Sri Lankan NBFI Report Card 2018

NBFIs Pressured by Weak Economic Growth and Vehicle Sales

Special Report

Rated Non-Bank Financial Institutions

Long-Term Local - and Foreign-Currency IDRs

People's leasing & finance PLC[a] (PLC)	B(lka)/ Stable

National Long-Term Ratings

Dialog Finance PLC[a] (DF)	AA(lka)/ Stable
People's Leasing & Finance PLC[a] (PLC)	AA-(lka)/ Stable
Central Finance Company PLC (CF)	A+(lka)/ Stable
Serendib Finance Limited[a] (Serendib)	A+(lka)/ Stable
HNB Finance Limited[a] (HFL) (formally known as HNB Grameen Limited)	A(lka)/ Stable
LB Finance PLC (LB)	A-(lka)/ Stable
Siyaptha Finance PLC[a] (Siyapatha)	A-(lka)/ Stable
Senkadagala Finance PLC (Senka)	BBB+(lka)/ Stable
AMW Capital Leasing and Finance PLC[a] (AMWCL)	BBB+(lka)/ Stable
Richard Pieris Finance Limited (RPF) [a]	BBB+(lka)/ Stable
Singer Finance (Lanka) PLC (SFL)	BBB(lka)/ Stable
Mercantile Investments and Finance PLC (MIF)	BBB-(lka)/ Stable
Abans Finance PLC[a] (AFP)	BB+(lka)/ Stable
Bimputh Finance PLC (BIM)	BB(lka)/ Negative
Ideal Finance Limited (Ideal)	B+(lka)/ Stable
Fintrex Finance Ltd (Fintrex) (formally known as Melsta Regal Finance Limited)	B(lka)/ Stable

[a] Support-driven ratings
Source: Fitch Ratings, Fitch Solution

Peer averages in this report are calculated as the asset weighted average of the 16 NBFIs rated by Fitch.

IFRS compliant published financials for period ended 30 September 2018 were not available for Serendib, HFL, RPF, Ideal and Fintrex.

Stressed Financial Profiles: Fitch Ratings expects Sri Lankan non-banking financial institutions (NBFI) to continue to face pressure on asset quality and profitability in the medium term. A slowdown in Sri Lanka's economic activities and lacklustre growth in the sector's core vehicle-financing segment continue to weigh on NBFI's financial profiles. Furthermore, higher taxes on financial institutions would pose an additional threat on smaller NBFIs in meeting enhanced capital requirements due to a further weakening in internal capital generation.

Muted Growth Prospects: Macro-prudential policy measures taken by the authorities since 2015 to curb imports, and stringent rules on vehicle financing, could continue to dampen growth prospects. Leasing and hire purchases made up the largest proportion of sector loans, with 53% at end-December 2018. Loan growth year-on-year had already slowed to 9.0% by end-2018 from a high of 31.0% in 2015, due to the imposition of tighter loan-to-value ratios on vehicle-financing by the Central Bank of Sri Lanka (CBSL).

Heightened Risk Appetite: NBFIs' risk appetite is likely to remain high in light of their rising exposure to risker non-core lending segments outside of vehicle financing that they aggressively expanded during 2015-2017. We view these non-core segments as risky due to larger ticket sizes, poor collateral protection, and a lack of experience in these segments. Nonetheless, we expect NBFIs to scale down growing into these risky segments in the medium term, reflecting the increased pressure on their asset quality and capitalisation.

Rising NPLs: The sector's NPL ratio (overdue by more than 180 days) spiked to 7.7% by end-2018 from 5.9% at end-2017, with the target customer base suffering from the economic slowdown. Fitch-rated NBFIs' median NPL ratio of 4.7% at end-September 2018 was far below than that of the sector, driven mainly by better ratios at larger companies. Fitch-rated large NBFIs generally possess better franchises with more sophisticated risk management.

