

Rating

| | |
|-----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| C- | Minimum required: Procedures are functional but with certain failings. There are minor risks in the medium term for operations, but these risks are being managed and monitored |
|-----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

UGAFODE, Uganda

September 2006

■ Description of the institution

UGAFODE was founded in 1995 by eight Ugandans comprising local business people, professionals and church leaders and was soon affiliated to the Opportunity International network. It received the financial and technical support of Opportunity International as well as DFID, SUFFICE and the Microfinance Outreach Plan and (MOP) now operates under the status of a Company limited by Guarantee. As of July 2006, UGAFODE manages a loan portfolio of 1,786 M USD and serves approx. 12,000 borrowers with both group and individual lending methodologies. It has a 7-branch network located in the south and south-western regions of Uganda.

Performance indicators

(K USD, unless otherwise stated)

| | Dec. 2003 | Dec. 2004 | Dec. 2005 | Jul. 2006 |
|------------------------------|--------------|--------------|--------------|--------------|
| ACTIVITY | | | | |
| Total number of staff | 69 | 80 | 92 | 89 |
| Total assets (M UGS) | 991 | 1,600 | 1,960 | 2,130 |
| Loan portfolio | 1,920 | 2,766 | 3,569 | 3,975 |
| Active borrowers | 828 | 1,342 | 1,550 | 1,786 |
| APR* | 9.949 | 10.959 | 12.817 | 11.816 |
| PAR >31 (%) | | | | >75% |
| Write-off ratio (%) | 9.2 | 7.4 | 3.6 | 6.4 |
| Risk coverage ratio (%) | 5.5 | 2.1 | 1.5 | 0.2 |
| | 0.0 | 21.1 | 35.7 | 50.9 |
| PERFORMANCE | | | | |
| ROE (%) | (23.0) | (21.4) | (2.5) | 2.1 |
| Liabilities / Equity (%) | 69.6 | 107.4 | 89.1 | 85.1 |
| ROA (%) | (15.5) | (11.3) | (1.3) | 1.1 |
| OSS (%) | 73.3 | 80.9 | 97.5 | 102.4 |
| FSS (%) | 67.3 | 76.0 | 96.7 | 93.9 |
| Portfolio Yield (%) | 56.6 | 59.1 | 59.7 | 62.0 |
| Operating exp. ratio (%) | 71.6 | 64.6 | 55.7 | 53.4 |
| Staff productivity | 144 | 137 | 139 | 133 |
| Funding exp. ratio (%) | 3.1 | 6.8 | 4.1 | 4.6 |
| GROWTH | | | | |
| Loan portfolio | 47.6 | 44.6 | 21.6 | 18.1 |
| Assets | 13.6 | 44.1 | 29.0 | 11.4 |
| Exchange rate USD/UGS | 1,937 | 1,729 | 1,821 | 1,866 |

Evaluation summary

UGAFODE reaches out to underserved remote rural areas with a well-designed group lending methodology that also induces high operating costs. The development of individual loans, offered mainly in urban areas with higher average loan sizes, allowed the institution to come close to the operational sustainability in 2005. The planned improvement of the MIS system, the reinforcement of Branch management and the review of the individual loan methodology will be important drivers to reduce the current level of portfolio at risk and achieve the additional efficiency gains that are required by a context of fierce competition, both in urban and rural areas. The dedicated Board and Management team have the appropriate skills to lead UGAFODE through these organizational changes with limited external support. Beyond the current stated intention to transform into an MDI, more clarity would be necessary regarding the future governance and ownership structure as well as the long-term vision and mission of the institution. The Executive Director position, unfilled at the time of this report, will have a key role to play in this strategic process and might need the support of microfinance experts to complement inputs provided by the Board.

Improvements needed to reach minimum requirements on specific evaluation areas

- Conduct proper reconciliation of portfolio and accounting data to clear out suspense accounts; especially important as long as the MIS system is semi-manual.
- Strengthen the methodology and Loan Officers (LO) skills for individual loans in order to better control the credit risk.
- Reduce Portfolio At Risk (PAR) in urban branches through a more appropriate evaluation of client repayment capacity (and indebtedness).
- Apply a standard provisioning and write-off policy.

Strategic goals

The medium-term goal of UGAFODE is to convert into an MDI in order to be able to offer a broader range of services to its clients and expand its branch network to reach a national coverage.

Planet Rating

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▪ Institutional presentation

Networks

UGAFODE is a member of the Association of Microfinance Institutions of Uganda (AMFIU) and is affiliated to the Opportunity International (OI) worldwide network.

Ownership

UGAFODE was founded by a group of eight Ugandans comprising local business people, professionals and church leaders who have also constituted its Board of Directors since inception.

Legal form, supervision and audit

UGAFODE was established in 1995 and registered as an NGO under the 1989 NGO Registration Statute. It was later transformed into a Company limited by guarantee and not having a share capital. Based on the current nature of its services, and under the current categorization of financial institutions in Uganda, UGAFODE is a Tier 4 institution that is not subject to any direct supervision by the Central Bank. Stayner and Carr have been the institution's auditors since its inception providing annual audits of the institution's activities and financial statements for the fiscal periods ending 31st December every year.

Donations

The institution has received a substantial amount of funding in soft loans and grants since inception from various organizations. The latter include among others, bilateral donor agencies such as DFID and USAID, development partners such as Opportunity International, and the Women Opportunity Fund as well as its own revolving fund. The total amount of these donations stood at 2,166 M UGS as of 31st July 2006.

