FitchRatings

30 Jun 2019 | Rating Changed Outlook to Negative

Fitch Revises Outlook on MIF to Negative; Affirms Five Sri Lankan Finance Companies

Fitch Ratings-Colombo/Taipei-01 July 2019: Fitch Ratings has revised the Outlook on Mercantile Investments and Finance PLC (MIF) to Negative from Stable and has affirmed the ratings. At the same time, Fitch has affirmed the ratings of the following Sri Lankan finance companies:
- Central Finance Company PLC (CF)
- LB Finance PLC (LB)
- Senkadagala Finance PLC (Senka)
- People's Leasing & Finance PLC (PLC)

The rating actions follow Fitch's periodic review of Sri Lanka's large and mid-sized finance companies. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
NATIONAL RATINGS

Fitch expects Sri Lankan non-banking financial institutions to continue to face pressure on asset quality and profitability in the medium term. The sector's non-performing loan (NPL) ratio (overdue more than 180 days) spiked to 7.7% by March 2019, from 5.9% at March 2018, with the target customer base suffering from the economic slowdown, which we expect to continue throughout the financial year. Higher taxes on financial institutions lowered sector profitability by 28% during the financial year ending March 2019 (FY19), in addition to the impact of rising credit costs from weakening asset quality and the adoption of SLFRS 9.

The ratings of the finance companies in the peer group are driven by their high-risk appetite, as reflected in the companies' predominant exposures to more vulnerable customer segments. The ratings are highly sensitive to asset quality trends and our assessment of capital availability to absorb this stress.

Finance Companies with Ratings Driven By Intrinsic Strength

MIF
The Negative Outlook on MIF's National Long-Term Rating reflects our expectation that MIF's

capital buffers could deteriorate further from pressure on its already-weak asset quality and below-average earning generation.

MIF's National Long-Term Rating reflects its high-risk appetite, which stems from its weak underwriting standards, evolving risk controls and high reliance on concentrated short-term funding that has led to considerable negative maturity mismatches. The rating also takes into consideration the company's long operating history.

MIF's asset quality, as measured by its reported six-month regulatory gross NPL ratio, further deteriorated to 9.6% (FY18: 7.6%) and stood above the sector's 7.7% at end-FY19. We expect MIF's NPL ratio to remain elevated in the medium-term due to operating environment challenges, despite potentially significant recoveries on its single largest NPL (backed by collateral), which accounts for around 4% of gross loans.

We believe MIF's concentrated deposit-base and reliance on short-term funding pose a risk to its funding profile, particularly in a challenging operating environment. Short-term funding comprised 75% of total funding at end-FY19 (FY18: 71%) and, in our view, its unutilised credit lines do not adequately cover the negative maturity mismatches. We expect deposits to remain a major funding source for MIF (FY19: 70% of funding).

CF

CF's rating reflects its high risk appetite stemming from its retail-centric loan book, which is concentrated in registered three-wheelers; and weakened asset quality. This is partly mitigated by CF's healthy capitalisation, supported by above-industry profitability. The rating also captures CF's established franchise, which is underpinned by solid market share and a long operational record of 61 years in the domestic market.

CF's reported six-month regulatory gross NPL ratio surged to 5.6% in FY19 (FY18: 3.7%), but remained lower than that of the sector. We expect further downside risk to asset quality given CF's aggressive loan growth of 19.1% in FY19 with a back drop of a weakened operating environment. Notwithstanding, CF's better-than-peer capitalisation should counterbalance any credit shocks. CF remains Sri Lanka's highest-capitalised licensed finance company, with regulatory Tier 1 and total capital ratios of 26.0% and 25.9%, respectively, at end-FY19.

LB

LB's rating reflects its established franchise, high profitability from high yielding products and satisfactory capital levels. This is counterbalanced by the company's high risk appetite due to a large exposure to gold-backed lending.

LB's balance-sheet leverage remains the highest among large peers, with debt/tangible equity of 6x. Some moderation is likely in the medium term, with the company's internal capital generation outpacing slower loan growth. LB's regulatory capital ratios remain in line with those of peers due to its exposure to capital-efficient products, such as gold-backed lending.

LB's gold-loan exposure increased by 28% in FY19, to account for 22% of gross loans (FY18: 19%), partly compensating for the slowdown in leasing. We believe the high exposure to gold-backed lending could pose a threat to asset quality due to potential volatility in gold-prices, but the exposure has so far been managed through active monitoring and risk-control measures.

Senka

Senka's rating reflects its high risk appetite stemming from its SME-centric loan book and lower financial flexibility compared with peers due to a heavy reliance on secured wholesale funding. This offsets any potential benefits stemming from Senka's established franchise in the domestic vehicle-financing sector and well-matched maturity gaps.

Senka's asset quality witnessed sharp deterioration in FY19, similar to peers, reflecting a high exposure to the SME segment, which is highly susceptible to the prevailing weak operating environment. Its reported six-month regulatory gross NPL ratio surged to 4.9% in FY19, from 2.3% in FY18, although it remains better than that of the sector. We expect asset-quality pressure to persist in FY20, as a meaningful economic recovery is not probable in the short term.

