MANAGEMENT DISCUSSION & ANALYSIS REPORT

I - INDUSTRY AND COMPANY OVERVIEW

i. Economic Scenario

The economic scenario in 2016 was characterised by an increase in macro-economic risks due to the drop in oil prices at the beginning of the year, and then by stress on cash flow in certain sectors in Oman. The slowdown in China and Brexit were global factors that also contributed to the increased risk, as demand for oil slowed down. The government has made attempts to improve the flow of cash to the economy by borrowing offshore and we expect the situation to improve going forward. The Tanfeedh initiative seeks to bring various important stakeholders together and provide a long term platform to diversify the economy away from its dependence on oil. We saw demand for automobiles drop sharply in the second half due to cautious market sentiment but as oil prices improve, we expect a more positive market in 2017.

ii. Finance and Leasing Sector

The Finance and Leasing sector was also affected by the challenging economic conditions and while the net debtors grew by 3.8% over the previous year, there was a drop in profits for the sector. The main reason for the drop in profits was the sharp increase in borrowing costs which affected all the finance companies. Muscat Finance had adopted a cautious approach to growth and focussed its attention on ensuring low accretion to non-performing loans and on maintaining profit margins, to ensure improvement in shareholder value.

iii. **Objects and Business**

Muscat Finance was incorporated in 1987, and is licensed and governed by the Central Bank of Oman under the Banking Laws of the Sultanate of Oman. As a listed company, it is also regulated by the Capital Markets Authority. The main objects under the licence are – Hire Purchase financing, Equipment leasing, Debt Factoring, Working Capital financing and Consumer durable loans. Over the last 29 years, the company has supported the local economy and enabled the dreams of many individuals and entrepreneurs. It has established an enviable reputation and continues to maintain its track record of consistent profits and uninterrupted dividends. The Company operates through its Head Office in Muscat as well as through an extensive network of six branch offices located at Barka, Sohar, Sur, Salalah, Ibri and Nizwa, and kiosks at two malls in Muscat.

iv. Products

The company continues to provide products which support the needs of the customers and assist in the government's efforts to grow the economy. It provides financing of vehicles, equipment, warehouse financing and plant and machinery to business establishments in the form of financial leasing. It also provides short term finance to them by way of factoring of receivables. Loans are also provided to individual customers to purchase vehicles and consumer durables for their homes.

During the year, in order to ensure that Muscat Finance continues to diversify its sources of funding, the company issued Unsecured Non-convertible Subordinated Bonds worth RO 5 million, through the private placement route. These bonds are now listed on the Muscat Securities Market.

v. Business Development:

During the nearly three decades of its operations, the Company has set up a large customer database comprising of almost 100,000 customers. This has enabled the company to obtain a substantial share of repeat business.

In addition, the six branches, two kiosks and the vehicle dealers serve as a source point of service and new business referrals.

An independent rating agency, which completed its review of the company in December 2016, reaffirmed its ratings of Muscat Finance of 'omBBB' Long term and 'omA3' Short term.

vi. Opportunities and Challenges

Opportunities

a) The Government's emphasis on diversifying the economy, driven by the Tanfeedh initiative, and the stable oil prices are expected to provide more opportunities for the leasing sector as a whole. We are planning to support the SME sector with a focus on Factoring, Warehouse financing and increasing our focus on LCs and Guarantees.

b) We will continue to diversify our sources of funding and look at innovative funding opportunities, both onshore and offshore.

Challenges

a) All banks and FLCs are expected to adopt IFRS 9 reporting standards from 2018 and are expected to do parallel reporting from 2017 onwards. This may require additional provisioning for impairment and could impact profit margins in the future.

b) Increased cost of borrowings owing to the tight liquidity in the market may impact Net Interest Income and profits.
c) If the cash flow situation remains difficult in the first half of the year, then there will be an increase in non-performing loans with subsequent impact on provisioning and profits.