Funding sources as of July 2006

| Loan provider | Interest rate | Duration | Initial amount (M UGS) | Initial amount (USD) | Out. as of Dec. 2005 (M UGS) |
|----------------------------|---------------|----------------------|------------------------|----------------------|------------------------------|
| Opportunity International. | 3.5% | Renewable every year | 45.4 | 24,330 | 45.4 |
| ECLOF | 14% | 1 year, renewable | 200 | 107,181 | 200 |
| Stromme | 14% | 2 years | 150 | 80,386 | 150 |
| MSCL | 13% | 2 years | 500 | 267,953 | 350 |
| OI – OVC | Grant | -- | 326.2 | 174,812 | 464.6 |
| OI – YAP | Grant | -- | 132.3 | 70,934 | 132.3 |
| Action Aid | Grant | -- | 72 | 38,584 | 72 |
| Rotary Seed | Interest free | 2 years | 213 | 167,708 | 182.6 |
| TOTAL | | | | | 1,596 |

Management team

The management team comprises four managers in charge of Operations, Finance and Administration, Human Resources and Management Information Systems as well as a Chief Internal Auditor, and is led by an Executive

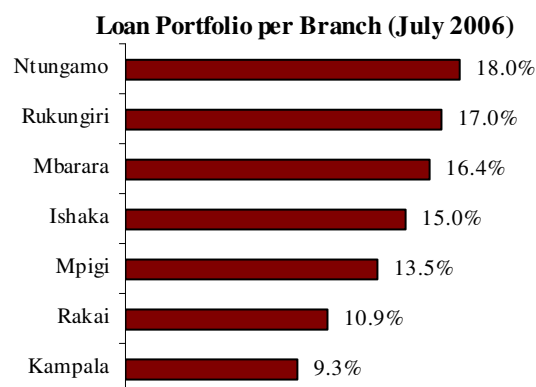
Director. Currently however, the Operations Manager doubles as the acting Executive Director and has led the management team since the resignation of the former ED in March 2006. The Operations Manager has a solid track record in the Ugandan banking sector spanning over 10 years and oversees the activities of UGAFODE.

Organization

- Each branch is headed by a Branch Manager who is specifically in charge of loan approval, team management and reporting to HQ. Other branch staff includes accounts assistants, loan officers and a supervisor for the case of larger branches. These undertake the day-to-day operations of the branches including group selection and trainings, loan disbursements and recovery.
- The management team at headquarters retains all strategic as well as some operational and functional duties including loan approval for some loan categories, overall performance target setting and monitoring as well as liquidity management.

Market penetration

Through its 7-branch network, UGAFODE covers the south central and south western parts of the country targeting both rural and urban clientele. The branch network includes the districts of Kampala, Mpigi, Wakiso, Mukono, Masaka, Rakai, Mbarara, Mubende, Ntungamo, Bushenyi, Rukungiri, Kanungu and Sembabule.



Products and services

At present UGAFODE doesn't offer any savings product although members' mandatory and voluntary savings are collected and deposited at banks in which the clients open checking accounts.

The institution offers four loan products: Trust and Solidarity group loans, Salary earners' loans and Individual loans. However, the Salary earners' loan product has recently been suspended due to severe repayment problems. Loan amounts range from 300,000 to 2,500,000 UGS for Trust and Solidarity groups and up to 5,000,000 UGS for individual loans. All loans, irrespective of category, bear a

flat interest rate of 3% per month. Additional charges include application fees ranging from 1,000 – 2,000 UGS, commission fees amounting to 2% of the loan and compulsory savings of 10% of the initial requested loan amount for the group loans. Repayment periods vary from weekly to fortnightly for group borrowers and monthly for the individual loan products. The annual effective rates thus range from 70% to 100% depending on the type of loan and repayment schedules¹.

■ Governance

Governance and Decision Making is rated “c”

Decision making

- + Overall, UGAFODE benefits from an inclusive and efficient decision making process, with regular and rich communication between management team members and between management and the Board of Directors (BOD). Meetings are adequately formalized in detailed meeting minutes and all decisions are clearly stated on the record.
- + Although the BOD is quite small (most meetings are held with 5 or 6 Board members due to the important international or national positions of some members), the active board members are extremely committed and engaged in the strategic decision-making process, sometimes meeting several times per month. Board members are well-versed in the main internal issues.
 - The Board lacks specific experience in microfinance, although some members have banking backgrounds. This shortcoming has been somewhat mitigated by the board’s exposure to international experience and best practice through the Opportunity International association.
 - The Board is largely well-structured, with functioning subcommittees to address specific issues such as loans and personnel, but lacks a specific audit committee.
 - The Board receives the necessary financial and operations reports to inform the decision-making process. However, because of the inherent weaknesses in the MIS system, the data is neither completely reliable nor timely (see I). This should however be improved when the implementation of the new MIS is finalized.
- There is a notable disconnect between UGAFODE’s stated mission and values of serving poor Ugandans, and some strategic decisions taken by the BOD and management. For example, the increasing focus on individual lending and the decision to pursue MDI status lends an up-market focus to operations. This disconnect reflects a lack of strategic clarity between social and financial objectives.

¹ Weekly repayments imply that the monthly interest rate of 3% is in fact applied on a 28 days period.

- Board members consider becoming shareholders² of the institution in their own name in order to comply with the ownership structure clarification required to transform into an MDI: the potential risk of mission drift related to the transformation into a for-profit, privately owned structure is not sufficiently addressed by UGAFODE’s Board.
- Although the board exercises strong ownership and control, this sometimes limits UGAFODE’s access to outside resources. For example, an external Board member might prove beneficial in terms of an outside perspective and additional technical guidance in the decision-making process.

Planning

- + UGAFODE has a detailed 5-year business plan that charts the path towards the goal of MDI conversion. The planning process has involved the appropriate buy-in and participation from the relevant management and operational staff. The plan has been officially endorsed and widely disseminated.
- + The business plan includes a detailed budget, as well as detailed financial projections created using the MicroFin application. This budget is consistently tracked against actual expenditures and variances are analyzed for overruns. The financial projections and budgeting process are set to improve even further with the additional involvement of branch-level staff. The budget also includes projected costs of MDI transformation.
 - While the budget and projections are comprehensive, some of the assumptions, notably the productivity levels and portfolio quality are overly optimistic and may prove difficult to reach given UGAFODE’s operational realities.
- The planning process does not fully address all of main risks facing UGAFODE in the near term. For example, the funding shortfall which threatens the planned portfolio growth, the difficulties surrounding the adoption of the new MIS system, and the need to strengthen training and credit processes in order to improve portfolio quality. The plan is currently being revised.

Management team

- + Overall, UGAFODE’s HQ management team is strong, motivated, knowledgeable, and committed. Management roles are well defined, thanks to clear job descriptions. Communication between managers is frequent and efficient, contributing to quick decision-making. While most managers are specialized, there is a degree of polyvalence within the team: managers understand the main tasks and importance of their various functions. All

² The exact shareholding structure is yet to be determined as well as the way capital contribution would be made (valorization of pro-bono involvement for the institution, cash, other types of contributions).

management team members have relevant qualifications for their jobs.

