

ICRA Lanka revises the issuer rating of Nation Lanka Finance PLC

October 24, 2019

Instrument	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	Revised to [SL]B- (Negative) from [SL]B (Stable)

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group Company of Moody's Investors Service, has revised the issuer rating of Nation Lanka Finance PLC (NLF or the Company) to [SL]B- (pronounced S L B minus) from [SL]B (pronounced S L B). The outlook is revised to Negative from Stable.

Rationale

The rating revision factors in the weakness in the capital and liquidity profile of NLF. The Company's core capital was about LKR 866 Mn as of Jun-19, below the regulatory minimum capital requirement (LKR 1.5 Bn effective from Jan-19), as a result of SLFRS-9 day one adjustment of LKR 377 Mn and the failure of the Company to raise fresh equity capital. The failure to meet the regulatory capital has led to the imposition of LKR 5.0 Bn deposit cap in January 2016 and subsequently increased to LKR 7.3 Bn in January 2019 by the Central Bank of Sri Lanka (CBSL) and the same is expected to significantly constrain NLF's financial flexibility. As of Jun-19, NLF's deposit base was about LKR 5.9 Bn. Further, NLF is required to increase its minimum capital to LKR 2.0 Bn by Jan-20 and LKR 2.5 Bn by Jan-21. To meet the same, 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 moderate. The ability of the Company to raise commensurate capital on a timely basis would be crucial from a rating perspective. ICRA Lanka takes note of the participation of some key shareholders (constituting about 60% of the shareholding in Jun-18) in the recent rights issues and subordinated debenture issuance of the Company. However, support from them going forward, considering NLF's future capital requirements, remains to be seen.

NLF's liquidity position would be highly stretched thereby making it vulnerable to any deposit outflow given the Company's limited resource profile (about 92% public deposits as of Jun-19), the imposed restriction on deposits, and non-availability of contingent liquidity lines. The rating continues to factor in NLF's small scale (net portfolio at LKR 6.2 Bn as of Jun-19), its subdued asset quality (gross NPA ratio at 15.68% as of Jun-19) and moderate profitability indicators.

Ability to meet regulatory capital and, improvement in asset quality and financial indicators would be crucial, going forward, from a rating perspective.

Outlook: Negative

The Negative outlook reflects NLF's continued weakness in the various financial and asset quality indicators. NLF's ability to raise capital to meet the current and upcoming regulatory requirement on a timely basis would be a key rating sensitivity in the near term. The outlook may be revised to "Stable" in case of significant improvement in NLF's capital, liquidity and asset quality profiles going forward. The

rating may be downgraded in case of NLF failing to meet the regulatory capital requirement in the near term.

Key rating drivers

Credit challenges

Modest loan portfolio with weak asset quality indicators; NLF reported a modest net portfolio of LKR 6.2 Bn as of Jun-19, with exposures towards loans (33%), micro finance (30%), leasing (20%), pawning/gold loans (8%) and Others (including the legal stock of 6%). NLF curtailed Micro Finance and discontinued the unsecured Business Loan portfolio due to the substandard quality experienced on the products. NLF has steadily increased the share of vehicle financing, which consists of cars & vans, 2wheelers and 3wheelers. The Company reported Y-o-Y portfolio growth of 8.26% in FY2019 as compared to 8.47% reported in previous year. The Company's growth was above the systematic average of 4.03% due to its relatively smaller asset base. The Company is expecting to grow its vehicle financing portfolio to LKR 10 Bn by FY2020. Going forward, Key focus will be vehicle financing and gold loans. ICRA Lanka expects modest portfolio growth in the short to medium term, as a result of regulatory funding constraints imposed by CBSL. The Company reported 12.94% gross NPA as of Mar-19 as compared to 11.9% as of Mar-18. Micro finance and business loans were the main contributors for the high NPA. As of Jun-19, Micro finance reported a standalone Gross NPA of 20.75% as compared to 18.23% in Mar-19 (10.93% in Mar-18). Sharp increase in Micro Finance NPAs was due to the announcement made by the Government to waive off the Micro Finance loans granted to the flood affected areas of the country. Business loans reported a standalone NPA of 10.13% in Jun-19, as compared to 5.59% in Mar-19 (14.42% in Mar-18) due to the prevailing adverse macroeconomic conditions. NLF has curtailed its micro operations and discontinued the unsecured business loans and is taking legal action to recover the portfolio. Going forward, ICRA Lanka expects higher slippages in the short to medium term but a marginal improvement in Gross NPA ratio with the proposed write off of the NPAs of the Micro Finance portfolio.

