

ICRA Lanka reaffirms the ratings of LOLC Finance PLC

March 18, 2019

LOLC Finance PLC

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]A (Stable); reaffirmed
Listed Subordinated Unsecured Redeemable Debenture Programme	5,000	[SL]A- (Stable); reaffirmed
Listed Subordinated Unsecured Redeemable Debenture Programme	3,500 (2,500 issued)	[SL]A- (Stable); reaffirmed

Rating action:

ICRA Lanka Limited, subsidiary of ICRA Limited, group company of Moody's Investors Service, has reaffirmed the issuer rating of [SL]A with stable outlook for LOLC Finance Company PLC ("LOFC" / "the Company") and issue ratings of [SL]A- with stable outlook for the LKR 5,000 Mn Listed Subordinated Unsecured Redeemable Debenture Programme and the LKR 3,500 Mn (LKR 2,500 Mn issued) Listed Subordinated Unsecured Redeemable Debenture Programme of the Company.

Rationale:

ICRA Lanka has taken the consolidated performance of the LOLC group, which has interest in various segments including financial services, insurance, manufacturing, trading, plantation, renewable energy and leisure for arriving at the ratings.

The ratings factor in the group's long track record and leadership position in the Sri Lankan retail finance market, its experienced management team, commensurate risk management systems and its adequate funding profile. ICRA Lanka also takes note of the weakening in the asset quality profile of its Sri Lanka based non-bank finance companies (NBFCs) and the deterioration in the overall earnings profile during 9MFY2019, as interest spreads narrowed and credit costs increased. ICRA Lanka takes cognisance of the increase in the overdues in the softer buckets (<180 days past due) for the Sri Lanka based NBFCs and, the increase in the share of unsecured credit in the overall group's lending business, which is expected to keep portfolio vulnerability at higher levels in the near to medium term. The ratings also take note of the increase in the group leverage, although the portfolio growth of the entities in the financial services was relatively muted; the group is expected to divest its holdings in one of the overseas subsidiaries in the near term and use part of the proceeds to reduce the group level leverage. ICRA Lanka would closely monitor the asset quality performance and the extent of deleveraging over the next 1-2 quarters.

While ICRA Lanka takes cognisance of the diversification to newer geographies (Cambodia, Myanmar, Indonesia and Pakistan) over the recent past by the LOLC group, ability to manage country specific risks across business and regulatory cycles would be crucial from a rating perspective. Further, ICRA Lanka would continue to monitor the performances of the nonfinancial services entities and their contribution to the overall group going forward.

Outlook: Stable

ICRA Lanka believes that the LOLC group, on the back of its established presence, business experience and funding raising ability would be able to grow its business and provide timely and adequate capital support to the various group entities. The outlook may be revised to 'Negative' in case of a further weakening in the profitability, capitalisation and asset quality indicators of the group. The outlook may be revised to 'Positive' in case of a significant improvement in overall financial profile of the group and if the portfolio profile and asset quality improves.

Key rating drivers:

Credit strengths

Experienced management team and good risk management systems: LOLC group is one of the largest financial conglomerates in Sri Lanka with a history spanning more than 30 years. The group's operations can be broadly identified under financial and non-financial sectors. Finance sector (including insurance) contributed closer to 99% of the asset base and 93% of the gross income in FY2018. The LOLC group has an experienced senior management team, with knowledge in retail lending and banking, for managing its group operations including the foreign entities. The group has centralised the key business functions like IT & MIS, human resources, finance & accounts and risk management. The centralised model gives competitive advantage to LOLC group entities by optimising the overall operating cost. 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 in line with the evolving credit trends.

Fairly diversified group level exposures; increase in the share of micro-credit however is monitorable: LOLC group has diversified its finance sector operations to Cambodia, Myanmar, Indonesia and Pakistan over the recent past. LOLC group reported a consolidated loan portfolio of LKR 619 Bn in Sep-18. In Sep-18, LOLC's largest lending portfolio exposure is in Cambodia with 61% followed by Sri Lanka 38%, Myanmar, Pakistan and Indonesia account for the rest. The group's overall overseas entities accounted for 53% of the total assets as of Mar-18 and contributed for 34% of the gross income. Going forward, the Company is expecting to further diversify its global presence to East Asia and Africa. LOLC group's local financial sector subsidiaries have diversified their operations into all districts and offer diverse loans products. However, in Cambodia, the group largely extends micro-credit. As of Sep-18, close to 78% of the loan portfolio is contributed by the micro-credit segment, the borrower profile of which is modest and vulnerable to adverse economic cycles. The LOLC group's non-financial sector consists of manufacturing trading, leisure, entertainment, plantation and renewable energy. The non-financial sector performance was impacted by the weak performance in the leisure sector segment, while the contribution from the other segments continued to remain very modest.

Adequate funding profile: LOLC group has a diverse funding profile, with funding from various sources including, foreign funding agencies, local banks and public deposits. As of Dec-18, 48% of the group's funds were sourced through short and long-term borrowings and 52% was through deposits. LOLC group's NBFC subsidiaries maintain a lower short-term (< 1 year) mismatch that are below the industry averages. Deposits accounted for 63% of the PRASAC's funding in Sep-18 while LOLC Cambodia and LOLC Myanmar are largely funded by borrowings from banks and other funding institutes with a 58% and 84% exposure in Sep-18.