- Performance at the Branch Manager level is more uneven, partly because job functions and expectations are less clearly defined. In some branches, BMs are not qualified for the management role, due to inappropriate promotions and a lack of formalized management training.
- The continuing lack of an Executive Director (more than 6 months had elapsed since the previous ED's departure at the time of writing) is problematic and creates an ongoing and undue burden on the other management team members – particularly the operations manager who serves as acting ED. In general, there is a distinct shortage of staff resources throughout the middle- and upper-management levels, most notably in the Human Resources, Internal Audit and Finance departments.

Human resource management

- ✦ HR management understands the strategic role of the department within UGAFODE. The HR function is well formalized and the procedures are designed to maximize the effectiveness of recruiting and staff performance management.
- ✦ The HR Manager focuses appropriately on staffing needs assessment, and follows through with systematic training and regular performance reviews. The focus of recruitment is not only on relevant qualifications but also on skills and motivation, particularly for front-line staff. This should ensure that appropriate and skilled staff is recruited.
- Training is reasonably comprehensive, with initial and follow-up training at both the HQ and branch level. However, more specialized training for loan officers is clearly needed to bolster credit and client appraisal skills.
- Staff job satisfaction seems adequate, but the turn-over rate remains relatively high. This is partly due to the competitive labor market and a low pay scale. A recently approved salary-scale revision should alleviate some of this problem as well as alleviate some serious salary discrepancies in the upper management ranks.
- The proper systems and tools are in place for effective HR management but these are not always applied to the best effect. For example, the depth of staff evaluation is also limited in practice, despite the well-designed procedures.
- The HR department is seriously taxed by a shortage of staff: presently the HR Manager is forced to handle both strategic and administrative tasks for the entire organization, which constitutes a considerable workload and makes proper management of either set of tasks difficult.

Area for improvement:

- ✦ Clarify options for the future governance and ownership structure and ensure that they will be compatible with the current vision and mission of UGAFODE.
 - ✦ Fill in the ED position.
 - ✦ Ensure that Branch Manager have all the necessary skills and guidance to provide a stronger oversight on operations.
-

Information

Information and equipment is rated “d”

Description of the MIS

| | |
|-----------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Equipment | <ul style="list-style-type: none"> ▪ Computers, printers, and other equipment are up to date; 2 to 3 computers per branch ▪ Internal network in most branches and in HQ; all branches have an internet connection (except for Ishaka branch) |
| Accounting | <ul style="list-style-type: none"> ▪ Pastel (locally developed software) ▪ Accounting currently centralized in HQ ▪ Branch account assistant ▪ Monthly reconciliation with bank statements ▪ Annual reconciliation with portfolio data ▪ Monthly financial statements |
| Portfolio information | <ul style="list-style-type: none"> ▪ ZT and Excel files ; Implementation process of Bankers Realm underway ▪ Data input in the branches and sent to HQ on a monthly basis ▪ Monthly reports by BM sent to HQ |

Management Information System (MIS) and equipment

- ✦ The MIS infrastructure in both the HQ and the branches is up to date, with newer computers, printers, and even servers in some larger branches.
- Rollout of Banker's Realm is underway across the branch network and should be completed by the end of the year. This relatively sophisticated application can potentially provide a much more efficient and reliable information flow. However, both better staff training on the system and a more detailed analysis of the institution's information needs are required in order to realize any gains. IT staff is competent for a daily management of the system but needs adequate and continued support from the software vendor for a successful conversion to the new MIS.
- In the meantime, the concurrent use of three different systems for accounting and loan tracking (manual, ZT, Bankers Realm) creates additional redundant work. The ZT system is very inefficient, and its limited capacity is further impaired by time-consuming manual patches that create further opportunities for errors and frauds.
- The level of data security is insufficient across the old and new systems. Although back-up procedures limit

maximum data loss to one month, paper documentation is not properly protected (no safes or locked cabinets). The password procedures for accessing the MIS system are also inadequate: passwords are overly simplistic and not protected enough to ensure data security. Presently, there is limited or no checking of data for errors.

Information on activities

- + The basic information necessary for monitoring and decision-making, such as portfolio outstanding and number of active clients, is available at the end of each month with consolidated figures as well as breakdowns by branch and by loan officer.
- Multiple sources of data without proper reconciliation lead to differences in figures on number of clients, outstanding portfolio, portfolio at risk, and other indicators depending on the source.
- Detailed portfolio data by product is not available (although it could easily be compiled), making deeper analysis of trends in the performance of various products impossible. This weakness is exacerbated by the growing complexity of the product range. This should however be solved by the implementation of the new system.

Financial and accounting information

- + A detailed monthly performance report is generated, which includes the income statement per branch, as well as a comparison with the budget and analysis of trends and variances.
- Financial performance is tracked against projections but deeper analysis of trends and comparison to benchmarks is lacking. This kind of deeper analysis will be critical given UGAFODE's ambitious plans for growth, sustainability and transformation.
- The accuracy, consistency, and quality of financial and accounting data need to be improved. In particular, steps must be taken to ensure proper reconciliation of portfolio data (approved but non-disbursed loans, unaccounted for deposits and potential errors accumulated) to clear out ongoing suspense accounts rather than letting inaccuracies continue to accumulate over time. Currently, there is an imbalance of approximately 40 M UGS between the financial and accounting information in this suspense account.

Improvements needed to reach minimum requirements

- △ Conduct proper reconciliation of portfolio and accounting data to clear out suspense accounts.
-

Area for improvement:

- * Make sure that all new data entry processes are well thought of and standardized across branches to the benefits of the migration and ensure a good quality of the information.
-

Risk

Risk Management is rated "c"

Procedures and internal controls

- + Most procedures are formalized in manuals, which are largely up to date and disseminated to all relevant staff. UGAFODE has even formalized some policies that have not yet been implemented, such as the branch cash handling procedures. A clear and concise staff manual summarizes all relevant policies and procedures and is given to all staff upon entry.
- + Cash management is secure (cash received for purchase of loan applications and other small amounts) and does not present any significant risk.
- Although a general understanding of key financial and institutional risks prevails in the organization, several key control personnel do not seem to be aware of their critical roles in the control chain. This is not limited to administrative staff: it includes key members of the accounting team as well as branch managers.
- Although the loan policies and procedures are formalized in a detailed operations manual, adherence to policy has been weak among loan officers, on all procedures ranging from loan appraisal to client follow-up. This non-compliance is partly a result of weak supervision and enforcement of procedures by Branch Managers; which represents a significant operational risk.
- ZT and the manual accounting/loan tracking software present a risk of fraud and/or error due to their inherent inaccuracies combined with the lack of consistent verification procedures.

