. However, they are not complemented with explanations and analysis of trends (this information is specifically prepared for the BoD but not for all staff).

▪ **Risk**

Risk Management is rated “a”

Procedures and internal controls

LOK micro has developed comprehensive operating and organizational work procedures.

- Procedures are appropriately formalized at all levels (Regional Offices and HQ) in several manuals. The institution has been granted the ISO certification for two years, therefore it has to formalize all procedures, to standardize them and to keep them updated. These procedures are well understood by staff.
- There is a good separation of duties both at HQ and field levels. Credit procedures from evaluation to disbursement are conducted by different persons. The system of Credit Committees by levels of risk (loans higher than 12,000 BAM to be approved at HQ) is adequate.

- The recording of credit operations is centralized in the HQ, ensuring a unique entry of data in the loan tracking system. The risks related to the lack of parameters within the loan tracking system (amounts of loans, interest rates, etc.) is mitigated by the fact that the same loan information is inputted in the loan tracking system and in the accounting system by two different persons, allowing for reconciliations.
- There is a systematic control of staff performance based on monthly bonuses. Bonuses are closely related to operational objectives, allowing a monitoring of achievements and an additional level of internal controls.
- The use of bank intermediaries in handling credit disbursement and repayment limits the cash security risk.

Internal audit

The internal auditor has worked on a part time basis until November 2005, when he was hired on a full time position due to the expansion of operations. He has very valuable experience, having worked for many other private companies as an auditor. He follows comprehensive procedures that ensure an adequate control of credit operations. He also has a broad understanding of risks (financial, MIS, HR) that lead him to recommend improvements in existing procedures and to carry out various kinds of internal audits besides portfolio audit.

With frequent visits of Regional/satellite Offices (at least twice per year, with one programmed and the others unexpected), of all LOs, of clients (all delinquent clients), and HQ (at least three per year), the internal auditor covers the main areas of risk: credit, accounting, MIS. He also conducts confirmations of all receivables and liabilities for randomly selected clients. In 2006, with a full time position, he is expecting to increase by 50% his number of visits. The audit reports are directly communicated to the Audit Committee and then to the BoD, and recommendations proposed are subject to a relevant follow up.

However, the audit plans are disseminated in the annual operational plan, reducing the surprise factor of the internal audits. These plans only give the details about the months in which programmed controls are going to happen, without mentioning the exact days. The internal auditor carries out other extraordinary visits which are not programmed annually.

LOK micro was the first MFI in BiH to introduce ISO 9001:2000 standards for quality management. In accordance with this certification, it is obliged to conduct periodical internal audits in order to verify that all procedures are respected. This is done by a team of internal auditors consisting of five employees licensed by a foreign audit company. The audit itself covers the whole lending

process, starting with loan disbursement and ending with late payment monitoring.

Supervision is complemented with annual LIP monitoring visits and the comprehensive work of external auditors. Deloitte & Touche external audits follow IFRS and IASB and have been delivered without qualifications.

■ Activities

Activities: products and services is rated “a”

EUR, unless otherwise stated	déc. 2002	déc. 2003	déc. 2004	oct. 2005
Loan portfolio	4,148,075	4,784,252	6,867,427	8,751,122
Loan portfolio (BAM)	8,112,930	9,357,184	13,431,520	17,115,707
Evolution	3.7%	15.3%	43.5%	27.4%
Average outst. loan	4,003,882	4,380,583	5,569,160	7,900,632
Active borrowers	3,579	3,833	5,096	6,322
Evolution	(4.8%)	7.1%	33.0%	24.1%
Average outst. loan /client	1,159	1,248	1,348	1,384
% of GDP/capita	74.5%	77.5%	80.2%	78.5%
Average amount disbursed	1,731	1,843	1,868	1,863
% of GDP/capita	111.2%	114.4%	111.1%	105.6%
Rescheduled loans	0.0%	0.0%	0.0%	0.7%
PAR 31-365	0.4%	0.7%	0.8%	1.0%
PAR > 365	0.0%	0.0%	0.0%	0.0%
Write-off ratio	1.3%	0.8%	0.2%	0.2%

Marketing and competition

The BiH microfinance sector is highly competitive, mostly in urban areas where MFIs have been operating for years and commercial banks are also active. Rural areas also face increasing competition. Overall market demand is still expanding, but portfolio growth rates have slowed down with an increasing number of clients maintaining loans at more than one institution. By the end of September 2005, the 14 largest MFIs were serving around 140,000 clients on a total potential market estimated by some to be 250,000 to 350,000 clients. The microfinance portfolio outstanding stands around 140 million EUR. This is in addition to commercial banks' portfolio with the largest share attributed to ProCredit Bank BiH with over 20,000 micro-credit clients and an estimated portfolio of 17,5 million EUR at the end of September 2005.

The big ongoing trends are:

- MFIs going aggressively into rural areas providing agriculture-related loans;
- MFIs extending loan terms longer to around 36 months;
- MFIs looking to diversifying the product offerings themselves (e.g. housing loans) or in partnerships with other financial institutions (e.g. selling insurance products, mobilizing deposits); and
- Commercial banks “down-scaling” into the top 10% of MFI largest clients. The latter trend is partially explained

by excess local liquidity forcing commercial banks to look for new markets.

The days of “polite” competition in BiH is over. All MFIs have been facing more aggressive competition from ProCredit Bank who has been fast expanding its office network and hiring lots of new staff. With cheaper funding base (access to savings) and broader range of products, ProCredit Bank has started to poach top-end MFI clients. Thus far, MFIs have been mostly relying on word-of-mouth and fast quality service to gain and retain clients. Although industry portfolio quality remains strong overall, there are signs that the BiH microfinance sector is becoming more “normal” as evidenced by increasing portfolio-at-risk and write-offs recorded as the results of increased industry competition and client overindebtedness.

In this competitive environment, LOK micro conducted a very innovative strategy of product development in order to target the high-end segments of the market. By disbursing higher average loan amounts and introducing in the market new products such as life insurance, LOK micro aims for a distinctive and strategic positioning, supported by a refined marketing analysis.

LOK micro management pays a lot of attention to marketing, as shown by the recruitment of a new Operation Manager dedicated –among other things- to marketing and product development. LOK micro has conducted market research with 600 clients on issues such as overindebtedness, client satisfaction, loyalty and the introduction of new products. One of the results of these efforts has been the launching of L2, the promotional product for best clients, at lower interest rates.

However, the key competitive weakness of LOK micro is its current interest rates. Clients are currently less sensitive to interest rate applied than collateral requirements and speed of disbursement, but this factor will become crucial in the following years as competition grows. LOK micro is

MFI	Average Portfolio yield	Average Loan Size (BAM)
SINERGJA plus	20.1%	4,490
MIKROFIN	20.4%	2,845
EKI	20.5%	2,171
PARTNER	22.2%	2,545
BENEFIT	22.8%	1,751
Women for	23.4%	852
MI-BOSPO	25.0%	1,566
SUNRISE	28.6%	1,975
PRIZMA	29.0%	1,171
LOK micro	31.4%	3,167
MIKRA	34.8%	1,138

Source: LIP Sept. 2005

aware of this limitation and it has been decided to lower interest rates in the Operational Plan for 2006.

