# ICRA Lanka revises the issuer rating of Arpico Finance Company PLC

May 22, 2019

| Instrument* | Rated Amount | Rating Action |
|---|---|---|
| Issuer rating | N/A | Revised to [SL]B+ (Negative) from [SL]BB- (Negative) |

## Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has revised the issuer rating of Arpico Finance Company PLC (AFCP or the Company) to [SL]B+ (Pronounced SL B plus) from [SL]BB- (Pronounced SL double B minus). The outlook is retained at Negative.

## Rationale

ICRA Lanka has taken a consolidated view of Associated Motor Finance PLC (AMF) and its 94% owned subsidiary Arpico Finance Company PLC (AFCP) for arriving at the rating. The combined entity henceforth is referred to as AMF-group.

The rating revision factors in the deterioration in AMF-group's asset quality indicators, continued weakness in its capital profile and its stretched liquidity profile. The group's gross NPA ratio (GNPA%) increased to 8.9% as of Dec-18 vis a vis 4.4% as of Mar-18 (3.9% as of Mar-17), largely because of macro-economic challenges and operational issues faced by AFCP in its collections and recoveries. The group's delinquencies in the 90+ days past due (dpd) bucket increased sharply to about 23% as of Dec-18 from 13% as of Mar-18, indicating higher asset quality pressures going forward also. This, along with its weak solvency (net NPA/net worth) of 53% as of Dec-18 significantly impacts its overall credit risk profile.

AMF-group's capital position is considered on a group perspective by the Central Bank of Sri Lanka (CBSL) and the group's total capital adequacy ratio (CAR) remained below requirement (of 10%) at 7.4% (including unaudited PAT for 9MFY2019) as of Dec-18 (7.6% as of Dec-17). The Group's liquidity was characterized by ALM mismatches[1] of 15.4% in the <1-year bucket as of Dec-18 exposing it to refinance risks. The rating also takes note of the Group's moderate scale and competitive operating environment in the vehicle financing segment, which is also susceptible to adverse regulatory changes. ICRA Lanka takes cognizance of the group's declining profitability, in view of the shift in the product profile to more secured product categories and increase in credit related costs.

The rating also takes note of the group's established track records. ICRA Lanka notes that AMF and AFCP have obtained approval from CBSL to be merged by Nov-19 and for the merged entity to raise equity capital based on a capital plan submitted by the Group by Mar-20, subject to required regulatory approvals. This is likely to strengthen its business franchise and support business growth; however, ability to improve asset quality and capitalisation would be a key monitorable in the near term.

[1] Cumulative mismatch/ total assets

## Outlook: Negative

The Negative outlook notes that the Company's asset quality and capital profile would remain weak in the near to medium term. The outlook may be revised to 'Stable' in case of steady improvement in AMF-group's capital, liquidity and asset quality profiles going forward. The rating may be downgraded in case of any further deterioration in its asset quality and capitalisation, or overall financial risk profile. Any regulatory action on the Company, which could impact its business and financial performance, would also be a credit negative.

## Key rating drivers

## Credit strengths

**Established track record**- AMF and AFCP have established track records of over 50-years in operation as finance companies in Sri Lanka. AMF operates out of the head office and its sole branch in Kurunegala, but it has presence in about 100 dealer locations, while AFCP operates with 10 branches, including its head office. AMF is expected to merge with AFCP by November 2019, which would improve the overall synergies. AMF's current business, post-merger, is expected to operate as a strategic business unit within the merged entity, specialising in 2-wheeler financing. AMF-group's promoters are experienced professionals in financing business and are actively involved in the day to day business operations and decision making and also hold board positions in both AMF and AFCP.

## Credit challenges

**Further weakening in asset quality-** AMF-group's gross NPA ratio increased to 8.9% as of Dec-18 vis a vis 4.4% as of Mar-18 (3.9% as of Mar-17) because of the weak economic condition and challenges in the Group's collection and recovery initiatives. The shortcomings include lack of monitoring and supervision of collections and recoveries, largely at AFCP. The reported GNPA% of AFCP and AMF stood at 9.6% (3.8% as of Mar-18 and 4.1% as of Mar-17) and 6.7% (6.4% as of Mar-18 and 3.5% as of Mar-17) respectively as of Dec-18. The Group's delinquencies in the 90+ bucket remained high at 23% as of Dec-18 (13% as of Mar-18) indicating further pressure on asset quality. AFCP's delinquencies in 90+ bucket increased sharply to 25% as of Dec-18 from 11% as of Mar-18 while the same for AMF increased to 18% as of Dec-18 from 17% as of Mar-18. The group's credit costs (including provision & write-offs) increased to 3.4%[2] in 9MFY2019 vis a vis 2.4% in FY2018 largely because of losses in disposal of repossessed stocks. The group's ability to control further slippages and make improvements in asset quality would be a key monitorable going forward.