Internal audit

- + The internal audit process is regular, comprehensive, and formalized, covering all areas of operations. Client visits are also done at the branch level. The audit staff provides actionable feedback to HO managers and branch staff through internal audit reports. They also check to see whether necessary changes have been implemented during follow-up visits.
- + Well qualified external auditors with specific experience in microfinance institutions audit conduct annual verifications in accordance with CGAP external audit guidelines.
- Although internal audit reports are addressed to the BOD, the continuing lack of an audit committee means that board awareness of audit issues is limited.
- A serious lack of resources (only two audit staff) for the department makes effective internal audit difficult: limited vehicle access means that branches may sometimes be aware in advance of audit missions.

Area for improvement:

*Systematic controls (hierarchical controls and performance verification) have to be strengthened in order to complete the internal control chain.

Activities

Activities: products and services is rated “c”

Marketing and competition

UGAFODE faces high and diverse competition in most of its areas of operations: SACCOs and Village banks exist even in some of the most rural areas where UGAFODE provides its services; and MDIs and commercial banks such as PRIDE, FINCA, Uganda Microfinance Ltd. and Centenary Bank in all urban areas.

Having significant competitive disadvantages in terms of price and product range (SACCOs and MDIs offer savings products whereas UGAFODE cannot), UGAFODE has adopted a strategy of increasing the flexibility of its current loan products (simpler guarantees, smaller groups, longer terms, larger amounts and monthly repayments). The institution is also pursuing individual lending quite aggressively particularly in urban areas as part of the strategy aimed at attracting and retaining larger clientele base. While both these strategies have proved efficient in maintaining a reasonable portfolio growth, they leave the institution highly exposed to credit risks related to multiple borrowing and over-indebtedness of its clients, especially in urban areas.

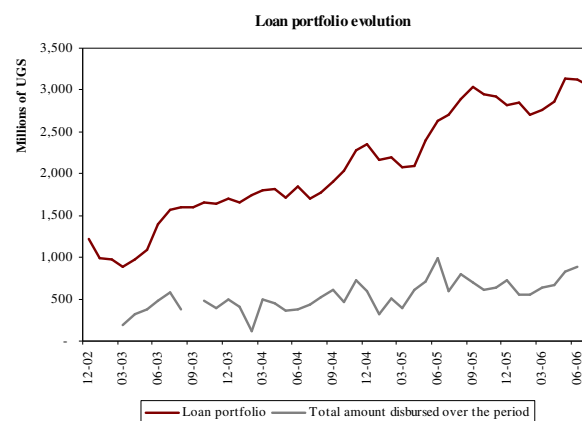
| USD , unless otherwise stated | Dec. 03 | Dec. 04 | Dec. 05 | Jul. 06 |
|-------------------------------------|---------|-----------|-----------|-----------|
| Loan portfolio (K UGS) | 828,486 | 1,342,268 | 1,550,217 | 1,786,239 |
| Evolution (%) | 47.6 | 44.6 | 21.6 | 18.1 |
| Average outst. loan | 685,957 | 1,082,507 | 1,404,092 | 1,562,431 |
| Active borrowers | 9,949 | 10,959 | 12,817 | 11,816 |
| Evolution (%) | NA | 10.2 | 17.0 | (7.8) |
| Average outstanding loan per client | 83 | 122 | 121 | 151 |
| % of GDP per capita | 29.4 | 33.5 | 36.5 | 47.5 |
| Average amount disbursed | 92 | 188 | 182 | 311 |
| % of GDP per capita | 32.3 | 51.4 | 54.8 | 97.5 |
| PAR > 31 (%) | 9.2 | 7.4 | 3.6 | 6.4 |
| Write-off ratio (%) | 5.5 | 2.1 | 1.5 | 0.2 |

Portfolio Management

+The institution's operations' policy clearly spells out the proper procedures for client appraisal and loan disbursement while, upon recruitment, LOs are provided with both theoretical and hands-on training particularly on the group lending methodology.

+Credit procedures ensure that prospective clients (group loans) undergo a substantial amount of orientation and training and in the basics of running a small business, borrowing as well and proper loan use as well as repayments and the group lending methodology.

- Efforts have been undertaken, in some branches, to improve portfolio quality by instilling mechanisms to ensure timely loan recovery and closer follow-up of late loans (for example the creation of LO daily activity schedules and field reports were observed in some branches).
- The latter efforts have however been hampered by inefficiencies in the current MIS as well as logistical limitations (LOs often have to travel long distances to reach clients whereas transportation is usually limited).
- Appraisal procedures for individual loan product applicants and analysis of their repayment capacities are still shallow particularly for those clients being graduated from the groups; pushing the individual loan products before sorting the above inadequacy further increases the institution's credit risk.
- Estimates of PAR per product indicate a poor portfolio quality for individual loans (estimated above 10%), highlighting the urgent need for an improvement of the loan methodology for this products (analysis of client repayment capacity and guarantee schemes).

**Portfolio composition and evolution**

UGAFODE's portfolio has continued to grow steadily over the last three years. Nevertheless the rate of portfolio growth has slowed considerably from slightly above 47% between 2002/3 to just above 21% in the 2004/5 period, a trend likely to continue through the 2005/6 period.

Trust and solidarity group loans have long been UGAFODE's core products and still represent more than 55% of the loan portfolio. The individual loans product launched in 2005 currently represent approximately a third of the portfolio and the institutions strategy is to further develop these individual products. The poor performance of the salary loan product (launched in 2002) due to complications in repayments has ultimately led its suspension by management as it undergoes review despite being relatively new product.

Portfolio diversification

The institution's loans target clients involved in various economic activities particularly micro-enterprises including petty trade, agricultural production and processing as well as

services provision although no specific policy is in place to ensure an evenly mixed portfolio.

