

ICRA Lanka while affirming the ratings at [SL] A-, revises outlook to negative for Lanka ORIX Leasing Company

September 23, 2013

Instrument	Amount	Rating Action
Issuer Rating	N/A	[SL]A- reaffirmed; outlook revised to negative from stable
Long Term Unsecured Redeemable Debenture Programme	Rs. 750 Mn	[SL]A- reaffirmed; outlook revised to negative from stable
Long Term Unsecured Redeemable Debenture Programme	Rs. 500 Mn	[SL]A- reaffirmed; outlook revised to negative from stable

ICRA Lanka has revised the outlook on the long term ratings of Lanka ORIX Leasing Company PLC (LOLC or the HoldCo) from ‘Stable’ to ‘Negative’ while reaffirming the issuer rating and the rating of LOLC’s Debenture programmes at [SL] A- (pronounced SL A minus)¹. Given the significant operational and financial linkages with the subsidiaries (especially pertaining to financial services), ICRA Lanka continues to take a consolidated rating view of the HoldCo and the key asset financing subsidiaries.

Most NBFIs in the country have reported deterioration in asset quality in the past year because of stressed operating environment and adverse weather conditions which adversely impacted the agricultural sector. ICRA Lanka’s decision to revise the rating outlook from Stable to Negative follows the significant deterioration seen in the Group level Asset Quality and the considerable decline in the profitability levels of the Group including the key financial services subsidiaries. LOLC Group’s deterioration has been sharper compared to peers due to delinquencies witnessed in a few large clients and high slippages recorded in LOLC group’s agricultural and trade sector exposures due to weak macroeconomic conditions. The operating environment continues to remain relatively stressed in the current fiscal and further deterioration in asset quality and related stress on profitability cannot be ruled out. Group level earnings also weakened sharply with the ROAA dropping to 1.66%% in fiscal 2013 from 4.45% in fiscal 2012 mainly because of sharp increases in funding and credit costs; however recovered to 1.74% in QE June 2013. Arresting asset quality deterioration and improvement in the earnings profile at a group level would be key rating sensitivities; ICRA Lanka would be closely monitoring the same.

The ratings continue to factor LOLC Group’s long track record in the retail finance sector, its leadership position in the Sri Lankan retail finance market, professional and experienced management team, adequate risk management systems with strong retail franchise. The rating also derives support from the committed support and oversight from its largest investor—ORIX Corporation of Japan (rated Baa2 with stable outlook by Moody’s) which has a 30% stake in the entity. ICRA Lanka has also taken note of

¹ For complete rating scale and definitions please refer to ICRA Lanka’s Website www.icralanka.com or other ICRA Rating Publications

the management's progress to de-leverage the Holdco from gearing of 2x as on March 2012 to 1.6x² by March 2013 by reducing intra-group exposures and the run-down of its lending book. The ability of the HoldCo and the LOLC group to improve on their operating margins while reducing the standalone and group leverage will have a bearing on the rating going forward.

Group's level Asset Quality has deteriorated significantly from the levels reported as at Mar-12. Group Level Gross NPA Ratio increased to 3.36% as at Mar-13 from 1.60% reported as at Mar-12. The key financial services subsidiaries recorded further deterioration in Asset quality in QE Jun-13. Low Group level Portfolio growth (1% for the FYE Mar-13), negative impact caused by exposure to agriculture sector and the slowdown in the economy were the main causes for this weakening in Asset Quality Levels.

LOLC group's earning profile has moderated considerably due to the fall in profitability levels of the key financial services subsidiaries as they account for more than 91% of the group PBT; increase in funding costs due to the volatile interest scenario seen during FY 2012 and significant increase in credit costs resulted in the moderation of group level profitability. Given that key cash flows for the Holdco is generated through the financial services subsidiaries ICRA Lanka notes that moderation in interest margins and increasing provisioning costs would put pressure on the financial services subsidiaries ability to service the Holdco's shared service fees. RONW for the group stood as 5.9% also recording a significant deterioration from 14.78% reported as at Mar-12. The Holdco's standalone earnings comprise mainly of shared services fees and interest income charged from on-lending to subsidiaries. The Holdco profitability levels moderated significantly in Fiscal 2013 owing to heightened costs of funds; Holdco's ROAA declined to 0.06% for FYE Mar-13 compared to 6.72% (including one-time gains) reported for FYE Mar-12.

ICRA Notes that the LOLC's leisure sector exposures continue to report losses due to hotels being closed down for renovation. Rs 904 Mn of losses (24% of total Group PBT) were recorded for the FYE Mar-13 in the leisure segment while the Trading Segment reported profits of Rs 148Mn (4% of total Group PBT). LOLC's insurance business turned profitable during the FYE Mar-13 however the power segment reported losses.

LOLC's has gradually scaled down its trading investment portfolio over the past FY. The trading and investments securities portfolio stands at around Rs. 1.2 bn (as at Mar-13) down from Rs 4.0Bn reported as at Mar-12. Seylan Bank was reclassified from the trading portfolio into an associate company. Further in Jun-13 LOLC through its subsidiary LOLC micro investments acquired a 33.4% stake in Nanda Investments and Finance PLC with the remaining 56.6% stake acquired by BRAC.

Company Profile

Setup in 1980 with equity participation from International Finance Corporation, ORIX Corporation and leading domestic financial institutions, Lanka ORIX Leasing Company PLC (LOLC) is a leading player in leasing and other lending activities. With the group diversifying into other interests including leisure and energy in the past few years, LOLC surrendered its Specialized Leasing Company (SLC) license from CBSL and is transforming itself into a holding company by transferring all operations to its subsidiaries. At the

² Adjusted for accounting adjustments under IFRS; the reported gearing under IFRS however stands at 0.6x

end of March 2013, financial services contributed 91% of PBT of the group while interests in leisure and power reported losses.

During the year ended March 2013, LOLC group reported net profit of Rs. 2.5 Bn on a total income of Rs. 33 Bn compared to net profit of Rs. 5.7 Bn on a total income of Rs. 28 Bn in the corresponding period of the previous fiscal.

September 2013

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