ICRA Lanka assigns [SL]B+ rating for Sarvodaya Development Finance Limited

October 10, 2018

Instrument*	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	[SL]B+(Stable)

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has assigned the issuer rating of [SL]B+ (Pronounced SL B plus) with a stable outlook to Sarvodaya Development Finance Limited (SDF or the company).

Rationale

The rating factors SDF's limited scale (portfolio at LKR 5.6 Bn), its subdued asset quality (gross NPA ratio at 6.8% in Jun-18), concentrated funding profile and, modest profitability indicators. The rating notes that the company would have to enhance its core capital to LKR 1.5 Bn by Jan-19, LKR 2.0 by Jan-20 and LKR 2.5 Bn by Jan-21 from about LKR 1.1 Bn in Jun-18 to meet the minimum core capital requirement for Licensed Finance Companies (LFCs). ICRA Lanka notes that, sizeable external capital infusion (in relation to the current net worth) would be required as internal generation is likely to remain modest. ICRA Lanka expects timely support from its parent, Sarvodaya Economic Enterprise Development Services (Guarantee) Limited (SEEDs) and its ultimate parent Lanaka Jathika Sarvodaya Shramadana Sangamaya (LJSSS). The rating also factors in SDF's professional and experienced Board of Directors, with knowledge and experience in banking and retail lending. Going forward, the company's ability to meet regulatory capital requirement, improvement in asset quality indicators and earnings profile would be crucial from a rating perspective.

Outlook: Stable

SDF's ability to raise capital to meet the regulatory requirement on a timely basis would be a key rating sensitivity. The outlook may be revised to "Positive" based on SDF's ability to grow its portfolio and improve its earnings profile and asset quality indicators while maintaining a healthy capital profile. The outlook may be revised to "Negative" in case of SDF failing to meet the regulatory capital requirement in a timely manner or in case of a significant deterioration in its financial risk profile.

Key rating drivers

Credit strengths:

Established franchise; experienced Board of Directors- SDF is a subsidiary of Sarvodaya Economic Enterprise Development Services (Guarantee) Limited (SEEDs), with the ultimate parent being Lanka Jathika Sarvodaya Shramadana Sangamaya (LJSSS), which is one of the large and established non-governmental organisation in Sri Lanka focusing on poverty alleviation in rural districts of the country. SDF has 30 branches and 21 customer service centres as in Jun-18. SDF's Board of Directors comprised of experienced professionals with experience in the banking/financial sector. ICRA Lanka notes that the company has taken initiatives to augment its internal controls and processes over the recent past.

Credit challenges

Sizeable external capital required to meet regulatory requirement and support medium term growth - SDF has a comfortable core capital adequacy ratio of 19.9% and gearing of 5.0 times as on June 30, 2018. However, according to the CBSL direction for LFCs, SDF's core capital is required to be increased up to 1.5 Bn by January 2019 and each year thereafter by LKR 500 Mn until it reaches LKR 2.5 Bn by 2021; SDF's core capital stood at about LKR 1.1 Bn in Jun-18. ICRA Lanka estimates that the company would require external capital support of about LKR 1.2-1.4 Bn over the period FY2019-FY2021 to meet the same (with adequate buffer) and support medium to long term growth. Therefore, SDF's ability to raise capital on a timely basis would be a key rating monitorable going forward.

Small scale of operations and modest competitive position: SDF is a relatively small player in the NBFI industry with a portfolio of about LKR 5.6 Bn as of June 2018. The company's portfolio consists of loans (about 81%), leasing and HP (about 13%) and legacy microfinance lending (about 6%) in Jun-18. SDF stopped microfinance lending from Dec-16 because of the high slippages witnessed and is currently maintaining the same as a collection portfolio. The loan segment largely consists of SME loans and micro-business loans (collectively 56% of the total portfolio in Jun-18), and cash backed loans (9% of the portfolio). The leasing portfolio mainly consists of lending for small cars, small lorries and 3-wheelers, which accounted for about 73% of the leasing portfolio in Jun-18. SDF expects to achieve a total portfolio of LKR 16.7 Bn by FY2021, with an exposure of 60% to loans segment, 30% to leases and, 10% to pawning. Pawning portfolio is negligible as of Jun-18. ICRA Lanka notes, that the operating environment for SME loans and leasing are quite competitive and SDF's ability to grow the portfolio in these product segments would be challenging given its modest competitive position.