Credit methodology

With well trained LOs, LOK micro has an adequate credit methodology:

- Clients' selection is based on standardized and simple loan application forms containing sufficient information for credit analysis and approval. Clients' repayment capacity is analyzed through revenue/installment ratios in the cash flow analysis led by LOs. The assessment is performed taking into account clients' expected business and family revenues, main expenses and owned assets.
- Besides repayment capacity, clients' selection takes into account repayment will, by checking their reputation within the community and track record.
- LOs conduct frequent visits to clients. The Internal Auditor and the Regional Office Managers accompanies them for a selected sample of clients. However, LOs visits are not always documented on follow up forms.
- LOs are informed about client delinquency within 24 hours and even before by looking at payment slips from banks collected daily. They apply from the first day of delinquency the well-defined recovery measures described in the Credit Manual. LOK micro has an internal legal officer who is in charge of following-up late repayment management. Written off cases are transferred to an external lawyer. LOK micro reschedules some loans but only delinquent ones and when repayment will has been verified.

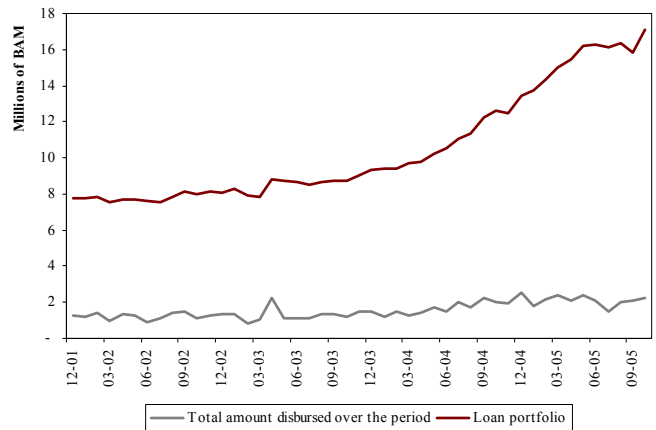
Higher loans (over 12,000 BAM) go through a rigorous evaluation. LOs make and analyze cash-flow projections for all repayment terms and calculate debt, liquidity and profitability ratios. The loan application includes a specific CAMPARIEL⁵ analysis. The Credit Manager takes part in the Credit Committees by phone or on the spot. However, the use of these loans for the stated purpose could be systematically checked, as the amounts at stake are high and the success of the financed project is key to repayment.

LOK micro's recruitment and training policies are designed to provide LOs with the appropriate skills to perform their assignments. The recruitment of new LOs is preceded by a 6 months to one year period of internship. This period is used to familiarize new staff with LOK micro's organizational chart and procedures. During this period, new staff is learning from other LOs before issuing loans under supervision. Loan officers are motivated by a good bonus scheme and are paid competitively with others MFIs.

However, LOK micro has to develop a deeper thinking on caseload per LO in order to equilibrate workload and reduce key person risk. Currently, at least three LOs manage a portfolio of over 1 M BAM despite a limit of 800,000 BAM considered as a maximum in the current operational plan.

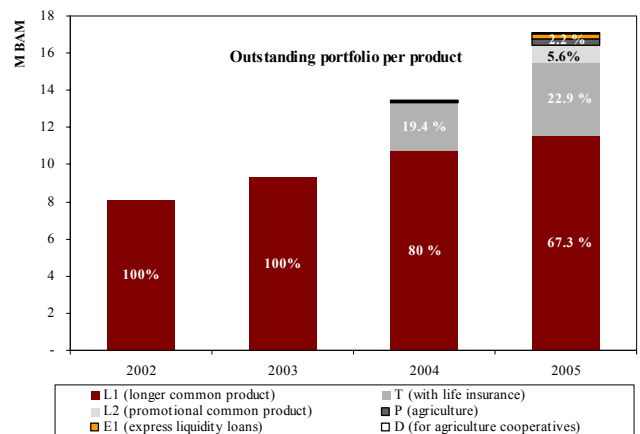
⁵ C- Character, A- Ability, M-Margin, P- Purpose, A- Amount, R- Repayment, I- Insurance, E- Environment, L- Legal

Loan portfolio evolution



Evolution of the portfolio

Portfolio growth has been constant, with a big jump in 2004 (43.5%), following the trend of the industry as a whole. Product L1 is the main product of the institution. However, with the introduction of activity-based products, its share of global portfolio is in a downward trend, while the T Product, introduced in 2003, is rising (from 19.4% in 2004 to 22.9% as of October 2005). The other products are developed for specific client needs and do not yet represent a significant part of the global portfolio (E1 represents 1.5%, D 0.6%). L2 represents 5.6% of portfolio as of October 2005 but its share is expected to disappear once the promotion is over.



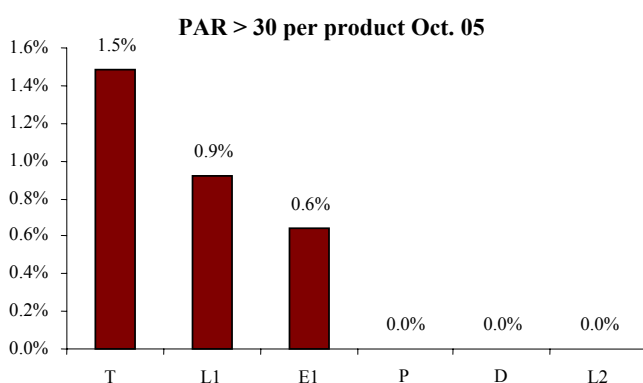
Quality of the portfolio

LOK micro has a very good portfolio quality, like most MFIs in BiH. PAR>30 is in a slight upward trend, but remains around 1,0%, the average performance for MFIs reporting to LIP. Written-off loans have diminished from 1.3 % in 2002 to 0.2% in October 2005. The average write off ratio for the MFIs reporting to LIP as of September 2005 was 0.7%.

This good performance must be compared to a higher PAR<30, at 4.2% as of October 2005. This might be showing a trend of some clients to slightly postpone their

payments, despite the fact they end up paying before 30 days of default.

Product T, the product with the highest average loan amount, has the highest PAR (1,5 % as of October 2005) whereas the smaller express liquidity loans (E1) have less delinquency. The increase of PAR is concentrated in certain areas that have suffered from difficult economic situations (closure of big public companies). Such are the cases of the Regional Offices of Travnik and Zenica (recently created), where PAR>30 was 1.42% and 2.01% respectively as of October 2005.



LOK micro only started rescheduling loans in 2005. Rescheduling can only be authorised by Credit Committee at HQ level with the presence of the Credit Manager, and only for clients with verified repayment will. The amount of rescheduling loans is not yet available by product. As of October 2005 rescheduled loans represent 0.7% of gross portfolio.

Portfolio diversification

LOK micro has established a precise diversification policy per sector in order to minimize risks. The idea is to limit agriculture to 25% of portfolio while production should not represent more than 10% given the difficult economic situation of the industrial sector. There is not a specific policy of diversification by region but LOK micro network is already quite spread within the Federation, generating a natural diversification.

