ICRA Lanka reaffirms the issuer rating of MCB Bank Limited (Sri Lanka branch)

September 19, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]A+ (Stable); Reaffirmed

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of MCB Bank's Sri Lanka branch (MCBSL or the Bank) at [SL]A+ (Pronounced SL A plus). The outlook on the rating is stable.

Rationale

The rating factors in the financial, managerial and operational support provided by MCB Bank Limited, Pakistan (MCB; rated Caa1/ NP by Moody's) to its Sri Lankan branch operation. The rating takes note of the comfortable capitalization (total capital including CCB at 30.1% as in June 2018) and healthy profitability indicators (RoA1.94% in CY2017 vis-à-vis 1.91% in CY2016). The rating takes note of MCBSL's weakened asset quality with gross NPA [1]of 5.24% as in June 2018 vis a vis 4.81% as in December 2017 (2.40% as in December 2016). The rating however takes cognizance of MCBSL's modest size and franchise, geographically concentrated presence, its concentrated exposures and a moderate deposit profile. MCBSL's portfolio is quite concentrated with top 10 exposures accounting for about 45% as in June 2018

Outlook: Stable

ICRA Lanka believes that MCBSL will continue to benefit from the support from MCB. The outlook may be revised to 'Positive' in case of a sharp improvement in the resource and earnings profile as portfolio expands, while keeping the asset quality under control. The outlook may be revised to 'Negative' in case of deterioration in profitability indicators.

Key rating drivers

Credit strengths

Support from MCB Bank of Pakistan (rated Caa1 by Moody's & AAA by PACRA); MCB is among the large commercial banks in Pakistan with market share of about 8% in terms of the share of customer deposits, as in December 2017. MCBSL started its operations in 1994 with the acquisition of the Middle East Bank's local operations in Sri Lanka. MCB provides operations, management and financial support to MCBSL. From an operational and management aspect, MCB overlooks accounting, internal audit, risk and compliance of MCBSL. Financially, MCB is expected to provide liquidity and capital support, whenever required.

[1]Based on ICRA's NPA computation

Comfortable capitalisation profile; The bank's capital profile is comfortable with CET-I (including CCB) at 33.63% and overall CAR at 30.06% as on June 30, 2018 (regulatory requirement 12.50% by January 2019). The bank's core capital stood LKR 5.9 Bn, which complied with the regulatory minimum requirement of LKR 5.0 Bn to be reached by December 2020. The current capital profile along with an expected steady internal generation would support the envisaged portfolio growth of about 15-20% per annum for the next 3 years.

Healthy profitability; MCBSL's net interest margins remained healthy at 5.37% for CY2017 (5.24%, provisional, in CYQ12018) as it was able to favourably re-price its loan portfolio. The bank's margins were further supported by cheaper foreign currency deposits and borrowings; share of foreign currency deposits and borrowings increased to 41%% in December 2017 from 31% in December 2016 (39% in June 2018). Following CBSL's revised foreign borrowing directions (issued in December 2017), the bank's cost of funds could increase in the current fiscal. The bank's operating expenses/ATA increased from 2.74% in CY2016 to 2.95% in CY2017 (3.01%, provisional, in Q1CY2018) because of the branch level renovations and overall systems improvements undertaken. Its credit costs (loan impairment expenses/ ATA) increased in CY2017 to 0.53% as compared to 0.22% in CY2016 as a result of the weakened asset quality. The net profitability remained healthy at 1.94% for CY2017 (1.91% in CY 2016, 1.78%, provisional in H1CY2018) Going forward, MCBSL's ability to maintain a conservative cost structure as business expands, and keeping its credit costs under control would be crucial for incremental profitability

Credit challenges

Modest size with limited franchise; MCB operates with eight branches and reported an asset base of LKR 27.0 Bn in June 2018. The bank presently focuses on corporate, SME and retail customers; as on June 30, 2018 the corporate exposure accounted for about 80% of the total portfolio, while SME and retail exposures stood at 13% and 7% respectively. The bank has taken measures to reduce its corporate exposure to 50% in the medium term with the growth of retail and SME portfolios. The bank however is faced with the challenge of growing its retail portfolio because of its limited franchise.

Weakened asset quality because of few large slippages; MCBSL's asset quality indicators went over the systemic levels, with the gross NPAs [2]at 4.52% as in June 2018 vis-à-vis 3.96% in December 2017 (1.34% in December 2016). Increase in NPA levels during CY2017 was mainly on account of two large facilities slipping into non-performing category during the period. With the new slippages, MCBSL's provision coverage further moderated to 8.6% in June 2018 as compared to 9.4% in December 2017 (32.5% as in December 2016); as a result, the solvency increased to 14.2% (Net NPA/Net worth) in March 2018 vis-à-vis 8.1% in March 2017. The bank's ability to undertake recoveries, control incremental slippages and achieve good quality growth in the SME and retail segments, would be crucial from a rating point of view.

Concentrated loan portfolio; MCBSL's portfolio is quite concentrated with top 10 group exposures accounting for about 45% as in June 2018. Close to 80% of the portfolio is concentrated in corporate customers. Over the medium-long term, the bank is expected to increase its share of retail and SME exposures.

Moderate deposit profile, liquidity however is comfortable; Deposits constituted about 84% (84% in December 2017) of the total debt as on June 30, 2018; fixed deposits accounted for about 44% (47% in

[2]Based on CBSL's NPA calculation

December 2017) of the total debt. ICRA Lanka continues to factor in the concentrated deposit profile, with top 10 deposits accounting for about 29% of the total deposits as in June 2018. Liquidity risk stemming from the short-term deposit base is partly mitigated by the relatively short tenured loan profile of the bank; as on June 30, 2018 MCBSL reported a positive cumulative ALM mismatch of 9% in less than one year maturity bucket (positive mismatch of 8% in June 2018)., ICRA Lanka takes cognisance of the existing contingency funding arrangements with the parent and ICRA Lanka expects MCB to extend timely liquidity support to MCBSL, when required.

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 Banks**

About the company:

MCB Bank Sri Lanka ("MCBSL") was established in Sri Lanka with the acquisition of Middle East Bank Limited's Colombo operations in 1994. Currently, MCBSL operates with 8 branches at Kollupity, Maradana, Pettah, Wellawatte, Kandy, Galle and Batticoloa with its Head Office branch in Colombo.

The bank currently focuses on corporate, SME and retail segments and is expected to steadily increase the share of SME and retail lending in the medium term. MCBSL also operates an Islamic Banking division.

During the year ended December 31, 2017, MCBSL reported a PAT of LKR 504 Mn on a total asset base of LKR 28.8 Bn as compared to a PAT of LKR 439 Mn on a total asset base of LKR 23.1 Bn in the previous financial year. For H1CY2018, MCBSL reported a PAT of LKR 245 Mn on a total asset base LKR 26.2 Bn.

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