Sanasa Development Bank PLC: Ratings reaffirmed

August 30, 2019

Summary of rated instruments

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]BBB- (Stable); reaffirmed
Guaranteed Redeemable Debentures, type B, guaranteed by Sampath Bank PLC	403	[SL]A+(SO) (Stable); reaffirmed
Guaranteed Redeemable Debentures, type D, guaranteed by Seylan Bank PLC	562	[SL]A-(SO) (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 Sanasa Development Bank (SDB or the Bank) at [SL]BBB- (Pronounced SL triple B minus) with Stable outlook.

ICRA Lanka has also reaffirmed the [SL]A+(SO) (pronounced SL A Plus Structured Obligation) rating with Stable outlook for the type B redeemable guaranteed debentures of SDB amounting to LKR 403 Mn, which are guaranteed by Sampath Bank PLC (Sampath). ICRA Lanka has also reaffirmed the [SL]A-(SO) (pronounced SL A minus Structured Obligation) rating with Stable outlook for the type D redeemable guaranteed debentures of SDB amounting to LKR 562 Mn, which are guaranteed by Seylan Bank PLC (Seylan). 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 concerned.

The ratings for the redeemable guaranteed debentures are based on the strength of the unconditional and irrevocable guarantees from Sampath Bank PLC (Sampath) for type B redeemable guaranteed debentures and from Seylan Bank PLC (Seylan) for the type D redeemable guaranteed debentures covering the principal and two interest instalments (Semi Annual). As the guarantor, Sampath Bank undertakes the obligation to pay on demand from the trustee, the total principal amounting to LKR 403 Mn, and two semi-annual interest instalments of type B redeemable guaranteed debentures. Seylan Bank also undertakes the obligation to pay on demand from the Trustee, the total principal amounting to LKR 562 Mn, and two semi-annual interest instalments of type D redeemable guaranteed debentures. The ratings also assume that the guarantees will be duly invoked by the Trustee, as per the terms of the underlying Trust Deed and guarantee agreements.

Rationale

The reaffirmation of the issuer rating factors in SDB's established franchise and adequate capital structure. ICRA Lanka notes the diversification of SDB's shareholder base with the presence of international investors; SBI FMO Emerging Asia Financial Sector Fund PTE. LTD (SBI-FMO), International Finance Corporation (IFC) and Financierings-Maatschappij voor Ontwikkelingslanden (FMO) holding 8.96%, 8.86% and 3.98% respectively as of Jun-19. The Bank's capital structure is currently adequate with minimum core capital at about LKR 7.6 Bn as of Jun-19, above the existing minimum threshold of LKR 5.0 Bn. The Tier I and total capital adequacy ratios (CAR) stood adequate at 10.24% and 14.21% as of Jun-19 compared to the applicable regulatory threshold of 8.50% and 12.50% respectively effective since January 01, 2019. However, the Bank's total CAR was below the regulatory threshold during Feb-May 2019, until the tier II complied debt of LKR 1.7 Bn was raised in early June 2019. ICRA Lanka estimates that the Bank would require large equity capital of about LKR 3.0-4.7 Bn (79-122% of its market capitalisation) over the next 3-years (until CY2021), assuming 17-20% growth in risk weighted assets (RWAs) to report a minimum Tier I CAR of 10.5% (including a buffer of 2.0%) and total CAR of 13.5% (including a buffer of 1.0%). ICRA Lanka expects the required capital to be raised in the near term and would closely monitor the Bank's ability to secure capital on a timely basis to support the envisaged portfolio growth and meet the Basel III capital requirements.

The rating continues to take cognisance of the weakening profitability profile, moderate scale of operation, moderate resource profile and weak liquidity profile. The rating further takes note of the moderation in asset quality indicators and expected increase in risk profile of the portfolio with the increase in exposure to micro SME segment with larger ticket sizes and project-based lending to co-operative segment. While, the reported gross NPA ratios remained below the industry level, the NPA generation ratio[1] increased to 8.32% as of Mar-19 from 7.04% as of Dec-18 and 1.37% as of Dec-17. Going forward, SDB's ability to maintain improved asset quality indicators, given its target customer segment and plans to move into larger tickets would be a key monitorable.