Credit risk coverage

Like its BiH peers, LOK micro has a conservative provisioning policy. Loan loss reserves cover largely PAR>30. This high coverage level is essentially due to an industry-wide provisioning of 2% even for healthy portfolios, per LIP requirement. However, this policy clearly generates over provisioning reducing profits, and therefore assets, for all MFIs in the sector.

Guarantees are requested for all loans as an additional measure of risk coverage, although their enforcement is not easy and guarantors are used more to pressure clients than

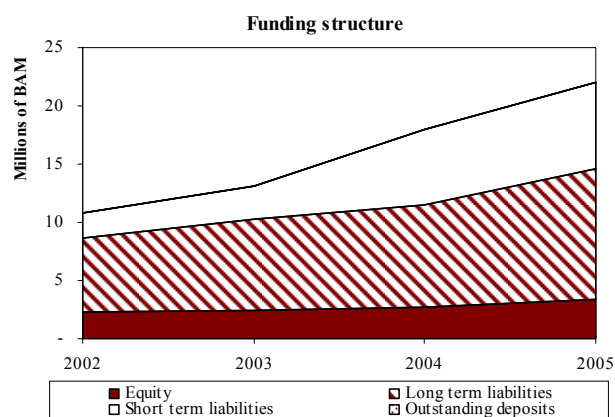
being an actual source of payment. LOK micro uses various types of collateral (administrative ban on salaries, promissory notes, etc.). Guarantee requirements are not rigorous and depend mainly on LOs assessment of risk. Nevertheless, LOK micro applies prudential limits such as not allowing a guarantor to guarantee various loans or to have an active loan.

Usually the internal legal officer carries out mutual consent actions (letters, visits) together with LOs collection actions as described in the Credit Manual. Once loans are written off, they are transferred to an external lawyer who initiates legal actions. From 1997 until October 2005, around 500,000 BAM were taken to court, but they came mainly from the written off portfolio of an MFI taken over by LOK micro.

EUR	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
Risk coverage ratio	812.8%	276.2%	256.7%	294.6%
PAR 31 net of loan loss provision / Equity	<0%	<0%	<0%	<0%

■ Financing and liquidity

Financing and liquidity is rated "a"



	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
Liabilities equity ratio	360.9%	426.3%	569.3%	559.7%

As a non deposit taking MFI, LOK micro finances its activities with equity 16% and debts 84% (concessional loans 37% and various commercial loans 47%). LOK micro has accessed resources from up to 10 commercial banks (Raiffeissen, Hypo-Alpe-Adria, HVB, Investment Bank, Unicredit, ABS, etc.). The institution has a high leverage ratio of 5.59, compared to the average of 2.65 for the MFIs reporting to LIP as of September 2005. This is mainly due to the fact that LOK micro has not received grants from international networks. Moreover, retained earnings have not accumulated as quickly as in other local MFIs, due to lower levels of profitability in previous years.

Additionally, unlike many other MFIs under LIP, LOK micro has not capitalized yet part of LIP loans. Indeed, the continuation of LOK micro under LIP was temporarily put in hold in 2002/2003 since the program had doubts about the viability of two companies LOK micro owned together with other partners: one was LOK Institute, a center that offered social and economic research services, in particular about LOK micro clients; the other was LOK Invest, a company created to manage and invest various funds, among which funds of LOK micro and its clients. LOK micro was requested to sell its shares of these companies if it was to continue receiving support from LIP, since they were not considered compatible with its core activities. The sell of these shares to LOK Institute, for a total value of 709,454 BAM, generated an investment income of 650,546 BAM in FY2002. It is expected that LOK micro will capitalize part of its LIP borrowings in 2005 or 2006, allowing for a lower leverage and less interest costs (according to LOK micro estimates, around 700,000 BAM will be capitalized from UNHCR and 2,100,000 BAM from LIP).

Asset liability management procedures

Asset & liability Management (ALM) risks are identified, limited and manageable given the current assets/liabilities structure.

- **Maturity risks are closely monitored:** Long term resources cover 263% of long term assets, generating a large capacity for funding longer term activities. There is a slight trend for longer term loans as agriculture lending develops (as of December 2003 long term portfolio only represented 8.6% of total portfolio; it represented 12.6% of total portfolio as of October 2005).
- **Limited FX risks:** The only debt in EUR of LOK micro is the one from LIP, that still accounts for 47% of total portfolio. LOK micro has protected itself against devaluation of the EUR by transferring the devaluation risk to the client if the currency board disappears, per credit contracts. BAM has a fixed parity with the EUR and the rate has not changed since the introduction of the EUR. However, if the BAM were to devalue the FX risk is technically transferred to clients but would obviously increase the credit risk for LOK micro.
- **Low interest risk:** only 18% of LOK micro's borrowings are linked to a variable interest rate (EURIBOR or CHF). Expected fluctuations represent a minor risk as they are compensated by LOK micro's high interest spread.

Financing strategy

LOK micro current financing strategy is dynamic and innovative. It includes a negotiation of interest rates for commercial financing from local banks, and the diversification of funding sources. The latest loans received have been negotiated together with Sinergija Plus in order

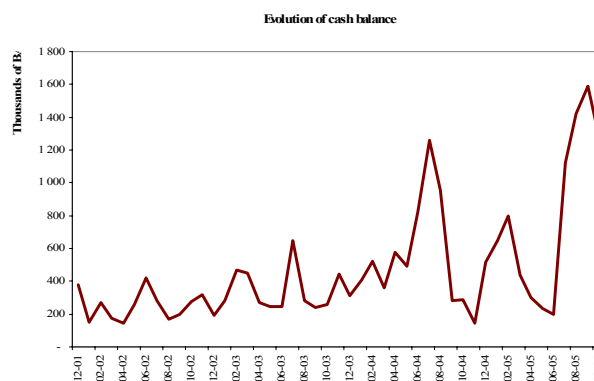
to increase the amounts and the leverage in interest rates. LOK micro is also holding negotiations with various international funds (rating is part of its approach to them). The agreement with Triglav is another innovative financing strategy, through which LOK micro obtains resources at a competitive cost from this insurance company (2 M BAM at 7% per year), to be disbursed in loans that include Triglav insurance policies. Finally, LOK micro uses its building as a mortgage for bank borrowings.

However, financing sources still need to be further diversified to ensure longer resources and more competitive interest rates, taking into account LOK micro's ambitious product policy. New products to be offered such as housing loans, investment loans, microleasing will require access to additional longer term resources at competitive rates.

The merger, the possible entry of a third partner and the creation of the new company are expected to generate an institution with a critical mass and a clearer property structure, which should be of interest to investors. However it is too early to assess the various consequences of these changes since the new law has not yet been published and the details of the merger have not yet been defined.

Liquidity management

LOK micro has an adequate liquidity management with detailed annual and monthly cash flow projections. Availability of funds in all operating areas is secured through monthly transfers to Regional Offices bank accounts according to their cash flow projections. Liquidity in Regional Offices is not centralized and can not be invested during the month in short term bonds. But in cases of need, transfers between offices can be organized during the month and most banks offer overdraft facilities. As of October 2005, liquidity represented 5.8% of assets, while the average for MFIs reporting to LIP was 6.0%. This ratio is higher than the average for LOK micro during the year (3.6%), due to a loan received from CBS Bank at the end of October.