Credit challenges

Weakened asset quality of Sri Lankan NBFCs: Consolidated gross NPA of the Sri Lankan NBFCs stood at 5.29% (4.62% in Dec-17) while foreign operations reported gross NPAs of 0.74% (0.54% in Dec-17) as in Sep-18. The performance of the Lankan operations was impacted by the subdued macroeconomic conditions which was further accentuated by adverse weather patterns and Government announcement of micro loan waivers in 12 districts. Build-up in the 90+days past due (dpd) for the Lankan based NBFCs of the group has been quite significant, indicating further stress; 90+dpd for the Lanka based NBFCs increased to 11.1% in Dec-18 from 7.2% in Dec-17. The group has slowed down the growth of the portfolio in Sri Lanka to consolidate the portfolio and concentrate on collections. The group has augmented its focus on recoveries, appointing a special taskforce to negotiate with the NPA customers and curtailing the unsecured loans. ICRA Lanka also notes the increase in the share of unsecured credit and microfinance in the overall group's NBFC exposure because of its foreign expansion, unsecured credit stood at 68% in Sep-18 as compared to 63% in Mar-18 (58% in Mar-17). High exposure to these segments increases the group portfolio vulnerability to any adverse regulatory or business development.

Deterioration in group earnings: Consolidated RoA declined to 1.56% for 9MFY2019 from 2.61% in FY2018 (2.0% in FY2017; adjusted for one-time gains). The moderation was largely because of the contraction in interest margins as cost of funds increased and the high credit cost in its Lankan NBFCs. LOLC's standalone earnings comprised mainly of fee income from shared services and interest income from lending to subsidiaries. Foreign subsidiaries contributed close to 34.4% of the group's income in FY2018 with Cambodian operations contributing 33.7% of the group income. LOLC's Manufacturing & Trading and Plantation & Renewable Energy segments from the nonfinancial sector reported moderate earnings performance during H1FY2019, while its leisure and entertainment sector continued to report losses as operations are yet to commence in some of its new investments.

Increase in the group leverage: LOLC group's consolidated gearing increased to 6.2 times in Dec-18 (6.7 times in Mar-18) from 6.1 times in Mar-17. LOFC, the largest Sri Lanka based NBFC of the group, reported a moderate capital adequacy ratio (based on the new regulation) of 11.94% in Dec-18 (11.03% in Sep-18) as compared to the regulatory requirement of 10.00% and would require regular capital infusion, over the next 2-3 years, to support growth and for maintaining a comfort capitalisation profile. Similarly, LDFFP would require capital support, notwithstanding its currently adequate capitalisation (CAR at 17.53% in Dec-18), if the portfolio grows at a higher pace (30% CAGR over FY2019-FY2022), as envisaged. CLC reported a healthy capital adequacy ratio (based on new regulation) of 18.35% in Dec-18 (17.76% in Sep-18). Considering CLC's current capital profile and projected growth (10-15% CAGR over FY2019-FY2022), it may not require any significant capital. The group expects close to USD 20 Mn capital investments in its overseas financial subsidiaries, the funding would be sourced through foreign entities without pressuring the local holding company. The group is expected to divest its holdings in one of the overseas subsidiaries in the near term and use part of the proceeds to reduce the group level leverage and also support capital requirement of some of the group entities. The extent of group level deleveraging would be crucial from a rating perspective.

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 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 was listed on the Colombo Stock Exchange (CSE). The LOLC Group is one of the largest business groups in the country, with the parent (LOLC) being the first leasing company to be established in Sri Lanka. The LOLC group has interests in financial services, insurance, manufacturing, trading, plantations, leisure and energy. LOFC offers savings and deposits in local and foreign currency, extends loans mainly for auto finance and Islamic finance.

During the year ended March 31, 2018, LOFC reported a net profit of LKR 2.2 Bn on a total asset base of LKR 211 Bn as compared to a net profit of LKR 1.6 Bn on a total asset base of LKR 123 Bn in the previous financial year. The company reported a net profit of LKR 2.5Bn for the 9MFY2019 on a total asset base of LKR 213 Bn.

Key financial indicators-LOFC

In LKR Mn	FY2017	FY2018	9MFY2019 (Unaudited)
Net Interest Income	7,030	9,832	14,714
Profit after Tax	1,587	2,191	2,481
Net worth (adjusted for revaluation reserves)	10,820	16,864	19,302
Loans and Advances	90,512	151,316	147,466
Total Assets	122,623	211,114	212,957
Return on Equity	15.7%	15.6%	18.1%
Return on Assets	1.4%	1.3%	1.6%
Gross NPA	4.4%	3.87%	7.30%
Net NPA	0.40%	1.12%	3.35%
Capital Adequacy Ratio	13.3%	11.10%	11.94%
Gearing (times, adjusted for revaluation reserves)	10.0	11.0	9.5

Rating history for last three years:

Instrum ent	Type	Current Rating (FY2019)			Chronology of Rating History for the past 3 years			
		Amount Rated (LKR Mn)	Amount Outstand ing (LKR Mn)	Date & Rating Feb 2019	Date & Rating in FY2017	Date & Rating in FY2017	Date & Rating in FY2016	
					Feb 2018	Jan 2017	Nov 2015	
Issuer rating	N/A	N/A		[SL]A (Stable)	[SL]A (Stable)	[SL]A (Stable)	[SL]A (Stable)	
Issue rating	Subordinated unsecured redeemable debenture	5,000	5,000	[SL]A- (Stable)	[SL]A- (Stable)	[SL]A- (Stable)	[SL]A- (Stable)	
Issue rating	Subordinated unsecured redeemable debenture	3,500	2,500	[SL]A- (Stable)	[SL]A- (Stable)	NA	NA	

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