Ongoing Capitalisation Challenges: Among the Fitch rated-NBFIs, six (Fintrex, Ideal, Bimputh, AFP, DF and Serendib) need additional capital to meet the enhanced capital requirement of LKR2.5 billion by 1 January 2021, while others may require external capital to support loan growth and meet the higher capital adequacy ratio requirement (see Related Research).

Fitch witnessed an average reduction in the Tier I ratio of 200bp among Fitch-rated NBFIs with the new capital adequacy framework, stemming mainly from risk weights for operational risk. However, the impact on specific companies varies, based on their exposure to unsecured retail claims such as microfinance – of which risk-weights have increased by 25% under the new methodology.

Pressure on Profitability: The profitability of Fitch-rated Sri Lankan NBFIs is likely to remain under pressure due to rising credit and funding costs amid high taxes. Fitch-rated peers' average return-on-assets declined – a trend witnessed across the sector – but continued to remain better than that of the sector. NBFIs' net interest margins are also affected by the companies' inability to reprice, due to their predominant fixed-rate lending practices.

Increase in Deposit Funding: Fitch-rated NBFIs are funded mainly through deposits, the share of which had increased to 61.9% by FYE18 from 55.3% at FYE16, a trend seen across the sector. Nevertheless, a highly concentrated and pricing-sensitive deposit base is susceptible to market events and less reliable in situations of market stress.

Related Research

Fitch Ratings 2019 Outlook: Global Finance and Leasing Companies (December 2018)

Fitch: Capital Regs to Raise Resilience of Sri Lanka Finance Cos (June 2018)

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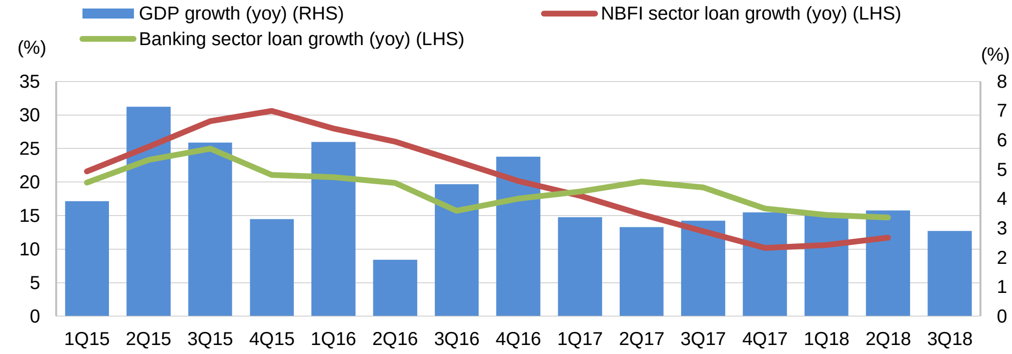
- Sri Lankan NBFI sector loan growth has slowed down considerably since end-2015 with tightened regulation on vehicle financing and increased tariffs on vehicle importation.
- The sector has also been affected by the slower-than-expected economic growth in Sri Lanka.

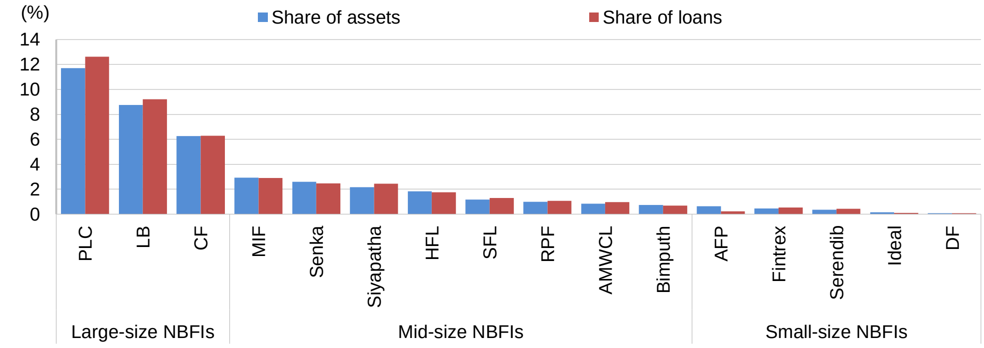
GDP Growth vs. Sectors' Growth



Source: Fitch Ratings, Fitch Solution, CBSL

- The five largest companies accounted for around 48% of sector assets at end-September 2018, while the remainder is distributed among 43 companies.
- Fitch- rated NBFIs represented 42% of the sector assets at end-September 2018.