Senka's heavy reliance on secured funding is likely to further limit its financial flexibility, especially in distressed-market conditions. Its unsecured debt/total debt ratio was low at 44.7% in FY19 due to a low share of deposits (33.2% of total funding at FYE19) in the funding mix compared with peers.

Finance Companies with Institutional Support-Driven Ratings

PLC

PLC's Issuer Default Ratings (IDR) and National Long-Term Rating reflect Fitch's view that its parent, the state-owned and systemically important People's Bank (Sri Lanka) (AA+(lka)/Stable), would provide PLC with extraordinary support, if required. People's Bank's propensity to support PLC stems from PLC's group role and integration as a strategically important subsidiary of People's Bank; PLC accounted for 9.8% of People's Bank's assets at FYE19. PLC also has 92 window offices within People's Bank branches and has board representation from People's Bank.

There is high reputational risk to People's Bank should PLC default, as the bank holds 75% of PLC and shares a common brand. People's Bank's ability to provide support to PLC is limited and stems from Sri Lanka's rating of 'B'/Stable.

DEBT RATINGS

The ratings on the senior debentures of LB, Senka and PLC are in line with the companies' National Long-Term Ratings, as they rank equally with claims of the company's other senior unsecured creditors.

Fitch has not provided any rating uplift for the collateralisation of CF's senior secured notes, as we consider recovery prospects to be average and comparable with that of unsecured notes in a developing legal system.

The subordinated debentures of LB and proposed subordinated debentures of Senka are rated one notch below the companies' National Long-Term Ratings to reflect their subordination to senior unsecured creditors.

RATING SENSITIVITIES

NATIONAL RATINGS

Finance Companies with Ratings Driven By Intrinsic Strength

MIF

The Outlook on MIF's National Long-Term Rating may be revised to Stable if the company can sustain capital buffers to sufficiently cushion its weaker asset quality amid higher operating environment-related risks. MIF's ratings could be downgraded if it experiences higher capital impairment due to sustained deterioration in asset quality and profitability or if its large maturity mismatches were to widen.

CF

CF's ratings could be upgraded if its risk appetite moderates, which Fitch does not expect in the medium term. The rating could be downgraded if capital buffers are substantially eroded due to weakening asset quality and prolonged rapid growth in the more vulnerable customer segments.

LB

Downgrade triggers for LB include heightened risk appetite or capital pressure from weaker profitability. This could be indicated through aggressive loan growth or deterioration in asset quality. An upgrade is contingent on LB achieving stronger capitalisation, lower-risk asset exposure and a more comfortable liquidity position.

Senka

An upgrade of Senka's rating is contingent upon the company sustaining stronger capital levels and improved financial flexibility through a more robust deposit franchise. Senka's rating could be downgraded if asset quality weakens, leading to a significant decline in capitalisation or excessive asset encumbrance.

Finance Companies with Institutional Support-Driven Ratings

PLC

A downgrade of PLC's IDRs and National Rating would occur if People's Bank's ability to support PLC was to weaken, if People's Bank was to cede its majority ownership in PLC or if PLC's strategic importance to its parent was to diminish over time, reflecting a reduced propensity to support PLC. However, Fitch does not anticipate this in the long term. PLC's ratings are also sensitive to changes in the sovereign rating, as this would affect People's Bank's ability to provide support to PLC.

DEBT RATINGS

The ratings on the senior debt of CF, LB, Senka and PLC will move in tandem with the companies' National Long-Term Ratings.

The assigned subordinated debt ratings will move in tandem with the National Long-Term Ratings.

The rating actions are as follows:

Mercantile Investments and Finance PLC

National Long-Term Rating affirmed at 'BBB-(lka)'; Outlook revised to Negative from Stable

Central Finance Company PLC

National Long-Term Rating affirmed at 'A+(lka)'; Outlook Stable

Senior secured National Long-Term Rating affirmed at 'A+(lka)'

LB Finance PLC

National Long-Term Rating affirmed at 'A-(lka)'; Outlook Stable

Senior unsecured National Long-Term Rating affirmed at 'A-(lka)'

Subordinated debt National Long-Term Rating affirmed at 'BBB+(lka)'

Senkadagala Finance PLC
National Long-Term Rating affirmed at 'BBB+(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'BBB+(lka)'
Proposed subordinated debt National Long-Term Expected Rating affirmed at 'BBB(EXP)(lka)'

People's Leasing & Finance PLC
Long-Term Foreign-Currency Issuer Default Rating affirmed at 'B-'; Outlook Stable
Long-Term Local-Currency Issuer Default Rating affirmed at 'B-'; Outlook Stable
National Long-Term Rating affirmed at 'AA-(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'AA-(lka)'

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Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Non-Bank Financial Institutions Rating Criteria (pub. 12 Oct 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
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