■ Efficiency and Profitability

Efficiency and Profitability is rated “b”

	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
ROE	4.3%	7.7%	9.3%	27.8%
Liabilities / Equity	360.9%	426.3%	569.3%	559.7%
ROA	0.8%	1.6%	1.5%	4.2%
Profit generation				
Operational self-sufficiency	103.1%	106.5%	107.2%	120.2%
Portfolio Yield	35.1%	34.6%	31.8%	31.4%
Operating expense ratio	32.3%	27.5%	22.3%	17.9%
Staff productivity	75	78	108	111
Loan officer productivity	143	153	182	176
Average outstanding loan per client (EUR)	1,159	1,248	1,348	1,384
Asset management				
Outstanding loan portfolio / assets	73.0%	70.2%	73.0%	75.4%
Non-portfolio income as a % of financial revenues	3.0%	1.9%	2.5%	2.7%

Overview of the profitability

LOK micro is a profitable and efficient institution. ROA, ROE and operational self-sufficiency have increased steadily, with an acceleration in 2005. This has been possible despite a progressive decrease of portfolio yield related to the development of the T Product. The results show a high level of efficiency, as can be seen in the downward trend of the operating expense ratio. The much quicker growth of ROE is directly related to an increasing liabilities/equity ratio that is notably high for an NGO (see “F”). However, LOK micro operational self-sufficiency, of 120.2% as of October 2005, is lower than the average of the MFIs reporting to LIP as of September 2005, of 127.8%.

Portfolio yield and effective interest rate

Portfolio yield has decreased over the period, due to the development of the T Product, which has a lower APR than the L1 Product (see “Presentation” for APR details). This trend is expected to continue as competition grows and pressure on interest rates increases. The launching of promotional products and of the agriculture product with lower interest rates shows it. Portfolio yield is quite similar to the weighted APR of the institution, estimated at 32.3% as of October 2005. This shows the good portfolio quality.

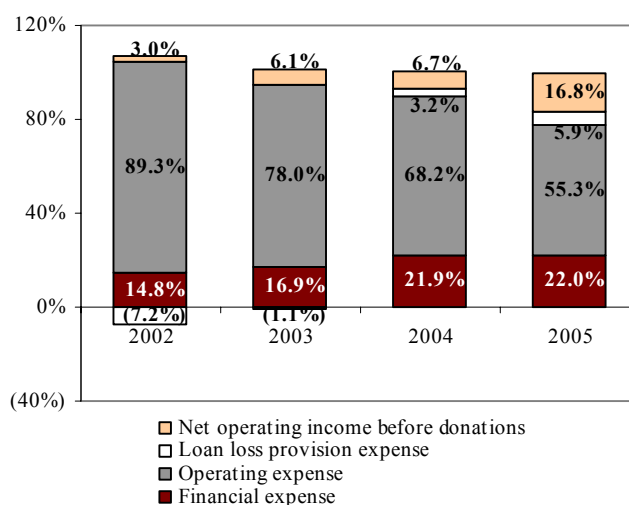
Portfolio yield of LOK micro is one of the highest of the microfinance industry (MFIs reporting to LIP), with the average as of September 2005 being 25.7%. Only Mikra has a higher portfolio yield (34.8%), but this MFI applies a village banking methodology that requires higher interest rates to cover its costs.

Operating expense ratio

The operating expense ratio has experienced a dramatic decrease (32.3% in 2002, 17.9% in October 2005), related mainly to portfolio growth. The ratio is expected to continue decreasing with the increase in economies of scale resulting from the higher average outstanding loans per client, client growth and the control of operating costs. This ratio is slightly higher than the average for MFIs reporting to LIP as of September 2005, of 16.3%.

- Staff productivity has been trending upward over the period and reached 111 in October 2005. LO productivity has also increased but suffered a dip, going from 182 clients per LO in 2004 to 176 in October 2005. This is related to the recruitment of eight LO in 2005 for the opening of four satellite offices.
- The average outstanding loan per client has grown steadily, from 1,159 EUR in 2002 to 1,384 EUR in October 2005. This is a high average for MFIs reporting to LIP, where the average is 1,058 EUR as of September 2005.
- Operating costs have been almost stable, with negative growth in 2003 (-6.6%) and just a 2.8% increase in 2004. This, together with an amazing growth of average portfolio (9.9% in 2003, 27.1% in 2004), explains the quick reduction of the operating expense ratio.

Cost structure in % of financial income



Funding expense ratio

The funding expense ratio has an increasing trend during the period, despite portfolio growth. This is a result of higher interest rates as the institution accesses more commercial financing and leverage increases. The average cost of debt increases as well, but remains lower than commercial rates (around 10%) due to the presence of soft funds from LIP (44% of total liabilities).

Asset management

Loan portfolio only represents 75.4% of total assets, while the average for MFIs reporting to LIP is 89% as of

September 2005. This relates to the important share of fixed assets in total assets (15.5%). Indeed, LOK micro owns its HQ. It bought the building after it sold its shares of LOK Invest and LOK Institute. This building is however a source of revenues since some offices are rented to other companies (rents represent around 2.5% of total financial revenue). Moreover, it has been mortgaged to obtain a loan from Investment Bank.

Adjusted performance

Details concerning the specific adjustments are included in the annexes

LOK micro is a profitable institution after adjustments since 2005. The adjustment expense ratio has decreased all over the period as commercial interest rates decrease and adjustment for inflation is not computed in 2004 and 2005 (average equity is lower than average fixed assets). There are no adjustments for provisions from 2004 because the provisioning policy of LOK micro is more conservative than the GIRAFE provisioning policy. Therefore, the only adjustment that was passed in 2005 is the adjustment for cost of funds.

	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
Adjustment expense ratio	9.1%	5.1%	3.5%	2.9%
AROE	(31.5%)	(10.4%)	(5.6%)	13.1%
AROA	(6.0%)	(2.1%)	(0.9%)	2.0%
Financial self-sufficiency	81.9%	92.3%	96.1%	108.6%

Profitability outlook

LOK micro's profitability is solid and is based on a high portfolio yield and a decreasing operating expense ratio. Based on preliminary figures as of December 2005, the improvement of profitability that was observed in 2005 should be confirmed, although less important than in October. Profitability ratios are however lower than the average for the sector (see "Benchmarking" section), despite having one of the highest portfolio yields. Therefore, the main challenges for LOK micro's profitability in the future are:

- Monitoring and probably reducing interest rates to avoid client desertion, given that LOK micro's interest rates are higher than the sector average.
- Generating additional economies of scale in order to increase efficiency and profitability (without increasing interest rates) and reach sector averages.

The merger with Sinergija Plus could have a direct, positive or negative, impact on LOK micro's profitability. It is too early to predict the results since the operating, financial and management characteristics of this merger are not defined yet. However, if both institutions manage to integrate their respective portfolios without affecting quality, they should be able to generate higher economies of scale, increase their client base and ease the access to financing.