Quality of the portfolio

- The calculated PAR figures indicate a downward trend over the past three years (from 9.2% in 2003 to 3.6% in 2005). Nevertheless the surge of this ratio back to 6.4% in July 2006 demonstrates the volatility of the portfolio quality and its vulnerability to external shocks (a portion of the problem loans in July 2006 was due to the outburst of the foot-and-mouth disease in Bushenyi and Ntungamo districts and the consequent ban on cattle trade in areas of south-western Uganda).
- The imperfection of portfolio data generation process could imply errors in the PAR data. The implementation of the new MIS and subsequent improvement in data quality will have an impact on the evolution of PAR figures.
- Urban branches are where the highest PAR ratios are found (16% in Kampala and 12% in Mbarara³) which underscores the risks rising from client over-indebtedness and cross-lending in the highly competitive areas.
- + The institution’s write-off policy stipulates a bi-annual write-off of loans over 120 days from a loan loss reserve, calculated and set aside on a monthly basis. The policy also outlines the implications of write-offs on branch and individual LOs’ performance appraisal; ensuring reasonable follow-up and recovery of loans even after write-off.
- However the actual write-off of loans has not, until of recent, conformed to the policy stipulations with an observed delay in write-offs as well as inadequate procedure in follow-up of written-off loans.

Credit risk coverage

| | Dec. 03 | Dec. 04 | Dec. 05 | Jul. 06 |
|------------------------------------------------|---------|---------|---------|---------|
| Risk coverage ratio (%) | 0.0 | 21.1 | 35.7 | 50.9 |
| PAR >31 net of loan loss provision expense (%) | 13.8 | 10.3 | 3.5 | 4.5 |

- The institution has progressively put in place a clear loan loss provisioning policy, and is now accounting for provisions on a monthly basis. However the institution’s use of the amount in arrears rather than PAR in calculating loan loss provisions does not sufficiently cover the credit risk.
- The group solidarity provides a reasonably adequate level of protection against risk thanks to a proper initial training of the groups. Some of the operational procedures (weak training for members entering the group after the first loan) nevertheless reduce the efficiency of this risk coverage mechanism.
- The risk coverage methods for individual loans are inadequate: the use of collateral such as chattels has

³ PAR >31

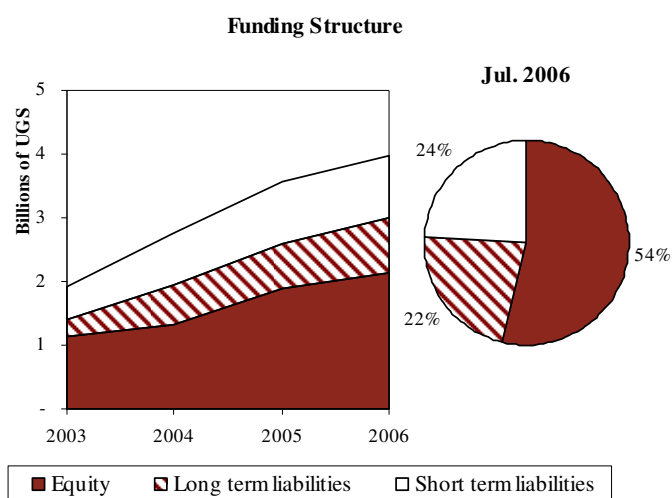
proved insufficient in many cases due to difficulty in disposing of them.

Improvements needed to reach minimum requirements

- △ Strengthen the methodology and LO skills for individual loans in order to better control the credit risk
- △ Reduce PAR in urban branches through a more appropriate evaluation of client repayment capacity (and indebtedness)
- △ Apply a standard provisioning and write-off policy

■ Financing and liquidity

Financing and liquidity is rated “c”



| | Dec. 2003 | Dec. 2004 | Dec. 2005 | Jul. 2006 |
|----------------------|-----------|-----------|-----------|-----------|
| Liabilities / Equity | 69.6% | 107.4% | 89.1% | 85.1% |

As a non-deposit taking institution, UGAFODE essentially funds its activities through donations and loans. Equity capital remains the dominant component of UGAFODE’s funding structure (54% of total funding as at July 2006) although over the last three years the institution’s borrowings have increased significantly (from 120 M UGS in 2002 to more than 600 M UGS as at July 2006).

- The initial funding from DFID (521,400 GBP or 1,042,800 UGS in 1999) was followed by significant funding provided by UGAFODE’s strategic partner, Opportunity International. OI has provided the bulk of the donations for capacity building with a contribution of more than 1 B UGS (570 K USD), and channelled loan capital grants from USAID and worth 1 B UGS (570 K USD).
- The institution has been able to obtain loans from most of the Ugandan wholesale lenders specialized in microfinance and currently has outstanding loans from MSCL, Stromme and ECLOF-U, for a total amount of 525 M UGS.
- UGAFODE has maintained low leverage levels (liability to equity ratio) over the last three years; as of July 2006 it

stood at 0.85 comfortably allowing for further borrowing should the need arise to increase operations and grow the portfolio.

Financing strategy

✚ The institution has clearly identified its funding needs and has shown its ability to access and manage loans from microfinance fund providers. It should soon access commercial funding thanks to the SUFFICE guarantee fund.

- UGAFODE is still in the learning curve in its negotiations of commercial loans. The current funding shortage –due to complication in the disbursements of pre-approved loans and the lack of available alternatives– illustrates the need for further sophistication in the fund search strategy. The presence of experienced bankers on the BOD should help the institution overcome that temporary difficulty.

Asset and Liability Management risks

At present UGAFODE's Asset and Liability Management risks are considered low:

- Minimal maturity risk: The funding structure is mainly long term (grants and non-interest bearing long term loans make up 72% of total funds) with a loan portfolio exclusively short term (ranging between 4 months – 12 months max.).
- No interest rate risk: UGAFODE borrows and lends on a fixed interest rate basis.
- Some FX risks: Most of the institution's loans are contracted in local currency (UGS) and from locally operating wholesale lenders apart from the 25K USD loan from OI.

Liquidity management

- The institution until recently had vague liquidity management procedures in place and steps have now been taken to adequately address this. The previously noted funding shortages are likely to hamper the new system's effectiveness.