Outlook: Stable

The Stable outlook reflects SDB's established franchise and adequate capital structure. The outlook may be revised to "Positive" in case of a steady improvement in the profitability indicators while maintaining comfortable capitalisation and asset quality profiles as portfolio expands. The outlook may be revised to "Negative", in case of deterioration of the Bank's capitalisation profile or a significant weakening in the profitability and asset quality profiles.

Key rating drivers

Credit strengths

Established franchise and strong promoter profile: ICRA Lanka takes into cognisance, the Bank's established position on the back of the SANASA movement, especially in the rural and semi urban segments due to the various credit plus activities. This link to SANASA provides a competitive edge for the Bank in the rural and semi urban regions in sourcing lending and deposit businesses. The Bank operates with 94 branches out of which about 55 are in the semi urban and rural areas. Further, the investment from the international investors (SBI-FMO, IFC and FMO) in CY2017 has diversified the Bank's shareholding base. SBI-FMO, IFC and FMO hold about 8.96%, 8.86% and 3.98% stake in the Bank, respectively, as of Jun-19. The assistance from the international investors has helped SDB to strengthen its systems and procedures over the period. Going forward, the Bank plans to leverage on technology to drive its business growth.

Adequate capital structure; however, would require sizable capital infusion to support growth: SDB's minimum core capital stood adequate at about LKR 7.6 Bn as of Jun-19, above the minimum regulatory requirement of LKR 5.0 for Licensed Specialised Banks (LSB) effective since January 2016. SDB's Tier I CAR was at 10.24% as of Jun-19 (11.00% as of Dec-18) vis a vis regulatory threshold of 8.50%. However, the Bank's total CAR stood marginally below the regulatory requirement of 12.50% during the period Feb-19 to May-19 (12.32% as of Mar-19). In November 2018, SDB received special permission from Central Bank of Sri Lanka (CBSL) to raise Tier II complied debt up to LKR 3.2 Bn and in June 2019, the Bank raised the first

[1] New NPAs/ opening closing net advances

tranche of LKR 1.7 Bn, which increased the total CAR to 14.21% as of Jun-19. The Bank plans to raise the other tranche of LKR 1.5 Bn in the near term. ICRA Lanka takes note that the Bank's current credit rating does not permit it to raise Tier II complied subordinated debt from the Colombo Stock Exchange (CSE) and assumes that further Tier II requirements are supplemented from equity capital.

ICRA Lanka notes that the Bank's internal capital generation will not be adequate to support the envisaged portfolio growth (18-20%) over the next 3-years, while maintaining a comfortable buffer to the CAR thresholds, which might impact the dividend pay-out ratio. As per ICRA Lanka's estimates, the Bank would need to raise about LKR 3.0- 4.7 Bn in equity, assuming 17-20% RWA growth in CY2019-CY2021, while maintaining a buffer of 2% and 1% over the minimum regulatory Tier I and total CAR respectively. ICRA Lanka expects the Bank to raise equity capital in the near term to support the envisaged portfolio growth and meet the Basel III capital requirements. The Bank's ability to secure commensurate capital on a timely basis given its growth expectation would be a key rating sensitivity.

Credit challenges

Weakening profitability: ICRA Lanka takes note of the moderation of SDB's RoA to 0.20% in Q1CY2019 vis a vis 0.40% in CY2018 (0.68% in CY2017) largely on account of the sharp increase in credit cost[2] (1.16% in Q1CY2019 vis a vis 0.59% in CY2018 and 0.40% in CY2017), because of deterioration in the asset quality of the portfolio. The Bank's cost to income ratio was high at about 73% in Q1CY2019 (82% in CY2018). The high cost to income ratio was driven by high operating expenses (operating expenses/ATA) in the range of 4.3-4.6% since CY2017 largely because of the investment in systems and human capital over the period. In Q1CY2019, NIM improved to 5.68% from 5.24% in CY2018 supported by the upward repricing of the lending portfolio, which is largely on variable rates, while the borrowing costs remained stable around 10.3%. The Bank's core fee-based income has remained moderate at about 0.24% in Q1CY2019 (0.25% in CY2018). Going forward, SDB's ability to improve profitability indicators would be a key rating sensitivity.