The Company shall monitor the emerging market scenario, align its business targets and expand its size cautiously in tune with the emerging market conditions

II - OPERATING AND FINANCIAL PERFORMANCE

During the year, the company shrunk its Debtors' portfolio owing to the increase in the macroeconomic risks. However, it was able to achieve a net profit after tax of RO 5.138 million, a growth of 18%. During the year, the Company decreased its provision charge to the profits by 35%. Incremental provisions for the year after write offs, comprised of almost RO 1.2 million and cumulative provisions, including reserve interest, reached RO 14.94 million, representing 9.97% of net assets. The financial highlights for the past five years are tabulated below:

(in RO '000s)

Particulars	2016	2015	2014	2013	2012
Gross Income	14,415	13,218	12,149	10,780	9,904
Interest Expense	4,072	3,015	3,007	2,783	2,107
Net Interest Income	10,343	10,203	9,142	7,997	7,797
Operating Expenses	3,485	3,194	2,939	2,681	2,361
Provision for doubtful debts	1,294	1,998	1,122	891	1,113
Net Profit after Tax	5,138	4,356	4,335	3,893	3,846
Net Investment in Finance Debtors	149,858	154,015	137,813	124,516	103,667
Provisions for impairment	14,941	13,556	11,526	10,337	9,101
Provision coverage ratio	95%	100%	83%	89%	95%
Net Worth	38,391	35,724	33,251	30,738	28,925
Dividend (%)	17%*	16%	16%	16%	17%

**Proposed dividend*

Gross income grew by 9.05% owing to the increase in portfolio in previous years and higher yields. Interest cost and operating overheads grew at 35% and 9.1% respectively.

The company has, since inception, distributed RO 49.42 million (inclusive of the current years) dividend by way of cash and stock dividends, against the capital of RO 7.40 million injected in cash.

RISK MANAGEMENT

The Company recognizes that strong risk management framework is essential to ensure sustained performance. The objective of Risk Management function is to protect earning, cash flow and, ultimately, shareholders' value. Risk Management forms an integral part of the Company's business process and constitutes an important element of decision making.

The Company's risk management framework is based on a holistic understanding of various risks, disciplined risk assessment, risk measurement and continuous risk monitoring. The policies and procedures established for this purpose are continuously benchmarked with international best practices. The Board of Directors has an oversight on all the risks assumed by the Company.

The key risks faced by the Company and its preparedness for the same are summarized below:

I. **Credit & Portfolio Risk:**

Credit risk is the risk of loss arising from a borrower defaulting on a loan or the borrower counterparty to a transaction failing to fulfill its obligation under the loan agreement. Credit risk emanates from non-payment by one or more borrowers or a systemic failure of a particular segment of business.

The risk is mitigated by conservative credit policies, which are reviewed at regular intervals, and revised in the light of developments in the external environment. The Company adopts a strategy of distributing risk across customers and industry segments. Segmental risk and industry trends are reviewed by the Risk Management Committee and Board, each quarter. The Company follows a prudent policy of provisioning that is compliant with the requirements of the Central Bank of Oman.

II. **Liquidity Risks:**

Liquidity risk is the risk that the Company may be unable to meet its financial obligation in a timely manner. Such an event could be triggered by inability to convert an illiquid asset like security or hard asset to cash without a loss of capital and/or income in the process. The liquidity position is monitored daily by treasury department, monthly by Asset Liability Management Committee and on a quarterly basis by the Risk Management Committee. The company, as a strategy, sources a significant part of the borrowings on a long term basis, in order to minimize maturity mis-matches. The company also arranges offshore funding lines to partially mitigate risks associated with liquidity in the domestic banking system.

III. Market Risks:

a) Interest Rate Risk:

As with any financial institution, the Company is exposed to interest rate risk due to changes in borrowing rates. The Company mitigates this risk by borrowings at fixed rates, wherever commercially viable, and maintaining a spread on new business. Further, to mitigate risk on floating rate borrowing company may enter in to hedging contracts. Interest rate risk and trends are monitored closely by ALCO committee and management.

b) Foreign Exchange Rate Risk

The foreign exchange risk arises from the fluctuation in currency rates. The Company's exposure in foreign currency borrowing exposes it to foreign exchange rate risk. The Company has created a special reserve, in line with regulatory requirement, as a measure of self-insurance against fluctuation in the US Dollar- Omani Rial parity. In addition, based on market conditions, the company enters into forward contracts to cover its outstanding foreign exchange positions.

Internal Systems & Controls and IT Systems

The Company's procedure manuals provide for clearly defined levels of authority for the Board, the Executive Committee and the internal Management. Most of the processes are built into the customised industry specific functional software. The company has an in-house Internal Audit Division which is supervised by the Audit Committee Members & Board of Directors. Overall operations are subject to periodic reporting to and examination by the Central Bank of Oman. The company has also put in place a Disaster Recovery and Business Continuity Plan and an annual testing is conducted to ensure its state of preparedness.

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