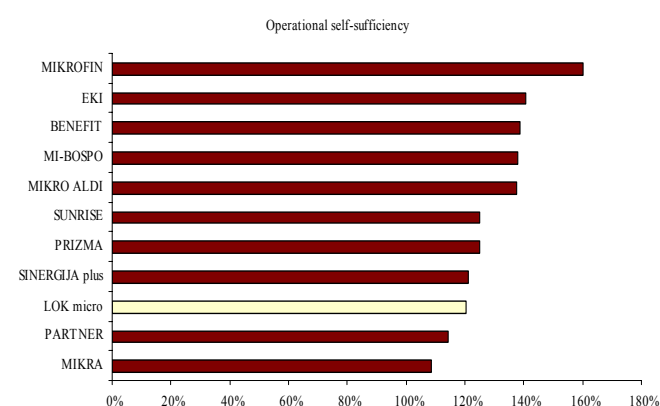
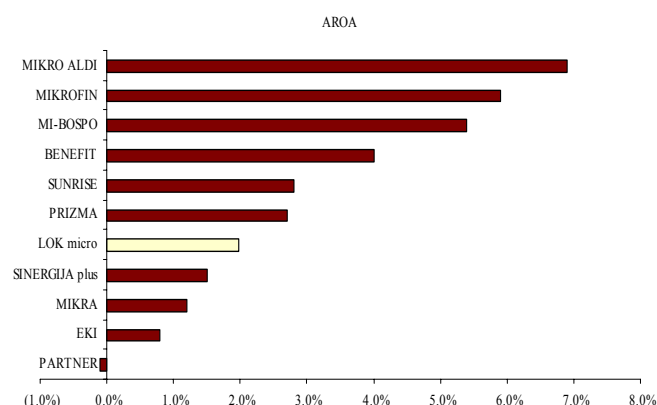
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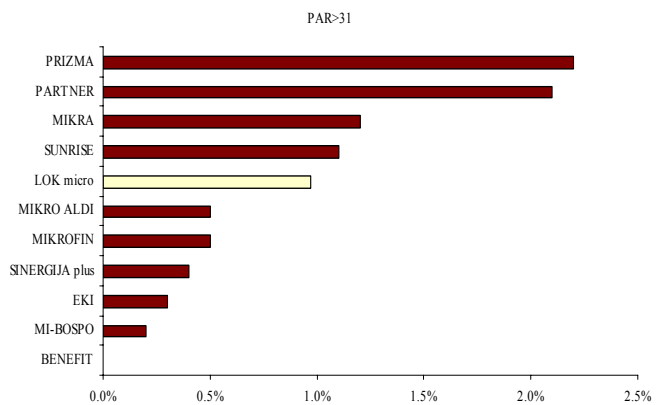
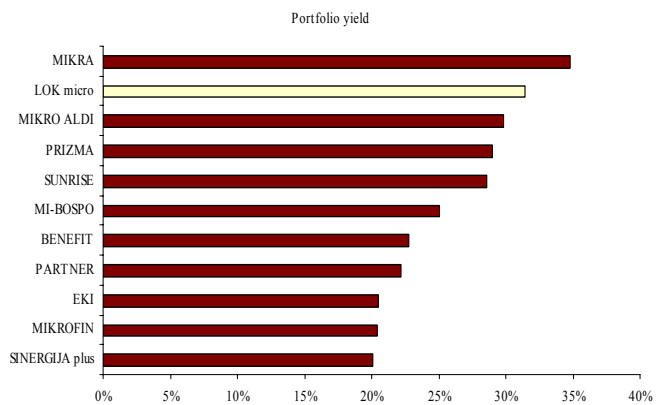
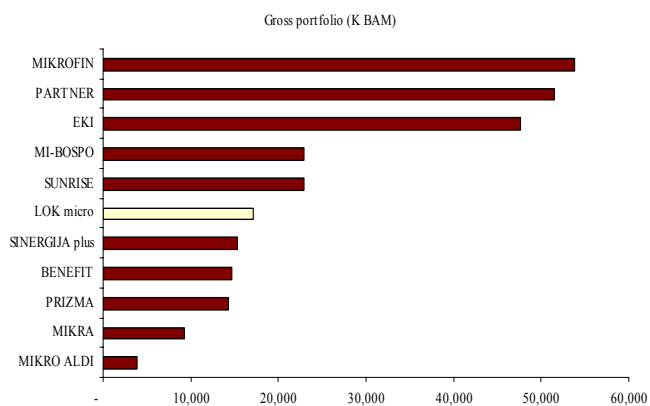
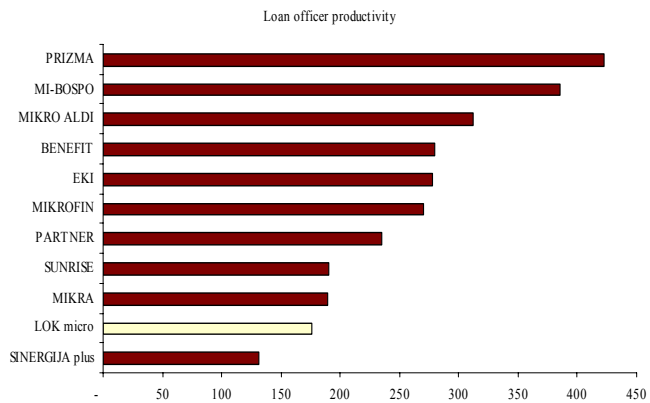
Benchmarking

Classification based on MBB criteria

Area	Europe and Central Asia (ECA)
MBB peer group	ECA Medium Broad: Aregak (Armenia), Constanta (Georgia), Finca (Kyrgystan), KLF (Kazakhstan) KEP (Kosovo), MI-BOSPO, Mikra and Prizma (BiH), NOA, OIS (Serbia), PSHM (Albania).
Maturity	Mature (8 years of operations)
Scale of operations	Medium with an outstanding portfolio of 8.8 M EUR.
Target population	Broad: average loan outstanding represents 78.5% of GDP per capita.

Source: LIP – September 2005 / Data of LOK micro as of October 2005 from Planet Rating report





Annexes

Acronyms

ALM	Asset/Liability Management
BAM	Bosnian Convertible Mark
BoD	Board of Directors
BiH	Bosnia and Herzegovina
CWS	World Confederation of Churches
EBRD	European Bank for Reconstruction and Development
EDF	Employment and Development Fund
EU	European Union
EUR	Euro
EURIBOR	Euro Interbank Offered Rate
FY	Fiscal Year (October 1st to September 30th)
HQ	Headquarters
HR	Human Resources
GNP	Gross National Product
GDP	Gross Domestic Product
IFAD	International Fund for Agricultural Development
IT	Information technology
KfW	German Development Bank
LIP	Local Initiatives Project
LO	Loan officer
MBB	MicroBanking Bulletin
MIS	Management Information System
MFI	Microfinance institution
MFC	Microfinance Center for Central and Eastern Europe and the Newly Independent States
NA	Not Applicable
NGO	Non Governmental Organization
PAR	Portfolio at risk
ROA	Return on assets
ROE	Return on equity
RS	Republika Srpska
SME	Small and medium sized enterprise
USAID	United States Agency for International Development
UNDP	United Nations Development Program
UNHCR	United Nations High Commissioner for Refugees
USD	United States Dollar

