ICRA Lanka reaffirms the [SL]A- rating of the proposed subordinated debentures program of LOLC Finance PLC

July 13, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Proposed subordinated unsecured redeemable debentures	3,500[1] (Reduced from 4,500[2])	[SL]A- (Stable); Reaffirmed
Issuer rating	N/A	[SL]A (Stable); Outstanding
Subordinated unsecured redeemable debentures	5,000	[SL]A- (Stable); Outstanding

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issue rating of [SL]A- (Pronounced SL A minus) with stable outlook assigned to the proposed LKR 3,500 Mn[1] (reduced from LKR 4,500 Mn[2]) subordinated unsecured redeemable debentures of LOLC Finance PLC (LOFC or the Company) to be listed on the Colombo Stock Exchange.

ICRA Lanka has an issuer rating of [SL]A (Pronounced SL A) with a stable outlook for the Company and an issue rating of [SL]A- (Pronounced SL A minus) with stable outlook for the LKR 5,000 Mn subordinated unsecured redeemable debentures of LOFC currently listed on the Colombo Stock Exchange.

Rationale

Lanka Orix Leasing Company PLC ("LOLC"/ "HoldCo") has 93.3% effective holding of LOFC. The ratings reflect the significant operational and financial linkages with LOLC and other peer subsidiaries and associates, especially entities in the financial services business. The contribution of financial services entities and other investments in financial services entities was about 85% of the consolidated PBT in FY2018 and accounted for 97% total group assets as on March 31, 2018.

At group level, the ratings factor in LOLC group's long track record, and leadership position in the Sri Lankan retail finance market, its experienced management team, commensurate risk management systems, its comfortable asset quality and adequate profitability indicators. ICRA Lanka takes note of the increase in group gearing and increase in the share of microfinance loans in the overall group lending portfolio post acquisition of PRASAC, thereby increasing the overall portfolio vulnerability considering the modest credit profile of the target borrowers. Also, while ICRA Lanka takes cognisance of the diversification to newer geographies (Cambodia, Myanmar and Pakistan) over the recent past, ability to manage country specific risks across business and regulatory cycles would be crucial from a rating perspective. ICRA Lanka would continue to monitor the performances of the non-financial services entities and their contribution to the overall group going forward.

[1] LKR 2,500 Mn with the option to issue up to a maximum of LKR 3,500 Mn

[2] LKR 3,500 Mn with the option to issue up to a maximum of LKR 4,500 Mn

The ratings continue to factor in LOFC's robust franchise, good competitive position and its experienced management team. However, the company's gearing is relatively high and asset quality is moderate; it would therefore be crucial for it to undertake recoveries and control incremental slippages to keep NPAs within reasonable levels. ICRA Lanka takes note of the moderation in LOFC's earnings profile with RoA reducing to 1.3% for FY2018 from 1.4% in FY2017 and 1.6% in FY2016. The moderation in FY2018 was partly because of the increased short-term liquid investments for LOLC Micro Credit Limited (LOMC) acquisition.

In January 2018, LOFC acquired LOMC by purchasing LOLC's 80% stake and Natherlands Development Finance Company's ("FMO") 20% stake for a consideration of LKR 12.2 Bn. The purchase consideration was settled using its internal resources. Between, January 29, 2018 to March 29, 2018, LOMC was a subsidiary of LOFC. On March 29, 2018, LOFC merged with LOMC.

ICRA Lanka does not expect any significant operational changes post-merger, as LOFC and LOMC have been sharing the branch network. However, operational level synergies and leverage are expected to improve post the merger. The customer profile and target asset classes of LOMC are relatively moderate as compared with LOFC, which is likely to expose the company to higher portfolio vulnerability during adverse business and economic cycle. However, the profitability of the merged entity is expected to improve, as LOMC reported better profitability indicators on account of its higher business yields

LOFC raised LKR 5.9 Bn via a rights issue in Mar-18; LOLC invested part of the proceeds received from sale of LOMC in the right issue. LOFC reported a tier I core capital ratio of 10.15% and capital adequacy ratio of 11.10% as on March 31, 2018; the total capital base of LOFC was LKR 18.4 Bn in Mar-18 (Tier I: LKR 16.9 Bn and Tier II: LKR 1.6 Bn). The proposed LKR 3.5 Bn subordinated debenture will further augment its regulatory capital adequacy position. ICRA Lanka expects the above to adequately support the overall capitalisation profile of the merged entity. Furthermore, ICRA Lanka expects timely support from LOLC group to LOFC in complying with the revised regulatory capital adequacy requirements, as prescribed by CBSL in June 2018.

Outlook: Stable

ICRA expects continuous operational, management and financial support from the LOLC group. The outlook maybe revised to "Positive" in case of steady improvement in the group' business and financial risk profile. The outlook maybe revised to "Negative" in case of a significant weakening in the capital adequacy, asset quality and significant deterioration in earnings of LOFC or, in case of weakening in the group's performance.

Key rating drivers

Credit strengths

Long track record and established retail franchise of the group: At the group level, the ratings factor in LOLC Group's long track record of more than 30 years, and leadership position in the Sri Lankan retail finance business. At group level, its financial subsidiaries have a branch network of 293 covering all 25 districts in Sri Lanka and has an employee strength of close to 5,300. LOFC has more than 10 years track record of successful operations as one of the largest NBFIs in the country and accounted for 26% of the total assets of the LOLC group in March 2018. LOFC operates with 135 branches in the country.