**Weak capital profile**- The AMF-group's consolidated gearing[3] remained high at 10.2 times as of Dec-18 (12.1 times as of Mar-18). During 9MFY2019, the gearing moderated largely because of subdued portfolio growth. The gearing of AMF and AFCP stood at 4.9 times and 8.2 times respectively as of Dec-18. Based on the CBSL approval granted for the merger plan in Nov-18, the group's capital position is considered by the regulator on a consolidated basis, till the merger is completed. AMF-group's total capital adequacy ratio (CAR) however continued to remain below the regulatory requirement (of 10%) at 7.4% (including

[2] Credit cost/Average total assets

[3] Total borrowings/ adjusted net worth

unaudited PAT for 9MFY2019) as of Dec-18 (7.6% as of Dec-17). Post the exemptions granted by CBSL for AMF to differ the deduction of deferred tax asset and investment made in AFCP in capital adequacy computation, AMF's total CAR improved to 15.5% (Tier-I at 14.2%) as of Dec-18 vis a vis 1.8% as of Mar-18. AFCP's total CAR, however, continued to remain below the threshold at 8.6% (Tier-I at 7.2%) as of Dec-18. ICRA Lanka notes that the Group's CAR will remain under pressure going forward until it secures commensurate fresh external equity post-merger, based on the CBSL approved plan, subject to required regulatory approvals. The Group's solvency ratio[4] stood high at 53% as of Dec-18 (18% as of Mar-18) because of the significant weakening in its asset quality during 9MFY2019. The same for AMF and AFCP stood at 16% and 50% as of Dec-18 respectively.

In addition, according to the CBSL direction for Licensed Finance Companies (LFCs), the group's core capital is required to be increased up to LKR 1.5 Bn by January 2019 and each year thereafter by LKR 500 Mn until it reaches LKR 2.5 Bn by 2021. The Group's capital is estimated at about LKR 2.2 Bn (provisional) as of Dec-18 post incorporating IFRS9 transition impact, hence is in compliance with the requirement up to Jan-20.

**Stretched liquidity profile**- AMF-group's asset liability mismatches (ALM) in <12-months' bucket stood at 15.4% (as a percentage of total assets) as of Dec-18 (20.7% as of Mar-18). The Group was faced with ALM mismatches as majority of the borrowing were short-term in nature compared to the tenor of its lending portfolio. The standalone mismatch of AMF was comfortable (at about positive 9%), but the same for AFCP was negative at 26%, as of Dec-18. While ICRA Lanka takes note of the healthy deposit renewal rate of about 80-85% and its un-utilised sanction limits (about LKR 1.3 Bn un-utilised bank facilities as of Mar-19), it would however be crucial for the group to improve its liquidity position to offset refinancing and interest rate risks, as the share of long tenure assets are expected to increase, going forward.

**Moderate scale of operations and competitive business environment**- AMF-group's franchise is limited with 12 branches (AMF-2 branches and AFCP-10 branches). The group's portfolio did not grow during 9MFY2019 and stood at about LKR 20.6 Bn as of Dec-18. As of Dec-18, about 91% of the portfolio was backed by vehicles (via leasing and Islamic financing products). Its leasing portfolio largely comprised of 2-wheelers, and cars & vans which accounted for about 44% and 36% as of Dec-18. The Islamic financing portfolio accounted for about 6% of the portfolio. The operating environment for vehicle financing is quite competitive with established NBFIs and banks competing for market share. In addition, unregistered vehicle leasing business is largely susceptible to adverse regulatory changes as observed in the recent past. To navigate these challenges, the group has expanded its 4-wheeler portfolio into registered vehicles segment, which accounted for about 60% of LKR 8.6 Bn 4W portfolio as of Dec-18. AMF-group continues to be a key 2-wheeler financier in the country. The other loans which were largely unsecured including corporate loans (about 4%) and microfinance (about 1%) were discontinued in Oct-18.

