ICRA Lanka revises the outlook to Negative for Commercial Credit and Finance PLC

July19, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	Issuer rating of [SL]BBB reaffirmed; Outlook revised to Negative from Stable
Listed Unsecured Subordinated Redeemable Debentures Programme	500	Issue rating of [SL]BBB-with Stable outlook withdrawn
Listed Guaranteed Subordinated Redeemable Debentures Programme	1,000	Issue rating of [SL]AA- (SO) with Stable outlook reaffirmed
Listed Guaranteed Subordinated Redeemable Debentures Programme	2,000	Issue rating of [SL]A+ (SO) with Stable outlook reaffirmed

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Commercial Credit and Finance PLC (CCFL or the Company) at [SL]BBB (Pronounced SL triple B) while revising the outlook to negative from stable. ICRA Lanka has withdrawn the issue rating of [SL]BBB- (pronounced SL triple B minus) for the LKR 500 Mn listed unsecured subordinated redeemable debentures programme, at the request of the company, as the same has been fully redeemed.

ICRA Lanka has reaffirmed the issue rating of [SL]AA-(SO)[1] (pronounced SL Double A Minus Structured Obligation) with stable outlook for the LKR 1,000 Million guaranteed subordinated redeemable debenture programme of the company, which is currently listed on the Colombo Stock Exchange. This rating is based on the strength of the unconditional and irrevocable guarantee from Hatton National Bank PLC (HNB) for the principal amount of LKR 1,000 Mn and the two quarterly interest instalments of LKR 52.5 Mn maintained as a security deposit with the Trustee. The guarantor undertakes the obligation to pay, on demand from the Trustee, LKR 1,000 Mn, the principal amount of the subordinated redeemable debentures. ICRA Lanka also factors in the undertaking from the Trustee to utilize the security deposit to pay the interest amount due to the investors and declare the entire guaranteed amount as payable, in the event the issuer does not meet the scheduled interest payment on any due date or in the event the issuer does not redeem the debenture in full on any redemption date and redeem the instrument in full. The rating also assumes that the guarantee will be duly invoked by the Trustee, as per the terms of the underlying Trust deed, Trustee's undertaking and guarantee agreements, in case there is a default in payment by CCFL.

ICRA Lanka has also reaffirmed the issue rating of [SL]A+(SO)[1] (pronounced SL A plus Structured Obligation) rating with stable outlook for the LKR 2,000 Mn guaranteed subordinated redeemable debentures programme, which is currently listed on the Colombo Stock Exchange. This rating is based on the strength of the unconditional and irrevocable guarantees from Sampath Bank PLC (Sampath) and HNB

[1] The letters SO in parenthesis suffixed to a rating symbol stand for Structured Obligation. A SO rating is specific to the rated issue, its terms, and its structure. The SO ratings do not represent ICRA Lanka's opinion on the general credit quality of the issuer(s) concerned

covering the principal and two interest instalments (semi-annual) of the proposed issue. Each guarantor undertakes the obligation to pay, on demand from the Trustee, LKR 1,000 Mn, being 50% of the total principal sum of LKR 2,000 Mn and, one half-yearly interest instalment of the Subordinated Redeemable Debentures. The rating also assume that the guarantees will be duly invoked by the Trustee, as per the terms of the underlying Trust deed and guarantee agreements, in case there is a default in payment by CCFL.

Rationale

The revision in the outlook factors in the weakening of CCFL's asset quality in FY2018; CCFL's gross NPA ratio increased to 7.0% as of Mar-18 vis a vis 4.4% as of Mar-17 largely because of macro-economic challenges and issues of CCFL in collections and recoveries. The rating however continues to factor in CCFL's established business presence in Sri Lanka and the experienced senior management team, its adequate profitability indicators, and comfortable liquidity position. ICRA Lanka takes note of the new capital adequacy requirement, which came into effect from Jul-18; the company would need capital infusion over the next 3-years, to absorb the impact of IFRS-9 transition and achieve the envisaged portfolio growth of 15-20% per annum, without adversely impacting its capital profile.

ICRA Lanka further takes cognizance of the company's high dependence on fixed deposits and exposure to customer segments with modest credit profile that is highly vulnerable to economic cycles. The rating also factors in the increased competition and stricter LTV rules, which may hinder CCFL's ability to grow its leasing portfolio as envisaged. Going forward, the company is expected to grow with focus on leasing and other asset backed lending; Microfinance (MF) and other unsecured loan share in the overall portfolio is expected to reduce from the current levels (32%) to about 20% over the next 1-2 years. Increased focus on asset backed lending is expected to lend some support to the asset quality profile going forward.

Outlook: Negative

The negative outlook reflects the deterioration in CCFL's asset quality indicators. The outlook may be revised to 'Stable' in case of steady improvement in CCFL's asset quality while maintaining a comfortable capital and earnings profile. The rating may be downgraded in case of a further moderation in asset quality or financial risk profile of the company.