Subdued asset quality indictors: SDF's gross NPA ratio stood at 6.8% in Jun-18 (6.2% in Mar-18). The gross NPA ratio of the active portfolio, which mainly consisted of asset backed loans (property, vehicles, etc.) and leasing, stood at about 4.8% in Jun-18 vis a vis 4.1% in Mar-18. The slippages during the period were largely because of the impact of drought on SDF's agriculture-based SME customer segment. The legacy microfinance portfolio (about 6% of total portfolio) accounted for about 33% of total NPA portfolio as of Jun-18. The gross NPA ratio of the same was high at 37.5%. In FY2017 and FY2018, the company has written off about LKR 109 Mn and LKR 153 Mn respectively from the microfinance portfolio. The microfinance portfolio's high slippages were primarily because of poor loan evaluation and inadequate follow up for collections. SDF has stopped granting microfinance facilities from Dec-16 and maintained it as a collection portfolio. The company's ability to maintain healthy asset quality indicators would be a key monitorable going forward.

Limited funding diversity and subdued liquidity profile: Total borrowings of SDF stood at about LKR 5.2 Bn and about 95% of it comprised of customer deposits in Jun-18 (fixed deposits 65% and savings deposits 30%). The bank borrowings represented the balance 5%. The fixed deposits placed by the Sarvodaya societies stood at about 23% of the total deposits, however the same has reduced from 50% in FY2013. The savings deposit base stood range bound at about LKR 1.5-1.6 Bn since Mar-14, and majority of it comprised of savings from Sarvodaya society members. SDF's ALM profile is characterised by mismatches in the <1-year bucket (15.0% of total assets in Jun-18) as majority of deposits (about 76%) mature in less than 12-months. Good renewal rate of 85-90% and sanctioned credit lines of about LKR 250 Mn provide comfort on SDF's overall liquidity profile.

Modest profitability indicators: SDF's profitability has been volatile over the last four years with RoA ranging from -0.2% to 1.4%. In FY2018, SDF recovered from its losses to record a PAT of LKR 80 Mn (net loss LKR 35 Mn for FY2017). The RoA improved to 1.4% in FY2018 vis a vis -0.8% in FY2017. The improvements achieved in operating expenses and provisioning costs largely contributed to profitability. The operating expenses (as % of average total assets) came down to 12.5% as of FY2018 (15.0% in FY2017) with improvement in the employee productivity. SDF's credit cost decreased to 1.6% in FY2018 vis a vis 3.8% in FY2017, largely because of lower provisioning for legacy microfinance portfolio. During Q1FY2019, RoA stood at 0.7% largely because of contraction of NIM due to increase in borrowing costs. Going forward, it is crucial for SDF to achieve good profitability indicators while keeping the credit and operational costs under control.

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

Links to applicable criteria: **ICRA Lanka Credit Rating Methodology for Non-Banking Finance Companies**

About the company:

Sarvodya Development Finance Limited (SDF) is a licensed finance Company established in 2010. SDF is a 80% owned subsidiary of Sarvodaya Economic Enterprise Development Services (Guarantee) Limited (SEEDs) and its ultimate parent is Lanka Jathika Sarvodaya Shramadana Sangamaya (LJSSS), which is one of the large non-governmental organisations in Sri Lanka with about 1,500-member societies representing all the districts in the country. In 2014, the Japanese investor Gentosha Total Asset Consulting Inc., invested in 20% of the company for a consideration of LKR 350 Mn. SDF is largely focusing on SME loans, micro business loans, housing loans and leasing.

During the year ended March 31, 2018, SDF reported a net profit of LKR 80 Mn on a total asset base of LKR 6.4 Bn as compared to net loss of LKR 35 Mn on a total asset base of LKR 4.9 Bn in the previous fiscal year. For the three months ended June 30, 2018 SDF reported a net profit of LKR 1 Mn (unaudited) on a total asset base of LKR 6.6 Bn.

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