Area for improvement:

- ✚ Work on several funding options in order to protect the institution against fund shortages

■ Efficiency and Profitability

Efficiency and Profitability is rated « d »

| | Dec. 03 | Dec. 04 | Dec. 05 | Jul. 06 |
|-------------------------------------------------------|---------|---------|---------|---------|
| ROE (%) | (23.0) | (21.4) | (2.5) | 2.1 |
| Liabilities / Equity (%) | 69.6 | 107.4 | 89.1 | 85.1 |
| ROA (%) | (15.5) | (11.3) | (1.3) | 1.1 |
| Profit generation | | | | |
| OSS (%) | 73.3 | 80.9 | 97.5 | 102.4 |
| Portfolio Yield (%) | 56.6 | 59.1 | 59.7 | 62.0 |
| Operating expense ratio (%) | 71.6 | 64.6 | 55.7 | 53.4 |
| Staff productivity | 144 | 137 | 139 | 133 |
| Loan officer productivity | 255 | 281 | 279 | 257 |
| Average outstanding loan per client (USD) | 83 | 122 | 121 | 151 |
| Funding expense ratio (%) | 3.1 | 6.8 | 4.1 | 4.6 |
| Cost of liabilities (%) | 6.5 | 14.0 | 11.9 | 7.9 |
| Loan Loss Provision expense ratio (%) | 4.1 | 2.4 | 2.4 | 3.3 |
| PAR > 31 (%) | 9.2 | 7.4 | 3.6 | 6.4 |
| Write-off ratio (%) | 5.5 | 2.1 | 1.5 | 0.2 |
| Asset management | | | | |
| Outstanding Loan Portfolio / Assets (%) | 83.6 | 82.6 | 78.1 | 81.3 |
| Non-portfolio income as a % of financial revenues (%) | 0.0 | 0.0 | 0.0 | 0.0 |

Overview of the profitability

Despite a decade of operations, UGAFODE has not yet reached profitability. The trend observed over the past three years however indicates that the institution should be able to be operationally sustainable over the next two years, which is in line with the business plan objectives. Nevertheless the plan to convert to an MDI within the next three years is likely to affect the profitability in the longer term.

Portfolio yield and effective interest rate

The portfolio yield lies around the 59% mark which is substantially lower than the effective interest rate charged on most loan products (approximately 70% for the individual loan and approximately 90% for group loans). This could be explained by inaccuracy in portfolio amount and poor portfolio quality data.

Operating expense ratio

Operating expenses have shown a downward trend over the past three years. An increase in the average loan per client (from 83 to 151 USD) appears as the main driver for that evolution. The operating expense ratio however remains relatively high (at 56% in 2005) and the implementation of the new MIS in the short run and the institution's likely conversion to an MDI in the medium term could further increase operational costs. Better information management and savings mobilization should nevertheless cut costs and improve the institution's operational and financial efficiency in the long term.

Funding expense ratio

UGAFODE's funding expense ratio is on a slow upward trend and remains relatively low at 4.1% in 2001 since the institution continues to fund its activities with an important

proportion of donations and concession loans. The cost of borrowings that is for now capped by the 14% mark (standard cost of loans provided by wholesale lenders in Uganda) is likely to increase when UGAFODE accesses commercial funding.

Loan loss provision expense ratio

The seemingly improved portfolio quality led to a reduction in the loan loss provision expense ratio in 2004 and 2005 while 2006 has also seen the gradual implementation of a stricter provisioning policy. The latter however still remains inadequate (given that the institution's provisions are calculated based on amount in arrears only) and the loan loss provision expense ratio is expected to increase in the short term.

Asset management

The lack of a clear liquidity management policy until 2006 is reflected in a relatively high level of cash in banks (approx. 10%). The fund shortage experienced since mid-2006 led to an improvement of the proportion of assets invested in the portfolio that however remains low (81%), notably due to the existence of high suspense accounts that represent for 6 to 7% of the assets in 2005 and 2006 (non-disbursed checks, un-reconciled difference between loan tracking and accounting data).

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

Rating Scale

| Factors | Area Rating | Global Rating | Explanation |
|---------|-------------|---------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4 to 5 | a | A+ A A- | Excellent The institution excels in the evaluation area and is a model for the sector. There is a long-term vision for continual improvement. There are no risks in the short and medium term for operations. Long-term risks are well managed and monitored. |
| 3 to 4 | b | B+ B B- | 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. |
| 2 to 3 | c | C+ C C- | Minimum required Procedures are functional but with certain failings. There are minor risks in the medium term for operations, but these risks are being managed and monitored. |
| 1 to 2 | d | D | Insufficient Procedures are in place, but with failings, and certain problems are only partially addressed. There are medium-term risks for operations. |
| 0 to 1 | e | E | Immediate risk of default or very insufficient There are immediate or underlying risks for operations or an unacceptable under performance. |