Key rating drivers

Credit strengths

Established franchise and experienced senior management team: CCFL has 121 branches across the island and plans to open about 10 new branches during FY2019. CCFL is one of the large non-banking financial institution in Sri Lanka with an asset base of LKR 84 Bn as of Mar-18. The promoter/CEO and the senior management team are experienced professionals in financing business.

Adequate profitability; though declining over the period- CCFL's RoA (PAT as a percentage of average total assets) stood adequate at 2.8% as of Mar-18 (3.8% as of Mar-17). The profitability was largely affected by increased cost of funds during FY2018. The weighted average lending yield was at about 28-29% for FY2018 and in FY2017. ICRA Lanka expects the lending yields to moderate going forward because of the company's steady shift into asset backed lending. CCFL's credit cost stood high at 3.4% (3.5% as of Mar-17) in FY2018 with the increased provisioning for slippages in unsecured lending; term loans, SME Loans and microfinance. Going forward, maintaining healthy level of profitability would be crucial for CCFL to fund the portfolio growth given the stricter capital adequacy requirements coming into effect from Jul-18.

Comfortable capital structure; however, would require fresh capital infusion over the next 3 years- CCFL's gearing has decreased to 5.6 times as of Mar-18 vis a vis 7.0 times as of Mar-17 (8.1 times in Mar-16) because of the degrowth in the portfolio during FY2018. However, going forward, with the envisaged growth in portfolio, gearing is likely to increase to about 7 times. The core and total capital adequacy ratios (CAR) of the company was comfortable at 14.5% and 14.8% respectively as of Mar-18. However, based on the revised CBSL direction for capital adequacy computation, CCFL's adjusted core and total capital adequacy ratios is estimated to be lower at 11.0% and 13.5% respectively as of Mar-18. ICRA Lanka estimates that the company may need to raise additional equity capital over the next 3 years, to absorb the impact of the increased impairment requirement under IFRS9 on retained earnings and to grow at 15-20% per annum during this period.

Credit challenges

Weak asset quality indicators- CCFL's gross NPA ratio increased to 7.0% as of Mar-18 vis a vis 4.4% as of Mar-17 (4.2% as of Mar-16) because of the weak economic conditions, adverse weather conditions and shortcomings in CCFL's collection and recovery initiatives. The gross NPA ratio of non-asset backed lending segment, namely factoring, term loans (including unsecured working capital lending) and microfinance increased to 22.8%, 13.7% and 7.0% respectively as of Mar-18 from 0.0%, 2.4% and 4.3% as of Mar-17. While the leasing portfolio's gross NPA ratio increased to 8.1% from 6.8% during the same period because of increased slippages witnessed, largely from lorries, 2-wheelers and cars, ICRA Lanka takes note of the steady shift towards asset backed lending by CCFL over the recent past; 68% of the portfolio is backed by assets as of Mar-18 (62% as of Mar-17). Further, CCFL has strengthened the collection and recovery processes during FY2018 and has revised the loans approval criteria to curtail incremental slippages. The company has written off about LKR 2.0 Bn in FY2018 (LKR 2.4 Bn in FY2017) largely from SME loan segments (LKR 731 Mn), term loans (LKR 659 Mn) and microfinance (LKR 531 Mn). CCFL has estimated the impact of IFRS9 on impairment charges at about LKR 2 Bn and expects to adjust the same against the opening retained earnings in Mar-19. ICRA Lanka notes that the total portfolio's delinquencies in 90+dpd stood high at about 15% as of Mar-18 (9% as of Mar-17). Therefore, the company's ability to control delinquencies in the softer buckets while bringing down the NPAs would be a key monitorable going forward.

Vulnerable customer base; operating environment characterized by high competition and susceptibility to unfavorable regulatory changes- CCFL's customer base mainly comprises of individuals with modest credit profile and businesses in the lower end SMEs who are susceptible to volatile economic environments. ICRA Lanka notes that this has increased the overall risk profile of the company which is evident from CCFL's above industry gross NPA ratio. In addition, the operating environment is quite competitive with established NBFIs and banks competing for market share. Further, the leasing business is susceptible to adverse regulatory changes as observed in the recent past. On the back of these challenges, it would be challenging for CCFL to grow its leasing portfolio as envisaged while maintaining asset quality.

Limited funding diversity; however, liquidity profile remains comfortable- The company is largely dependent on deposits, which accounted for about 83% of the total funding base as of Mar-18 (79% as of Mar-17) while debt instruments and bank borrowings accounted for the balance. The company's ALM mismatch (in <1-year bucket as a proportion of total assets) improved to -0.3% as of Mar-18 from -6.8% as of Mar-17, largely because of the moderation in leverage. CCFL's deposit renewal rate at 70% also provided comfort in terms of liquidity over the last few years. Going forward, it would be critical for the company to diversify its funding profile and secure longer tenure funding to offset liquidity related risks as it increases focus on longer tenure secured loans.