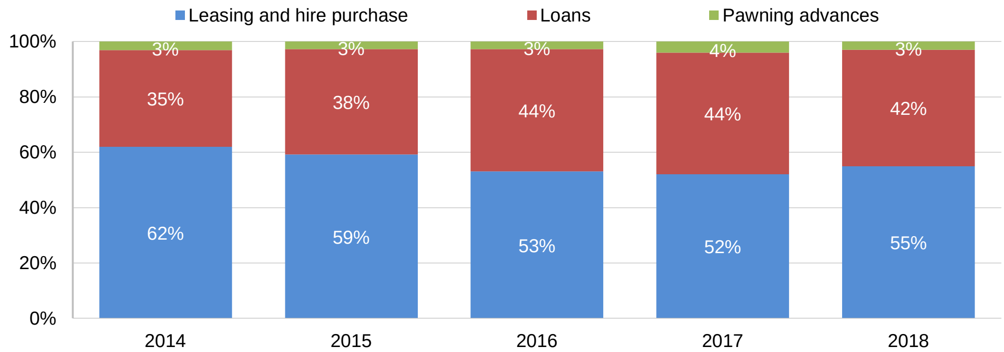
Market Share of Fitch-Rated NBFIs at End-March 2018



Source: Fitch Ratings, Fitch Solutions, NBFIs

- The sector's exposure to vehicle financing through leasing and hire purchases continued to decline, but is likely to remain the sector's core line of business in the medium term.

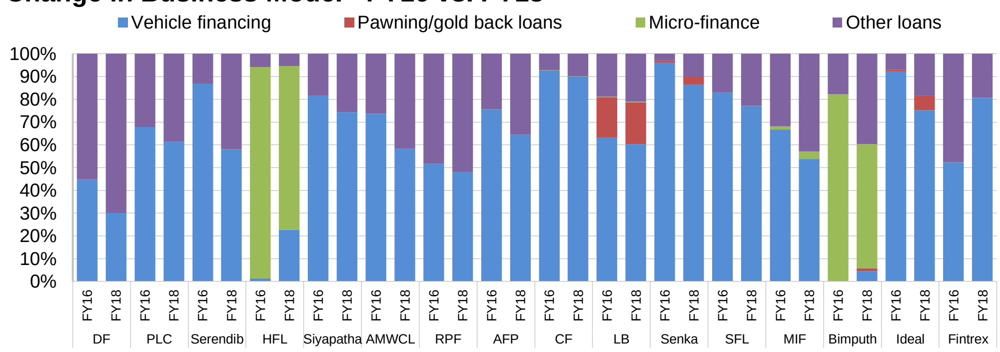
Loan Breakdown by Products



Source: Fitch Ratings, Fitch Solution, CBSL

- A notable shift in business models away from vehicle financing was witnessed among most Fitch–rated NBFIs during FY16-FY18.