■ Appendices

| UGAFODE Income Statement | Notes | UGS | | | | USD | | | | Evolution | | |
|------------------------------------------------------------------|-------|----------------------|----------------------|----------------------|----------------------|------------------|------------------|-----------------|----------------|----------------|-----------------|-----------------|
| | | Dec. 2003 | Dec. 2004 | Dec. 2005 | Jul. 2006 | Dec. 2003 | Dec. 2004 | Dec. 2005 | Jul. 2006 | 2004/2003 | 2005/2004 | 2006/2005 |
| Financial Revenue (a) | | 767,269,679 | 1,117,494,205 | 1,550,406,288 | 1,067,857,347 | 396,112 | 646,388 | 851,404 | 572,271 | 45.6% | 38.7% | (31.1%) |
| Financial Revenue from Loan Portfolio | | 752,535,591 | 1,106,011,978 | 1,526,028,194 | 1,053,740,274 | 388,506 | 639,746 | 838,017 | 564,705 | 47.0% | 38.0% | (30.9%) |
| Interest on Loan Portfolio | | 620,618,878 | 932,040,103 | 1,320,039,313 | 913,898,979 | 320,402 | 539,116 | 724,898 | 489,764 | 50.2% | 41.6% | (30.8%) |
| Fees and Commissions on Loan Portfolio | 1 | 128,742,783 | 165,393,360 | 193,114,296 | 131,426,850 | 66,465 | 95,668 | 106,048 | 70,432 | 28.5% | 16.8% | (31.9%) |
| Penalty Revenue on Loan Portfolio | 2 | 3,173,930 | 8,578,515 | 12,874,585 | 8,414,445 | 1,639 | 4,962 | 7,070 | 4,509 | 170.3% | 50.1% | (34.6%) |
| Financial Revenue from Investments | | - | - | - | - | - | - | - | - | - | - | - |
| Other Operating Revenue | 3 | 14,734,088 | 11,482,227 | 24,378,094 | 14,117,073 | 7,607 | 6,642 | 13,387 | 7,565 | (22.1%) | 112.3% | (42.1%) |
| Financial Expense (b) | | 41,168,409 | 126,870,091 | 104,090,353 | 77,793,394 | 21,254 | 73,385 | 57,161 | 41,690 | 208.2% | (18.0%) | (25.3%) |
| Interest paid on borrowings | | 17,964,583 | 74,147,915 | 75,329,863 | 51,770,416 | 9,274 | 42,889 | 41,367 | 27,744 | 312.7% | 1.6% | (31.3%) |
| Interest paid on deposits | | - | - | - | - | - | - | - | - | - | - | - |
| Net Inflation Adjustment Expense | | - | - | - | - | - | - | - | - | - | - | - |
| Other Financial Expenses | 4 | 23,203,826 | 52,722,176 | 28,760,490 | 26,022,978 | 11,979 | 30,496 | 15,794 | 13,946 | 127.2% | (45.4%) | (9.5%) |
| Financial income [c=a-b] | | 726,101,270 | 990,624,114 | 1,446,315,935 | 990,063,953 | 374,859 | 573,003 | 794,243 | 530,581 | 36.4% | 46.0% | (31.5%) |
| Net Loan Loss provision expense (d) | | 54,375,655 | 45,284,840 | 61,111,844 | 56,535,351 | 28,072 | 26,194 | 33,571 | 30,298 | (16.7%) | 35.0% | (7.5%) |
| Loan loss provision expense and write-off | | 59,441,155 | 49,350,340 | 62,145,844 | 68,136,670 | 30,687 | 28,546 | 34,139 | 36,515 | (17.0%) | 26.0% | 9.6% |
| Recovery from Loans written off | | 5,065,500 | 4,065,500 | 1,034,000 | 11,601,319 | 2,615 | 2,352 | 568 | 6,217 | (19.7%) | (74.6%) | 1,022.0% |
| Operating expense (e) | | 951,449,624 | 1,208,939,358 | 1,425,297,885 | 908,601,661 | 491,198 | 699,282 | 782,701 | 486,925 | 27.1% | 17.9% | (36.3%) |
| Personnel Expense (includes fringe) | | 617,590,597 | 794,072,577 | 915,866,557 | 582,900,430 | 318,839 | 459,312 | 502,947 | 312,380 | 28.6% | 15.3% | (36.4%) |
| Administrative Expense (non-staff operating expenses) | | 333,859,027 | 414,866,781 | 509,431,328 | 325,701,231 | 172,359 | 239,970 | 279,754 | 174,545 | 24.3% | 22.8% | (36.1%) |
| Depreciation and amortization | | - | 50,529,982 | 58,980,314 | 32,144,205 | 26,087 | - | 32,389 | 17,226 | - | 16.7% | (45.5%) |
| Consulting fees | 5 | 10,175,425 | 8,005,115 | 16,753,800 | 10,456,000 | 5,253 | 4,630 | 9,200 | 5,603 | (21.3%) | 109.3% | (37.6%) |
| Programme related expenses | 6 | 75,828,250 | 93,661,600 | 106,570,450 | 57,009,150 | 39,147 | 54,176 | 58,523 | 30,552 | 23.5% | 13.8% | (46.5%) |
| Board costs | | 12,858,500 | 20,208,450 | 19,382,350 | - | 6,638 | 11,689 | 10,644 | - | 57.2% | (4.1%) | (100.0%) |
| Travel and Conference costs | | 46,214,606 | 73,380,747 | 94,975,929 | - | 23,859 | 42,445 | 52,156 | - | 58.8% | 29.4% | (100.0%) |
| Office running costs | | 114,887,496 | 124,052,587 | 158,821,327 | 136,138,719 | 59,312 | 71,755 | 87,217 | 72,958 | 8.0% | 28.0% | (14.3%) |
| Admin. Costs | 7 | 24,426,050 | 23,463,400 | 21,343,000 | 65,619,607 | 12,610 | 13,572 | 11,720 | 35,166 | (3.9%) | (9.0%) | 207.5% |
| Miscellaneous costs | | 49,468,700 | 21,564,900 | 32,604,158 | 24,333,550 | 25,539 | 12,474 | 17,905 | 13,040 | (56.4%) | 51.2% | (25.4%) |
| Others | | - | - | - | - | - | - | - | - | - | - | - |
| Net Operating Income Before Taxes and Donations [f=c-d-e] | | (279,724,009) | (263,600,084) | (40,093,794) | 24,926,941 | (144,411) | (152,473) | (22,017) | 13,358 | (5.8%) | (84.8%) | (162.2%) |
| Income Taxes (g) | | - | - | - | - | - | - | - | - | - | - | - |
| Net Operating Income Before Donations [h=f-g] | | (279,724,009) | (263,600,084) | (40,093,794) | 24,926,941 | (144,411) | (152,473) | (22,017) | 13,358 | (5.8%) | (84.8%) | (162.2%) |
| Non Operating Revenue (i) | | - | - | - | - | - | - | - | - | - | - | - |
| Non Operating Expense (including related taxes) (j) | | - | - | - | - | - | - | - | - | - | - | - |
| Net Income Before Donations [k=h+i-j] | | (279,724,009) | (263,600,084) | (40,114,764) | 24,926,941 | (144,411) | (152,473) | (22,017) | 13,358 | (5.8%) | (84.8%) | (162.2%) |
| Donations (l) | 8 | 93,428,750 | 57,594,713 | 128,261,433 | - | 48,234 | 33,314 | 70,435 | - | (38.4%) | 122.7% | (100.0%) |
| Net Income (after Taxes and Donations) [m=k+l] | | (186,295,259) | (206,005,371) | 88,167,639 | 24,926,941 | (96,177) | (119,159) | 48,417 | 13,358 | 10.6% | (142.8%) | (71.7%) |