**Declining group profitability** - AMF-group's RoA (before tax) moderated to 1.9% for 9MFY2019 from 2.4% for FY2018 (3.1% for FY2017). ICRA Lanka expects the group's RoA to moderate going forward because of the decrease in group's NIM and expected increase in credit and provision costs. AMF's RoA (before tax) decreased to 0.5% in 9MFY2019 vis a vis 1.7% in FY2018. During 9MFY2019, AMF's credit cost stood high at 3.6% (3.6% in FY2018 and 2.3% in FY2017) largely because of weakening asset quality. AFCP's RoA moderated to 2.7% in 9MFY2019 from 2.9% in FY2018 (3.3% in FY2017), largely because of increased credit

[4] Net NPAs/ Adjusted Net worth

costs. The credit costs increased to about 3.3% from 1.9% (1.5% as of Mar-17) in the same period, largely because of the increased slippages and losses incurred in the disposal of the repossessed stock.

**Analytical approach:** ICRA Lanka has taken a consolidated view of AMF and AFCP. For arriving at the ratings, ICRA has applied its rating methodologies as indicated below**.**

**Links to applicable criteria:** **ICRA Lanka's Credit Rating Methodology for Non-Banking Financial Institutions**

## About the Company - Arpico Finance Company PLC (AFCP)

Arpico Finance Company PLC (AFCP) is one of the older finance companies in Sri Lanka, with a track record of over six decades. The Company is listed on the Main Board of the Colombo Stock Exchange. The controlling interest of AFCP was acquired by Alliance Finance Group in 1967 from the original shareholders. With the consolidation drive initiated by the Central bank, Alliance Finance Group divested its controlling interest to Associated Motor Finance PLC. The Company's major shareholder presently is Associated Motor Finance Company PLC with a stake of 94%. AFCP's primary customer segments are Retail and Small and Medium Enterprises (SME) sectors. The Company's key areas of operations are Deposits, Leasing & Hire Purchase, Loans and Islamic Finance. The Company presently has a total asset base of approximately LKR 17 Bn as of December 31, 2017 and operates through 10 branches and has staff strength of 398 employees.

During FY2018, AFCP reported a PAT of LKR 354 Mn on a total asset base of LKR 18,401 Mn as compared to a PAT of LKR 227 Mn on a total asset base of LKR 11,112 Mn in the previous financial year. For 9MFY2019, AFCP reported a PAT of LKR 351 Mn on a total asset base of LKR 17,924 Mn.

## Associated Motor Finance PLC (AMF)

Associated Motor Finance PLC (AMF) is one of the old Finance companies in Sri Lanka. AMF focuses on 2-wheelers as its key asset class. Imperial Imports and Exports (Pvt) Ltd (IIEP) which is a family owned company of Mr. Nalantha Dayamansa, holds 43.1% of the Company. Mr. Nalantha Dayawansa directly holds another 42.8% of the Company, while other Dayawansa family members hold 6.5% of the shares. Effectively Dayawansa family controls close to 92.0% of the Company. Imperial Imports and Exports (Pvt) Ltd is into motor trading business and it imports luxury vehicles and prime movers from UK.

During the FY2018, AMF reported a PAT of LKR 122 Mn on a total asset base of LKR 8,178 Mn as compared to a PAT of LKR 221 Mn on a total asset base of LKR 7,181 Mn in FY2017. For 9MFY2019, AMF reported a PAT of LKR 24 Mn on a total asset base of LKR 7,746 Mn.

AMF-group reported a PAT of LKR 443 Mn on a total asset base of LKR 25,202 Mn during FY2018 as compared to a PAT of LKR 419 Mn on a total asset base of LKR 17,518 Mn in FY2017. For 9MFY2019, AMF-group reported a PAT of LKR 337 Mn on a total asset base of LKR 24,895 Mn.

## ANALYST CONTACTS


**Mr. Vidura Welathanthri**
+94 11 4339907
vidura@icralanka.com

**Mr. A.M Karthik**
+91 44 45964308
a.karthik@icraindia.com


## RELATIONSHIP CONTACT


**Mr. W. Don Barnabas**
+94 11 4339907
wdbarnabas@icralanka.com



*Subsidiary of*

**ICRA Limited**

*A Group Company of Moody's Investors Service*

CORPORATE OFFICE
Level 10, East Tower, World Trade Center, Colombo 01, Sri Lanka
Tel: +94 11 4339907; Fax: +94 11 2333307
Email: info@icralanka.com; Website: www.icralanka.com




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