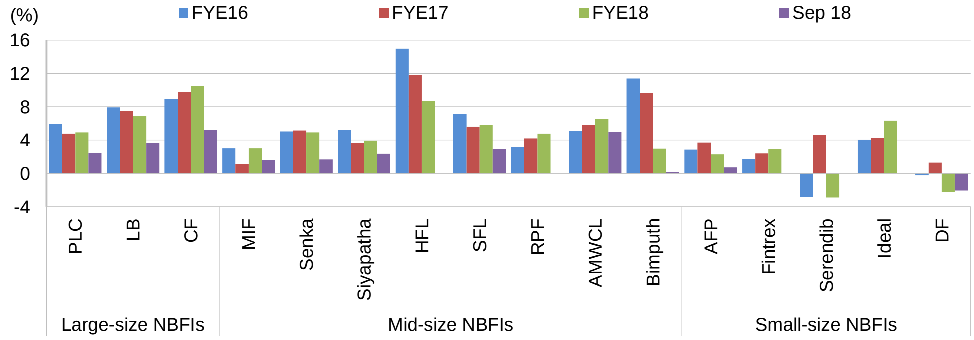
Change in Business Model - FY16 vs. FY18



Source: Fitch Ratings, Fitch Solution, NBFIs

- Elevated funding and credit costs exerted pressure on most of the Fitch-rated NBFIs' profitability.
- The sector's return-on-assets ratio had declined to 2.7% by end-2018, which is below its four-year average of 3.2% over 2014-2017.

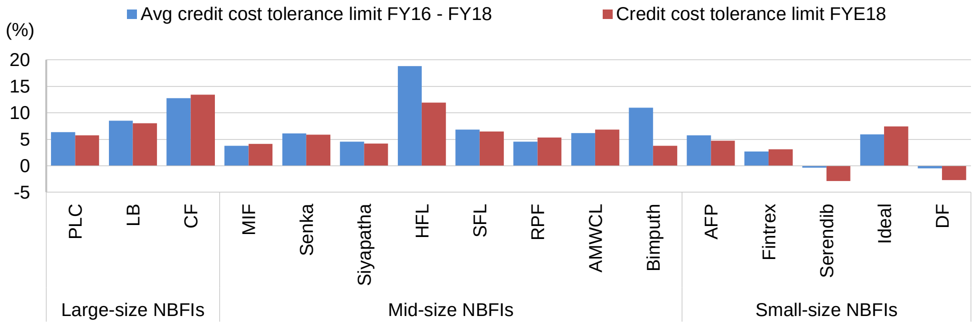
Profitability Indicators: Pre-Tax Net Income/Average Assets



Source: Fitch Ratings, Fitch Solutions, NBFIs

- Ability to absorb credit-cost shocks have weakened in FY18 for most of the Fitch-rated-NBFIs, due mainly to rising credit costs.

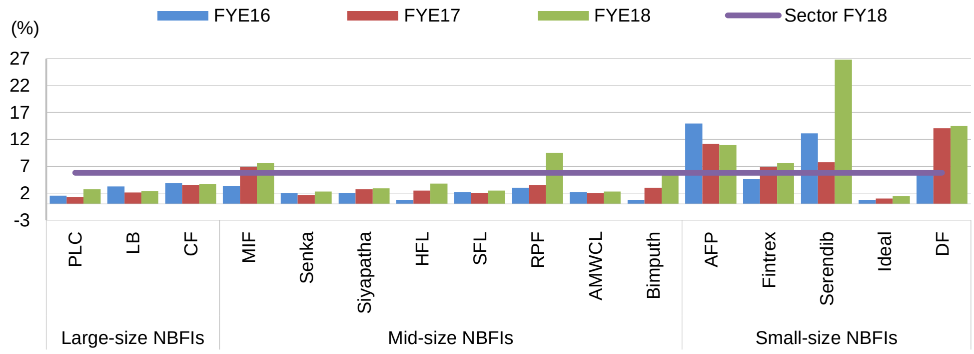
Profitability Indicators: Credit Cost Tolerance Level[a]



[a] Gap between pre-impairment operating profits and credit cost as a % of average loans
Source: Fitch Ratings, Fitch Solutions, NBFIs

- As with the sector in general, deterioration in asset quality was evident across Fitch-rated NBFIs in recent years, mainly as a result of difficult operating conditions.
- Above-sector NPL ratios of small-size Fitch-rated NBFIs reflects their more aggressive lending standards and weaker risk controls.