Formulas and ratios

- Personnel productivity: Active borrowers / Total personnel (end of period)
- Loan officer productivity: Active borrowers / Total Loan Officers (end of period)
- Return on assets ROA: Net operating income before donations / Average assets
- Adjusted return on assets: AROA: Adjusted net operating income before donations / Average assets
- Return on equity: ROE: Net operating income before donations / Average equity
- Adjusted return on equity: AROE: Adjusted net operating income before donations / Average equity
- Leverage: Debt (savings + debts) / equity (end of period)
- Portfolio yield: Portfolio revenue / 13-month average gross outstanding portfolio
- Operating expense ratio: Operating expense / 13-month average gross outstanding portfolio
- Funding expense ratio: Interest and fees paid on funding liabilities / 13-month average gross outstanding portfolio
- Cost of funds ratio: Interest and fees paid on funding liabilities / Average funding liabilities (deposits + borrowings)
- Loan loss expense ratio: Net loan loss expense / 13-month average gross outstanding portfolio
- Adjustment expense ratio: Total adjustments / 13-month average gross outstanding portfolio
- Net portfolio as a % of assets: Net outstanding portfolio / total assets (end of period)

- Operational self-sufficiency: Revenue from operations / (Financial expense + Loan loss expense + Operating expense)
- Financial self-sufficiency: Revenue from operations / (Financial expense + Loan loss expense + Operating expense + Adjustments)
- Risk coverage ratio: Loan loss reserves / Portfolio at risk (31-365 days)
- Write-off ratio: Loans written off / 13-month average gross outstanding portfolio

Notes to the financial statements

General notes to financial statements per CGAP Disclosure Guidelines

0 The MFI follows the CGAP disclosure guidelines.

1 The Financial Statements presented include a balance sheet, income statement, and accompanying notes.

2 The financial statements provided include 3.5 years of data.

3 Segment Reporting for Multiservice Microfinance Institutions: LOK micro only offers microfinance services.

4 Portfolio reporting

4.1 Loan loss provision expense: expenses related to actual or anticipated loan losses are shown separately from other expenses in the income statement ("loan loss expense").

4.2 The loan loss reserve is shown as a negative asset in the balance sheet. It is calculated each month by the finance manager according to the methodology described in the table.

Provisioning methodology

Provision	2% on healthy portfolio, 31 to 60 days 60%, 61 to 90 days is 80% and after 90 days 100%.
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Write-off Loans that are more than 180 days late are written off.

4.3 Loans are written off when they are past due over 180 days upon decision by the Credit Committee.

4.4 The following table reconciles these movements:

BAM	dec. 2002	dec. 2003	dec. 2004	oct. 2005
Loan loss reserve, January 1st	563,792	270,037	175,718	282,761
+ Loan loss provision expense	153,490	204,684	289,582	584,090
- Provision reversal	331,077	216,663	157,684	333,566
- Loans written off during the year	116,168	82,340	24,855	44,171
Loan loss reserve, year end	270,037	175,718	282,761	489,114

4.5 Accrual vs. Cash accounting: Interest income is being computed in a cash basis. However, according to the external auditors the impact of this policy is non material on given that most loans are short term and payments are monthly.

5 Portfolio quality

5.1 Indicators: Portfolio quality and the calculations of such are displayed in the tables in Section A and the calculations are based on standard portfolio at risk calculation of: (outstanding loan principal for loans in arrears over X days)/(total portfolio outstanding).

5.2 Renegotiation of loans: the MFI refines some loans. Such loans are tracked separately in the loan software and represent as of Oct. 05 0.8% of total portfolio.

5.3 Insider loans: the MFI does not allow employees to borrow funds.

6 Donations

6.1 Revenue from donations is shown separately from income generated by operations in the income statement.

6.2 Current period donations:

Donor	Amount (BAM)	Conditions and comments
Blue Bridge-net assets	555,701	Equity received from institutions taken over by LOK micro. It includes grants received by these institutions but also their own retained earnings.
Business Center-net assets	219,959	
NBR Modriva-net assets	519,464	

6.3 Donations accounting methodology: Grants for operations to be used in the current operating period are recorded in the income statement (LOK micro has never received such grants). Grants for fixed assets were recorded directly in the balance sheet with amortization of such assets passing through the income statement. Grants for loan funds are recorded directly in the balance sheet. Please note that the financial statements disclosed in this report have been modified for presentation to better reflect donations.

6.4 In-kind donations: There were no in-kind donations identified.

6.5 Cumulative amount of all prior period donations: See table above. The total amount is 1,295,124 BAM.

7 Details of liabilities

7.1 Liabilities are listed in a table at the end of the report.

7.2 Deposits: LOK micro is not allowed to collect savings.

8 Other significant Accounting Policies

8.1 Accrual or deferral income/expense accounting: all expenses and revenues are accounted on a cash basis.

8.2 Depreciation of fixed assets: The depreciation of fixed assets on a flat basis is done using the following table:

Type of assets	%
Intangible assets	15%-15.5%
Office equipment and vehicles	7.5%-15%
Buildings	1.28%

8.3 Inflation accounting: none

8.4 Currency mismatch: please refer to the F area for more information on potential mismatch.

8.5 Accounting treatment of unrealized gains or losses due to foreign currency fluctuations: none.

Specific notes to the financial statements

Balance sheet

- In 2002 short term investments are income from the sale of shares from LOK Invest and LOK Institute of Economics and Organization (IOE). The difference between the sale and the value of the shares in balance sheet was recorded as investment income in Income Statement.
- LOK Micro does not accrue interests.
- In 2002, it is exclusively a small loan to LOK Belgrade to open an MF1 in Serbia. However this project was a failure for legal reasons. The long term portfolio in the following years is net of provisions, therefore a bit underestimated.
- In 2003 the high increase of fixed assets relates to the purchase of a building with money from the sale of shares of LOK Invest and LOK IOE.
- In 2002, other assets include advance for the building purchase of 413,418 BAM.
- Equity from foundations bought by LOK Micro that include donations and retained earnings. Refer to point 6.2 in the previous notes for more details.

Income statement

- Includes income from rent of other companies working in the LOK micro building.
- Includes currency differences, insurance costs, member fees in the local microfinance network, publications costs, costs of collection.
- Net income from the sale of shares of LOK Invest and LOK IOE.
- Various grants given to local associations, football teams and other particulars. Planet Rating did not check the identity of the beneficiaries of each of these loans but has a list of all the names.