Moderation in asset quality indicators; however, remains better than the industry: SDB's reported gross NPA ratio increased to 3.27% as of Mar-19 vis a vis 2.57% as of Dec-18 (2.06% as of Dec-17); however, it remains better than the systemic level (4.22% as of Mar-19). The NPA generation ratio[3] increased to 8.32% as of Mar-19 from 7.04% as of Dec-18 and 1.37% as of Dec-17 indicating pressure on the asset quality. The increased NPAs during the period are largely because of the weak macro-economic conditions affecting SDB's vulnerable customer base who have modest credit profile. The retail segment's gross NPA ratio increased to 2.84% as of Mar-19 vis a vis 2.39% as of Dec-18 and 1.44% as of Dec-17 largely because of slippages witnessed in personal loans granted to lower-grade staff in both government and private sector. The SME segment reported a GNPA% of 4.90% as of Mar-1vis a vis 3.58% and 4.56% despite its portfolio growth of 18% (annualised) in Q1CY2019 and 64% in CY2018. Co-operative segment had the lowest gross NPA ratio of about 0.66%, as of Mar-19 (0.33% as of Dec-18) due to its cash backed lending products. ICRA Lanka notes that the portfolio's risk profile is increasing with the envisaged move towards larger ticket sized micro SME loans and project based co-operative loans, which demands commensurate credit origination and monitoring practices. The ability to keep asset quality under control, in view of the above, would be crucial going forward considering the stress emanating from the SME segment and the larger loan sizes.

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[2] Credit provision/ average total assets

[3] New NPAs/ closing net advances in the previous period

Moderate scale of operation: SDB is a relatively small player in the banking industry with an asset base of about LKR 95 Bn as of Mar-19, accounting for 0.8% of the industry. During CY2016-CY2018, the Bank's portfolio grew at a CAGR of 19% marginally higher than the banking industry average of 18% during the same period. In Q1CY2019, the Bank's portfolio reported a YoY growth of 14% to LKR 80 Bn, with exposure to asset backed lending at 30%. The share of retail lending declined to 64% as of Mar-19 from 66% as of Dec-18 (72% as of Dec-17), while the share of SME and co-operative segments each marginally increased to 29% and 7% as of Mar-19 from 66% and 28% as of Dec-18 (22% and 6% as of Dec-17) respectively. Going forward, the Bank expects to grow its portfolio at a rate of about 18-20% over the next 3-years to achieve a portfolio of around LKR 130 Bn by Dec-21. The envisaged portfolio mix is one third exposure to retail, SME and co-operatives each.

Moderate resource profile: SDB's funding profile stood at about LKR 85.4 Bn as of Mar-19 and is largely characterized by public deposits, which accounted for about 82% of the total borrowings (77% as of Dec-18). The Bank's savings deposits remained moderate at about 18% (as a proportion of total deposits) since Dec-17 compared to LSB average of 33%. The top 10 depositors accounted for 6% of the total deposits as of Mar-19 (10% as of Jun-18). The other borrowings include long term borrowings from banks and other institutions, refinancing borrowings from CBSL, debentures and securitised borrowings accounting 14%, 3% and 1% each respectively.

Weak liquidity profile: SDB's asset liability management (ALM) profile is characterized by sizeable mismatches in the <1-year bucket (-21% as of Mar-19 vis a vis -20% as of Dec-18) due to the short-term nature of the deposits (about 70% of the deposits mature in 1-year or less), while the assets have an average tenure of about 5-7 years. However, the Bank's deposit renewal rate of 75-80% coupled with the availability of contingent funding lines to the extent of LKR 1.4 Bn provide comfort on SDB's overall liquidity profile. While the Bank's liquidity coverage ratio stood comfortable at 163% as of Mar-19 (against regulatory threshold of 100%), liquid asset ratio moderated to 20.67% as of Mar-19 from 23.22% as of Dec-18 (21.34% as of Dec-17) as the management has decided to maintain the same close to the regulatory threshold of 20% so as to optimise its investment portfolio.