Experienced management team and good risk management systems: LOFC's board comprises of 7 directors including 3 non-executive directors. The LOLC group has an experienced senior management team, with knowledge in retail lending and banking, for managing the operations of its group entities including LOFC. The group has centralised key business functions like IT & MIS, human resource, finance & accounts and risk management. The centralised model gives competitive advantage to LOLC group entities by optimising the overall operating costs. The group has a prudent loan origination policy and effective loan monitoring process, which provides them with early warning signals and helps them in adjusting the loan policies to be in line with the evolving credit trends. LOFC uses an IT system developed by a group company- Lanka ORIX Information Services Limited (LOITS). While LOFC leverages and adheres to group level internal controls and risk management policies, it has also implemented company specific measures to address the core business requirements. LOFC has a prudent provisioning policy which is stringent than the regulatory requirement.

Comfortable group asset quality: LOLC group maintained a comfortable consolidated gross NPA of 2.0% in December 2017 as compared with the systematic average of 5.4% reported during the same period. LOLC's subsidiaries, Commercial Leasing and Finance PLC ("CLC") and BRAC Lanka PLC ("BRAC") maintained gross NPAs of less than 3.0% in March 2018, while LOFC' asset quality was relatively moderate with gross NPA ratio of 3.9%. LOMC's low reported NPAs and write offs supported LOFC's asset quality post-merger. LOFC's reported NPAs stood at 5.9% in December 2017, therefore, going forward, ability to maintain comfortable asset quality would be a key monitorable.

Diverse funding profile of the group: LOLC group has a fairly diverse funding profile, with funding from various sources including, foreign multilateral funding agencies, local banks and public deposits. As of March 2018, 53% of the group's funds were sourced through short and long-term bank facilities and 47% was through fixed deposits.

Adequate earnings profile: In the FY2018, LOLC's consolidated RoA moderated to an extent on account of higher credit cost, largely on account of LOFC and, the increase in the systemic rates; the overall group profitability was however adequate at about 2.6%. Consolidated RoA which stood at about 3.0% in FY2016, improved to 4.1% in FY2017 on account of the one-time extraordinary gains.

Credit challenges

Increase in LOLC group's leverage: ICRA Lanka notes that the group level gearing[3] increased to 5.3 times as on March 31, 2017 from 4.6 times as on March 31, 2016; it stood at 5.9 times as on March 31, 2018. The increase in FY2017 was mainly because of the leveraged acquisition of the controlling stake in PRASAC Micro Finance Institution Ltd (PRASAC) in Cambodia and the consolidation of the same into the group. The standalone gearing of PRASAC stood at 6.5 times as on June 30, 2017. In addition, the sizeable long-term foreign currency funding secured by the group's financial services entities (namely LOFC, CLC, LOMC and BRAC) during the period, which were invested in deposits and government securities for hedging against exchange rate movements and the local currency borrowings secured against these deposits resulted in higher balance-sheet liabilities. The gearing adjusted for the above stood at 5.2 times as on March 31, 2018 (5.8 times as on March 31, 2017). LOFC' leverage is also quite high at 11.1 times in Mar-

[3] Gearing adjusted for revaluation reserves

2018, however ICRA Lanka expects timely capital support from the group for meeting the enhanced capital requirements for the next 3 years.

LOFC-standalone (excluding LOMC) asset quality and earnings remain moderate: Pre-merger LOFC's asset quality indicators deteriorated as gross NPA increased from 4.2% reported as on March 31, 2016 to 4.4% as on March 31, 2017 and further deteriorated to 6.0% as on December 31, 2017. Post-merger LOFC's asset quality improved due to write offs made on the factoring portfolio and LOMC's lower NPAs. For the FY2018, LOFC has written off LKR 4.4 Bn, out of which LKR 2.5 Bn pertained to the factoring portfolio. LOFC's standalone profitability (PBT/Average Total Assets) was moderate at 1.6% for FY2018 (1.9% in FY2017). Increased provisioning cost for factoring was the key contributor. While ICRA Lanka notes that the profitability would improve for the merged entity going forward, ability to keep its asset quality under control would be crucial.

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 LOLC:

Setup in 1980, Lanka Orix Leasing Company PLC (LOLC) has evolved itself from a financial services provider to a holding company which has interests in trading, plantation, leisure and energy. The ORIX Corporation of Japan which had 30% of LOLC since its inception, has presently divested the same. The group has diversified geographically into Cambodia, Myanmar and Pakistan. As of December 31, 2017, financial services contributed to about 85% of PBT of the group and 97% of total assets of the group.

During the FY2017, LOLC group reported net profit of LKR 21 Bn on a total Asset base of LKR 641 Bn compared to net profit of LKR 9 Bn on a total Asset base of 380 Bn in the previous fiscal. The Group reported a net profit of LKR 19 Bn on a total asset base of LKR 822 Bn in FY2018.

About LOFC:

LOLC Finance PLC (LOFC), (set up in 2001) established initially as a wholly owned subsidiary of LOLC (Lanka Orix Leasing Company PLC), has a strong Retail Franchise among Licensed Finance Companies (LFCs) in Sri Lanka. In July 2011, as per the Central Bank of Sri Lanka (CBSL) directions, LOLC divested 10% of its stake in LOFC and listed the Company on the Colombo Stock Exchange (CSE). The LOLC Group is one of the largest business groups in the country, with the parent (LOLC) being among the first leasing company to be established in Sri Lanka. The LOLC group has interests in trading, plantation, leisure and energy. LOFC offers savings and deposits in local and foreign currency, extends loans mainly for auto finance, micro finance and Islamic finance.

During the year ended March 31, 2017, LOFC reported a net profit of LKR 1.6 Bn on a total asset base of LKR 123 Bn as compared to a net profit of LKR 1.4 Bn on a total asset base of LKR 110 Bn in the previous financial year. The company reported a net profit of LKR 2.2 Mn for the FY2018 on a total asset base of LKR 211 Bn.

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