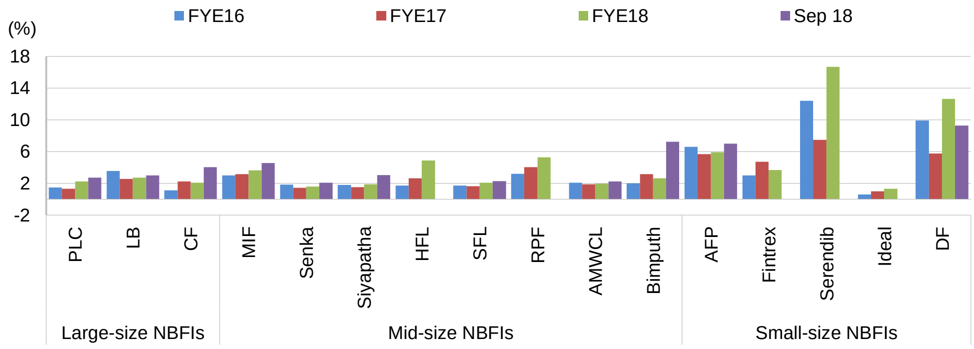
Asset Quality Indicators: Reported NPL Ratio



Source: Fitch Ratings, Fitch Solutions, NBFIs

- Reserves coverage of NPLs of most of the Fitch-rated NBFIs has declined due to acute deterioration of asset quality.
- This has raised these NBFIs' exposure to changes in the market value of underlying collateral.

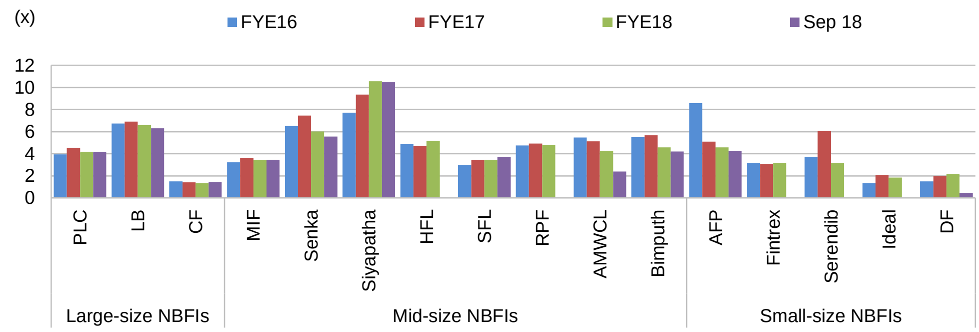
Asset Quality Indicators: Loan Loss Allowances/Gross Loans



Source: Fitch Ratings, Fitch Solutions, NBFIs

- The average debt-to-equity ratio of the Fitch-rated NBFIs stood at 4.6x at FYE18, which is below that of the sector's 6.7x.

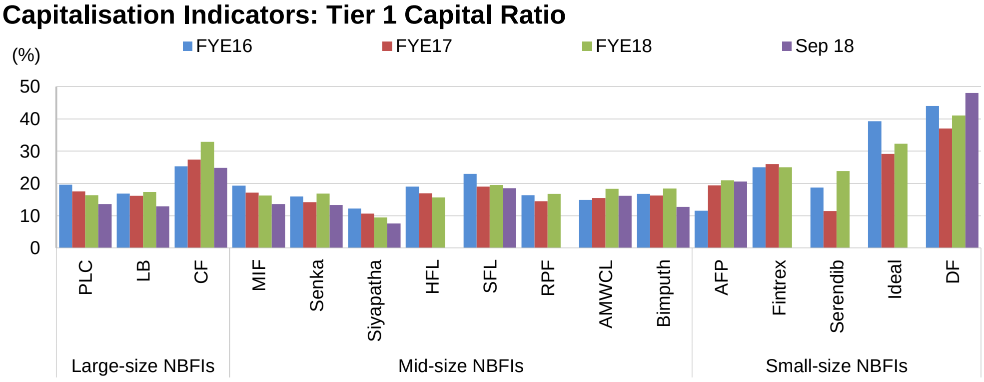
Capitalisation Indicators: Debt/Tangible Equity