Analytical approach: 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:

CCFL, a registered finance company, offers leasing, hire purchase, business credit facilities, microfinance, factoring, term loans and other personal loans apart from accepting deposits (fixed and savings). The company was established in 1982 as a specialized leasing company in Kandy. In October 2009, BG Investments (Pvt) Ltd. acquired the controlling stake of the company. Since the change of ownership, the company has rapidly expanded its service locations to about 121 from about 22 in FY2012. The company has an employee base of about 3,400 and caters to about 1,000,000 customers. CCFL's shares were listed in the Dirisavi Board (secondary board) of the CSE in June 2011. The company witnessed investments from the impact investor, Creation Investment Sri Lanka LLC in March 2014 and regional NBFI, Group Lease Holdings Pte Ltd in December 2016. As of March 2018, BG Investment (Pvt) Ltd held 50.04% of the shares, while Group Lease Holdings Pte Ltd. held 29.99%, Creation Investments Sri Lanka LLC owns about 8.09%. During FY2015, the company acquired majority stake in Trade Finance and Investments PLC, which presently is a 99.7% owned subsidiary.

During the year ended March 31, 2018, CCFL reported a net profit of LKR 2,351 Mn on a total asset base of LKR 83,793 Mn as compared to net profit of LKR 2,903 Mn on a total asset base of LKR 82,110 Mn in the previous fiscal year. The consolidated net profit for the year ended March 31, 2018 stood at LKR 2,542 Mn on a total asset base of LKR 90,119 Mn. The same was LKR 3,117 Mn on a total asset base of LKR 84,968 Mn in the previous fiscal year.

Guarantor Profiles:

Hatton National Bank PLC

Hatton National Bank PLC (HNB) is one of the larger private sector commercial banks in the country with total assets amounting to LKR 991 Bn as at March 31, 2018. It accounted for 9.3% of sector assets, 12.2% of sector loans and advances and 9.3% of sector deposits as of March 31, 2018. The bank was incorporated in the present form in the year 1970. Stassen's group with 17.8%, Sri Lanka Insurance Corporation Ltd with 12.5% and Employee Provident Fund with a 9.8% are the major shareholders of the bank.

The bank recorded a total income of LKR 28,123 Mn for the 3MCY2018 and LKR 106,295 Mn for CY2017 (LKR 84,260 Mn for CY2016). The net profits of the bank amounted to LKR 4,473 Mn during 3MCY2018 and LKR 16,467 Mn for the CY2017 (LKR 14,143 Mn for CY2016), which resulted in ROAA (PAT as a proportion of average assets) of 1.84% and 1.82% (1.79% in CY2016) for the respective periods. The bank had a gross NPA ratios of 2.72% and 2.28% as at 3MCY2018 and CY2017 (1.80% in CY2016) and net NPA ratios of 1.21% and 0.77% respectively for the said periods (0.46% in CY2016). The bank had a net worth of LKR 109,616 Mn as on March 31, 2018 with tier 1 capital adequacy ratio of 12.78% and total capital adequacy ratio of 15.77%.

Sampath Bank PLC

Sampath Bank PLC is one of the larger private sector commercial banks in the country with total assets of LKR 846 Bn as at March 31, 2018. Sampath accounted for 7.9% of the banking industry assets, 9.1% of the sector loans and advances and 8.3% of sector deposits as of March 31, 2018. The bank commenced operations as a licensed commercial bank in 1987 and was noted for introducing technology to the banking sector. Major institutional shareholders include Vallibal One PLC with a 14.95% and Employee Provident Fund with a 9.97% stake. The Sampath group companies includes Sampath Centre Ltd (97.14%), SC Securities (Pvt) Ltd (100%), Siyapatha Finance PLC (100%) and Sampath Information Technology Ltd (100%).

The bank recorded a total income of LKR 26,416 Mn for the 3MCY2018 and LKR 92,590 Mn for CY2017 (LKR 66,120 Mn for CY2016). The net profits of the bank amounted to LKR 3,310 Mn during 3MCY2018 and LKR 12,104 Mn for CY2017 (LKR 9,125 Mn for CY2016), which resulted in ROAA (PAT as a proportion of average assets) of 1.61% and 1.67% (1.54% in CY2016) for the respective periods. The bank had gross NPA ratios of 1.95% and 1.02% as at 3MCY2017 and CY2016 (1.61% in CY2016) and net NPA ratios of 1.02% and 0.75% respectively for the said periods (0.62% in CY2016). The bank had a net worth of LKR 65,381 Mn as on March 31, 2018 with tier 1 capital adequacy ratio of 9.48% and total capital adequacy ratio of 14.42%.

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