Adjustments	Data in BAM			
	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005
Adjustment for the cost of funds = (a*b)-c	530,758	422,702	384,669	369,995
Average amount of borrowings (a)	7,921,232	9,346,795	12,717,391	16,755,818
Shadow price of borrowings (b)	12.0%	10.0%	9.2%	9.2%
Interest expense on borrowings (c)	419,790	511,978	778,972	914,618
Adjustment for inflation = (d-e)*f	3,290	440		
Avg. Equity (d)	1,992,049	2,408,594	2,587,949	3,017,523
Average fixed assets (e)	895,447	2,188,681	3,444,850	3,460,606
Inflation rate (f)	0.3%	0.2%	0.9%	1.7%
Adjustment for in-kind donations	-	-	-	-
Staff and technical assistance				
Other				
Adjustments for provisions	177,589	2,141	-	-
Loan losses	177,589	2,141	-	-
Other risks				
Other adjustments				
Total adjustments	711,637	425,282	384,669	369,995
Net income before donations	85,788	185,231	240,077	700,273
Adjusted net income before donations	(625,849)	(240,051)	(144,592)	330,278
Adjusted net income before donations (EUR)	(319,991)	(122,736)	(73,929)	168,869

LOK micro Balance sheet	Notes	BAM				EUR				Evolution			
		Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005	2003/2002	2004/2003	2005/2004	
ASSETS		10,748,295	13,078,868	18,009,518	22,061,753	5,495,516	6,687,119	9,208,120	11,279,995	21.7%	(4.8%)	47.5%	22.5%
Short Term Assets		9,333,308	8,889,729	13,108,687	16,483,154	4,772,045	4,545,246	6,702,365	8,427,703	(4.8%)	(4.8%)	37.7%	25.7%
Cash and Due from Banks		189,243	313,552	516,586	1,285,759	96,758	160,317	264,126	657,398	65.7%	64.8%	148.9%	
Short Term Investments	1	1,300,000	150,000	800,000	300,000	664,679	76,694	409,034	153,388	(88.5%)	433.3%	(62.5%)	
Short Term Net Loan Portfolio		7,833,055	8,378,929	11,757,137	14,465,136	4,004,977	4,284,078	6,011,329	7,395,907	7.0%	40.3%	23.0%	
Short Term Gross Loan Portfolio	2	8,103,092	8,554,647	12,039,898	14,954,250	4,143,045	4,373,922	6,155,902	7,645,987	5.6%	40.7%	24.2%	
(Loan Loss Reserve)		270,037	175,718	282,761	489,114	138,068	89,843	144,573	250,080	(34.9%)	60.9%	73.0%	
Interest Receivable		-	-	-	-	-	-	-	-	-	-	-	-
On loan portfolio		-	-	-	-	-	-	-	-	-	-	-	-
On investments		-	-	-	-	-	-	-	-	-	-	-	-
Accounts receivable and other assets		11,010	47,248	34,964	432,259	5,629	24,158	17,877	221,011	329.1%	(26.0%)	1,136.3%	
Long term assets		1,414,987	4,189,139	4,900,831	5,578,599	723,471	2,141,873	2,505,755	2,852,292	196.1%	17.0%	13.8%	
Long Term Net Investments		-	-	-	-	-	-	-	-	-	-	-	-
Long Term Gross Loan Portfolio	3	9,838	802,537	1,391,622	2,161,457	5,030	410,331	711,525	1,105,135	8,057.5%	73.4%	55.3%	
Net Fixed Assets	4	991,731	3,385,631	3,504,069	3,417,142	507,064	1,731,046	1,791,602	1,747,157	241.4%	3.5%	(2.5%)	
Other Long Term Assets	5	413,418	971	5,140	-	211,377	496	2,628	-	(99.8%)	429.4%	(100.0%)	
LIABILITIES AND EQUITY		10,748,295	13,078,868	18,009,518	22,061,753	5,495,516	6,687,119	9,208,120	11,279,995	21.7%	37.7%	22.5%	
Liabilities		8,416,289	10,593,686	15,318,802	18,717,423	4,303,180	5,416,466	7,832,379	9,570,066	25.9%	44.6%	22.2%	
Short term liabilities		2,090,034	2,776,351	6,576,355	7,405,152	1,068,617	1,419,526	3,362,437	3,786,194	32.8%	136.9%	12.6%	
Demand Deposits		-	-	-	-	-	-	-	-	-	-	-	-
Compulsory Deposits		-	-	-	-	-	-	-	-	-	-	-	-
Short Term Time Deposits		-	-	-	-	-	-	-	-	-	-	-	-
Short Term Borrowings		2,000,000	2,550,000	6,325,000	7,131,917	1,022,584	1,303,794	3,233,921	3,646,491	27.5%	148.0%	12.8%	
Interest payable		-	-	-	-	-	-	-	-	-	-	-	-
Accounts Payable and Other Short Term Liabilities		90,034	226,351	251,355	273,235	46,034	115,731	128,516	139,703	151.4%	11.0%	8.7%	
Long term liabilities		6,326,255	7,817,335	8,742,447	11,312,271	3,234,563	3,996,940	4,469,942	5,783,872	23.6%	11.8%	29.4%	
Long Term Time Deposits		-	-	-	-	-	-	-	-	-	-	-	-
Long Term Borrowings		6,326,255	7,817,335	8,742,447	11,312,271	3,234,563	3,996,940	4,469,942	5,783,872	23.6%	11.8%	29.4%	
Other Long Term Liabilities		-	-	-	-	-	-	-	-	-	-	-	-
Equity		2,332,006	2,485,182	2,690,716	3,344,330	1,192,336	1,270,653	1,375,741	1,709,929	6.6%	8.3%	24.3%	
Paid-In Capital		-	-	-	-	-	-	-	-	-	-	-	-
Donated equity		1,295,124	1,295,124	1,295,124	1,295,124	662,186	662,186	662,186	662,186	0.0%	0.0%	0.0%	
Retained earnings without donations and reserves	6	1,036,882	1,190,058	1,395,592	2,049,206	530,149	608,467	713,555	1,047,742	14.8%	17.3%	46.8%	
Current year		679,914	153,176	205,534	653,614	347,635	78,318	105,088	334,188	(77.5%)	34.2%	218.0%	
Other equity accounts		-	-	-	-	-	-	-	-	-	-	-	-