Source: Fitch Ratings, Fitch Solutions, NBFIs

- Regulatory capital ratios of Fitch-rated NBFIs witnessed a moderate decline at end-September 2018 with the adoption of the new capital-adequacy framework.
- Bimputh and HFL suffered the biggest impact under the new capital-adequacy ratio calculations of around a 600bp reduction, due to their significant exposure to microfinancing which is to be risk-weighted at 125%.

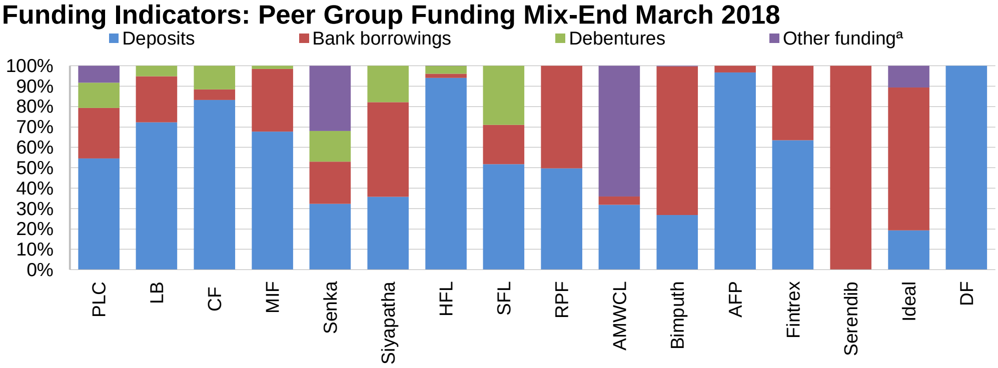
Capitalisation Indicators: Tier 1 Capital Ratio



Source: Fitch Ratings, Fitch Solutions, NBFIs

- Fitch-rated NBFIs have varying levels of funding diversity

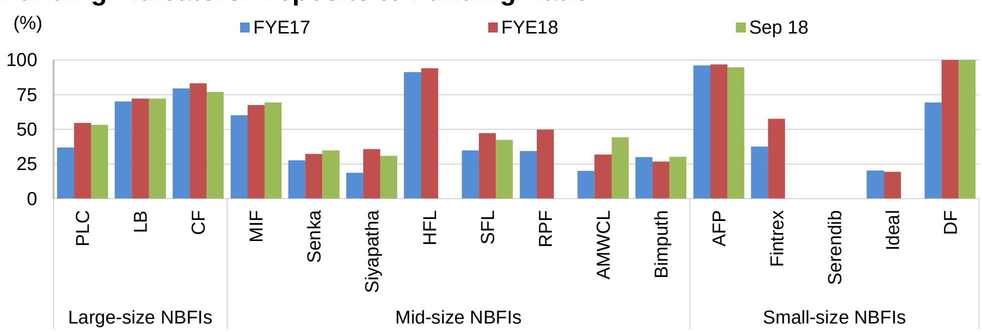
Funding Indicators: Peer Group Funding Mix-End March 2018



[a] Other funding includes commercial paper, asset-backed securities and inter-company loans
Source: Fitch Ratings, Fitch Solutions, NBFIs

- Deposit concentration is high among the mid- to small-size NBFIs; but the potential liquidity risk is partly mitigated through their access to bank funding lines.
- Serendib has not solicited deposits as a funding source, while DF is currently relying entirely on deposits.

Funding Indicators: Deposits to Funding Ratio



Source: Fitch Ratings, Fitch Solutions, NBFIs