Planet Rating - UGAFODE – September 2006

| UGAFODE Balance sheet | Notes | UGS | | | | USD | | | | Evolution | | |
|--------------------------------------------------|-------|----------------------|----------------------|----------------------|----------------------|----------------|------------------|------------------|------------------|--------------|--------------|--------------|
| | | Dec. 2003 | Dec. 2004 | Dec. 2005 | Jul. 2006 | Dec. 2003 | Dec. 2004 | Dec. 2005 | Jul. 2006 | 2004/2003 | 2005/2004 | 2006/2005 |
| ASSETS | | 1,919,594,089 | 2,765,792,177 | 3,568,504,485 | 3,975,117,143 | 991,014 | 1,599,806 | 1,959,640 | 2,130,288 | 44.1% | 29.0% | 11.4% |
| Short Term Assets | | 1,838,318,425 | 2,637,118,995 | 3,389,223,399 | 3,751,517,911 | 949,054 | 1,525,378 | 1,861,188 | 2,010,460 | 43.5% | 28.5% | 10.7% |
| Cash and Due from Banks | | 187,661,821 | 278,996,335 | 386,957,006 | 233,812,523 | 96,883 | 161,379 | 212,497 | 125,301 | 48.7% | 38.7% | (39.6%) |
| Short Term Investments | | - | - | - | - | - | - | - | - | - | - | - |
| Short Term Net Loan Portfolio | | 1,604,777,115 | 2,283,907,202 | 2,786,344,089 | 3,233,557,324 | 828,486 | 1,321,071 | 1,530,118 | 1,732,882 | 42.3% | 22.0% | 16.1% |
| Short Term Gross Loan Portfolio | 1 | 1,604,777,115 | 2,320,552,524 | 2,822,945,941 | 3,333,122,047 | 828,486 | 1,342,268 | 1,550,217 | 1,786,239 | 44.6% | 21.6% | 18.1% |
| (Loan Loss Reserve) | | - | 36,645,322 | 36,601,852 | 99,564,723 | - | 21,197 | 20,100 | 53,357 | - | (0.1%) | 172.0% |
| Interest Receivable | | - | - | - | - | - | - | - | - | - | - | - |
| On loan portfolio | | - | - | - | - | - | - | - | - | - | - | - |
| On investments | | - | - | - | - | - | - | - | - | - | - | - |
| Accounts receivable and other assets | 2 | 45,879,489 | 74,215,458 | 215,922,304 | 284,148,064 | 23,686 | 42,928 | 118,573 | 152,277 | 61.8% | 190.9% | 31.6% |
| Long term assets | | 81,275,664 | 128,673,182 | 179,281,086 | 223,599,232 | 41,960 | 74,428 | 98,452 | 119,828 | 58.3% | 39.3% | 24.7% |
| Long Term Net Investments | | - | - | - | - | - | - | - | - | - | - | - |
| Long Term Gross Loan Portfolio | | - | - | - | - | - | - | - | - | - | - | - |
| Net Fixed Assets | | 81,275,664 | 128,673,182 | 179,281,086 | 223,599,232 | 41,960 | 74,428 | 98,452 | 119,828 | 58.3% | 39.3% | 24.7% |
| Other Long Term Assets | | - | - | - | - | - | - | - | - | - | - | - |
| LIABILITIES AND EQUITY | | 1,919,594,089 | 2,765,792,177 | 3,568,504,485 | 3,975,117,143 | 991,014 | 1,599,806 | 1,959,640 | 2,130,288 | 44.1% | 29.0% | 11.4% |
| Liabilities | | 787,898,742 | 1,432,465,203 | 1,681,377,490 | 1,827,700,306 | 406,762 | 828,575 | 923,326 | 979,475 | 81.8% | 17.4% | 8.7% |
| Short term liabilities | | 500,866,465 | 815,371,716 | 983,934,279 | 962,059,181 | 258,578 | 471,632 | 540,326 | 515,573 | 62.8% | 20.7% | (2.2%) |
| Demand Deposits | | - | - | - | - | - | - | - | - | - | - | - |
| Compulsory Deposits | | - | - | - | - | - | - | - | - | - | - | - |
| Short Term Time Deposits | | - | - | - | - | - | - | - | - | - | - | - |
| Short Term Borrowings | | 430,748,350 | 625,748,350 | 640,400,000 | 817,398,350 | 222,379 | 361,949 | 351,675 | 438,048 | 45.3% | 2.3% | 27.6% |
| Interest payable | | 12,540,341 | 13,813,258 | 12,602,259 | 17,598,091 | 6,474 | 7,990 | 6,921 | 9,431 | 10.2% | (8.8%) | 39.6% |
| Accounts Payable and Other | 3 | 57,577,774 | 175,810,108 | 330,932,020 | 127,062,740 | 29,725 | 101,693 | 181,731 | 68,094 | 205.3% | 88.2% | (61.6%) |
| Short Term Liabilities | | - | - | - | - | - | - | - | - | - | - | - |
| Long term liabilities | | 287,032,277 | 617,093,487 | 697,443,211 | 865,641,125 | 148,184 | 356,943 | 383,000 | 463,902 | 115.0% | 13.0% | 24.1% |
| Long Term Time Deposits | | - | - | - | - | - | - | - | - | - | - | - |
| Long Term Borrowings | 4 | 239,726,520 | 540,629,925 | 592,949,612 | 779,540,054 | 123,762 | 312,714 | 325,618 | 417,760 | 125.5% | 9.7% | 31.5% |
| Other Long Term Liabilities | 5 | 47,305,757 | 76,463,562 | 104,493,599 | 86,101,071 | 24,422 | 44,229 | 57,383 | 46,142 | 61.6% | 36.7% | (17.6%) |
| Equity | | 1,131,695,347 | 1,333,326,974 | 1,887,126,995 | 2,147,416,837 | 584,252 | 771,231 | 1,036,314 | 1,150,813 | 17.8% | 41.5% | 13.8% |
| Paid-In Capital | | - | - | - | - | - | - | - | - | - | - | - |
| Donated equity | 6 | 1,249,490,101 | 1,543,103,628 | 2,008,756,980 | 2,189,956,980 | 645,065 | 892,571 | 1,103,107 | 1,173,610 | 23.5% | 30.2% | 9.0% |
| Retained earnings without donations and reserves | | (117,794,754) | (209,776,654) | (121,629,985) | (42,540,143) | (60,813) | (121,340) | (66,793) | (22,798) | 78.1% | (42.0%) | (65.0%) |
| Current year | | (279,724,009) | (263,600,084) | (40,114,764) | 24,926,941 | (144,411) | (152,473) | (22,029) | 13,358 | (5.8%) | (84.8%) | (162.1%) |
| Other equity accounts | | - | - | - | - | - | - | - | - | - | - | - |