LOK micro Income Statement	Notes	BAM				EUR				Evolution		
		Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005	Dec. 2002	Dec. 2003	Dec. 2004	Oct. 2005	2003/2002	2004/2003	2005/2004
Financial Revenue (a)		2,830,109	3,024,154	3,558,877	4,160,751	1,447,012	1,546,225	1,819,625	2,127,358	6.9%	17.7%	16.9%
Financial Revenue from Loan Portfolio		2,745,915	2,965,213	3,468,775	4,049,548	1,403,964	1,516,089	1,773,556	2,070,501	8.0%	17.0%	16.7%
Interest on Loan Portfolio		2,745,915	2,965,213	3,468,775	4,049,548	1,403,964	1,516,089	1,773,556	2,070,501	8.0%	17.0%	16.7%
Fees and Commissions on Loan Portfolio		-	-	-	-	-	-	-	-	-	-	-
Penalty Revenue on Loan Portfolio		-	-	-	-	-	-	-	-	-	-	-
Financial Revenue from Investments		-	-	-	-	-	-	-	-	-	-	-
Other Operating Revenue	1	84,194	58,941	90,102	111,203	43,048	30,136	46,068	56,857	(30.0%)	52.9%	23.4%
Financial Expense (b)		419,790	511,978	778,972	914,618	214,635	261,770	398,282	467,637	22.0%	52.1%	17.4%
Interest paid on borrowings		419,790	511,978	778,972	914,618	214,635	261,770	398,282	467,637	22.0%	52.1%	17.4%
Interest paid on deposits		-	-	-	-	-	-	-	-	-	-	-
Net Inflation Adjustment Expense		-	-	-	-	-	-	-	-	-	-	-
Other Financial Expenses		-	-	-	-	-	-	-	-	-	-	-
Financial income [c=a-b]		2,410,319	2,512,176	2,779,905	3,246,133	1,232,377	1,284,455	1,421,343	1,659,721	4.2%	10.7%	16.8%
Net Loan Loss provision expense (d)		(203,252)	(32,942)	114,059	247,011	(103,921)	(16,843)	58,317	126,295	(83.8%)	(446.2%)	116.6%
Loan loss provision expense and write-off		(177,587)	(11,979)	131,898	250,524	(90,799)	(6,125)	67,438	128,091	(93.3%)	(1,201.1%)	89.9%
Recovery from Loans written off		25,665	20,963	17,839	3,513	13,122	10,718	9,121	1,796	(18.3%)	(14.9%)	(80.3%)
Operating expense (e)		2,527,783	2,359,887	2,425,769	2,298,849	1,292,435	1,206,591	1,240,276	1,175,383	(6.6%)	2.8%	(5.2%)
Personnel Expense (includes fringe)		1,587,567	1,537,335	1,680,213	1,634,666	811,710	786,027	859,079	835,791	(3.2%)	9.3%	(2.7%)
Administrative Expense (non-staff operating expenses)		940,216	822,552	745,556	664,183	480,725	420,564	381,197	339,591	(12.5%)	(9.4%)	(10.9%)
Depreciation and amortization		80,042	92,572	125,214	114,987	40,925	47,331	64,021	58,792	15.7%	35.3%	(8.2%)
Consulting fees		-	-	-	-	-	-	-	-	-	-	-
Marketing/Advertising and entertainment		197,130	131,385	97,129	64,735	100,791	67,176	49,661	33,098	(33.4%)	(26.1%)	(33.4%)
Rent/ Utilities/ Material		245,729	168,457	158,338	130,360	125,639	86,131	80,957	66,652	(31.4%)	(6.0%)	(17.7%)
Insurance/ Bank fees and commissions		107,379	126,376	131,891	74,655	54,902	64,615	67,435	38,170	17.7%	4.4%	(43.4%)
Transport/ Telecommunication expenses		145,304	135,978	131,365	125,408	74,293	69,524	67,166	64,120	(6.4%)	(3.4%)	(4.5%)
Audit		25,000	24,000	24,000	-	12,782	12,271	12,271	-	(4.0%)	0.0%	(100.0%)
Others	2	139,632	143,784	77,619	154,038	71,393	73,516	39,686	78,758	3.0%	(46.0%)	98.5%
Net Operating Income Before Taxes and Donations [f=c-d-e]		85,788	185,231	240,077	700,273	43,863	94,707	122,749	358,044	115.9%	29.6%	191.7%
Income Taxes (g)		-	-	-	-	-	-	-	-	-	-	-
Net Operating Income Before Donations [h=f-g]		85,788	185,231	240,077	700,273	43,863	94,707	122,749	358,044	115.9%	29.6%	191.7%
Non Operating Revenue (i)	3	650,546	-	-	-	332,619	-	-	-	(100.0%)	-	-
Non Operating Expense (including related taxes) (j)	4	56,420	32,055	34,543	46,659	28,847	16,389	17,662	23,856	(43.2%)	7.8%	35.1%
Net Income Before Donations [k=h+i-j]		679,914	153,176	205,534	653,614	347,635	78,318	105,088	334,188	(77.5%)	34.2%	218.0%
Donations (l)		-	-	-	-	-	-	-	-	-	-	-
Net Income (after Taxes and Donations) [m=k+l]		679,914	153,176	205,534	653,614	347,635	78,318	105,088	334,188	(77.5%)	34.2%	218.0%

Financing sources

Loan provider	Disbursement date	Interest rate	Duration (months)	Initial amount (BAM)	Initial amount (EUR)	Outstanding amount 31/10/05 (BAM)
Odraž	29/06/04	5.0%	155	8,109,080	4,146,107	8,109,080
Unicredit	01/04/05	9.5%	37	300,000	153,388	249,997
Unicredit	01/04/05	9.5%	12	200,000	102,258	200,000
Raiffeisen Bank Sarajevo	11/04/05	8.5%	12	1,000,000	511,292	1,000,000
Raiffeisen Bank Sarajevo	31/01/05	8.5%	12	500,000	255,646	500,000
Raiffeisen Bank Sarajevo	25/07/05	8.5%	12	500,000	255,646	500,000
Investment Bank Sarajevo	29/07/02	Euribor	42	300,000	153,388	33,336
Investment Bank Sarajevo	24/12/03	Euribor + 3%	37	134,400	68,718	69,686
Investment Bank Sarajevo	10/03/03	Euribor	38	80,000	40,903	17,777
Investment Bank Sarajevo	01/12/04	Euribor	37	57,600	29,450	55,467
Investment Bank Sarajevo	24/12/04	Euribor	37	432,500	221,134	416,481
Investment Bank Sarajevo	07/02/05	Euribor + 3%	37	432,500	221,134	432,500
ABS Bank Sarajevo	01/10/04	8.5%	12	500,000	255,646	500,000
ABS Bank Sarajevo	27/06/05	8.5%	12	320,000	163,613	320,000
Hypo Alpe-Adria Bank dd Mostar	25/08/05	6 months Euribor + 5,6%	61	1,000,000	511,292	1,000,000
Triglav BH dd	22/12/05	7.0%	7	2,000,000	1,022,584	2,000,000
Upi Bank DD Sarajevo	09/12/04	10.0%	12	1,500,000	766,938	1,500,000
Udr Slijepih Kant. Sarajevo	02/04/04	0.0%	24	21,607	11,047	10,807
CBS Bank DD Sarajevo	31/10/05	8.0%	12	500,000	255,646	500,000
HVB-CPB Sarajevo	27/04/05	3 months CHF + 7,2%	-	988,408	505,365	990,389

Loan products description

Name of the product	Product L1 (common product)	Product T (with life insurance)	Product P (for agriculture)	Product E1 (for liquidity needs)
Creation Date	1997	2002	2003	2004
Client type (rural, urban, etc.)	Rural and urban	Rural and urban	Rural	Rural and urban
Authorized loan size	Up to 30,000 BAM	Up to 30,000 BAM	Up to 30,000 BAM	Up to 5,000 AM
Average disbursed loan size	3,347 BAM	6,313 BAM	4,356 BAM	1,232 BAM
Authorized loan length (minimum and maximum)	Up to 36 months	Up to 24 months	3 months	Up to 5 months
Average loan length (months)	13	15	22	3
Grace period	3 months	None	6 months	None
Collateral requirements and other conditions	Promissory note, blank check, guarantors	Promissory note, blank check, guarantors + life insurance policies from Triglav	Promissory note, blank check, guarantors...	
Repayment Schedule	Monthly	Monthly	Monthly with only interests during the grace period	Monthly
Nominal monthly interest rate	2.923%	2.17%	0.71%	3.0%
Flat or declining ?	Declining	Declining	Declining	Declining
APR	35.1%	26.0%	9.6%	40.1%
Fees and penalties	None	None	None	None
Major changes since creation	Longer repayment terms, possibility of grace	Longer repayment terms		Increased amount and repayment term

Organizational chart