Analytical approach: For arriving at the ratings, ICRA Lanka has applied its rating methodologies as indicated below**.**

Links to applicable criteria: [ICRA Lanka's Credit Rating Methodology for Banks]

About the Bank:

Established in the year 1997, SANASA Development Bank PLC (SDB) is a Licensed Specialised Bank. SDB provides financial solutions to retail, SME and co-operative customers through its 94 branches spread across the country. In 2012, the Bank was listed on the Colombo Stock Exchange. Close to about 27% of the total shareholding is with SANASA affiliated entities as of March 2019, which includes, cooperative societies, trusts and other institutions. The other top shareholders include Dr. Thirugnanasambandar Senthilverl (12% holding), Ayenka Holdings (Pvt) Ltd. (12%), FMO (collectively 13%) and IFC (9%).

During the CY2018, SDB reported a profit after tax (PAT) of LKR 357 Mn on a total asset base of LKR 96,818 Mn as compared to a PAT of LKR 508 Mn on a total asset base of LKR 82,375 Mn in the previous calendar year. For 3MCY2019, SDB reported a PAT of LKR 48 Mn on a total asset base LKR 95,320 Mn.

Guarantor Profiles:

Sampath Bank PLC

Sampath Bank PLC (Sampath) is one of the larger private sector commercial banks in the country with total assets of LKR 911 Bn as of Mar-19. Sampath accounted for 7.8% of the banking industry assets, 8.6% of the sector loans and advances and 8.1% of sector deposits as of March 31, 2019. Sampath 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%).

Sampath recorded a total income of LKR 28,865 Mn for the 3MCY2019 and LKR 115,310 Mn for CY2018 (LKR 92,590 Mn for CY2017). The net profits of the Sampath amounted to LKR 2,163 Mn during 3MCY2019 and LKR 12,143 Mn for CY2018 (LKR 12,104 Mn for CY2017), which resulted in RoA (PAT as a proportion of average assets) of 0.95% and 1.42% (1.67% in CY2017) for the respective periods. Sampath had gross NPA ratios of 4.87% as of Mar-19 and 3.69% as of Dec-18 (1.64% as of Dec-17) and net NPA ratios of 3.42% and 2.39% (0.75% as of Dec-17) respectively for the said periods. Sampatjh had a net worth of LKR 84,634 Mn as of March 31, 2019 with tier 1 capital adequacy ratio of 11.72% and total capital adequacy ratio of 16.19%.

Seylan Bank PLC

Seylan Bank PLC (Seylan) is a commercial bank in Sri Lanka with total assets of LKR 475 Bn as of Mar-19. Seylan accounted for 4.0% of the banking industry assets, 4.5% of the sector loans and advances and 4.3% of sector deposits as of March 31, 2019. Seylan commenced operations as a licensed commercial bank in 1987. Major institutional shareholders include Lanka Orix Leasing Company PLC (effective holidng of 23%), Sri Lanka Insurance Corporation (15%) and Employee Provident Fund (about 10%).

Seylan recorded a total income of LKR 15,015 Mn for the 3MCY2019 and LKR 54,872 Mn for CY2018 (LKR 49,174 Mn for CY2017). The net profits of Seyaln amounted to LKR 903 Mn during 3MCY2019 and LKR 3,189 Mn for CY2018 (LKR 4,430 Mn for CY2017), which resulted in RoA (PAT as a proportion of average assets) of 0.77% and 0.73% (1.16% in CY2017) for the respective periods. Seylan had gross NPA ratios of 5.96% as of Mar-19 and 5.98% as of Dec-18 (4.42% as of Dec-17) and net NPA ratios of 4.57% and 4.40% (3.10% as of Dec-17) respectively for the said periods. Seylan had a net worth of LKR 37,329 Mn as of March 31, 2019 with tier 1 capital adequacy ratio of 9.71% and total capital adequacy ratio of 12.57%.

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