Low capitalization as a result of inadequate capital support from the main promoters; Main shareholders of NLF as of Jun-19 are Nawaloka group 23.89% (held through Mr. U.H Dharmadasa 17.42% and Mr. H.K.J Dharmadasa 6.47%) and Mr. V Ramanan 55.52%. ICRA Lanka noted that the Company failed to meet the LKR 1.5 Bn core capital requirement on 01 January 2019. Since FY2016, the promoters have invested close to LKR 1.1 Bn (LKR 502 Mn in Mar-16 and LKR 600 Mn in Sep-18) through right issues and LKR 250 Mn as privately placed debentures. However, the same was not adequate to meet the regulatory requirements. The regulatory Capital Adequacy Ratio of the Company which is marginally above the regulatory minimum, limits NLF's ability to grow the business; NLF reported a tier I capital ratio of 8.47% and total capital ratio of 10.50% in Aug-19 as compared to the regulatory capital requirement of 6.50% and 10.50%. ICRA Lanka noted the continuous support from the main promoters Mr. V Ramanan and Nawaloka group, though the support has not been adequate. The Management is considering the possibilities of merger with another NBFIs or fresh capital infusion from a new investor to meet the regulatory capital requirements. Based on the new capital adequacy direction, ICRA Lanka estimates that close to LKR 1,200 Mn to LKR 1,500 Mn fresh capital infusion is needed till FY2022 to maintain a 10-30% annualised growth rate. ICRA Lanka will monitor closely the progress of the capital raising plans and foresees, tighter regulatory implication post Dec-19, if NLF failed to meet the regulatory capital requirements.

Modest and volatile profitability indicators; NLF reported a profit of LKR 167 Mn in FY2019 as a result of lower credit cost reported during FY2019 due to portfolio shift towards asset backed lending. The Company's yield moderated to 31.75% in 3MFY2020 as compared to 35.92% in FY2019 (37.75% in FY2018)

due to the shift in the portfolio towards low yielding asset backed lending and imposition of an interest rate cap on Micro Finance industry by CBSL. As of Jun-19, NLF reported a credit cost (credit cost reversal) of (2.63)% as compared to 0.93% reported in FY2019. The management has recognised the IFRS 9 impact of LKR 377Mn which would be recognised in four equal tranches in the next four years when computing the CAR. The Company has relatively high operating expenses due to its broader organisational structure. The Company reported operating expenses of 12.31% in FY2019 as compared to 11.16% in FY2018. The Company's ability to control the credit costs and rationalise its operating expenses will be key to maintaining a consistent profitability profile.

Weak liquidity and funding profile; NLF reported a positive 2.63% short term (less than 1 year) asset and liability mismatch in Jun-19. Modest portfolio growth has resulted in the positive short term mismatch on the liquidity of the Company. Close to 92% of the borrowings were from deposits and the LKR 7.3 Bn deposit cap imposed by the regulator would put pressure on the funding of the Company. Going forward, if the Company failed to address the regulatory capital requirements of the Company, ICRA Lanka anticipates further weakening on the liquidity in the short term.

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:

Nation Lanka Finance PLC (NLF) formally known as Ceylinco Finance PLC is a public limited company incorporated in Sri Lanka on 15th July 1987. The Company operates as a licenced finance company registered under finance business act for the past 30 years. NHL's main shareholders are Mr. V Ramanan (55.52%) and Mr. U.H Dharmadasa (17.42%) and Mr. H.K.J Dharmadasa (6.47%) representing the Nawaloka Group.

During the year ended March 31, 2018, NLF reported a PAT of LKR 167 Mn on a total asset base of LKR 8.9 Bn as compared to net loss of LKR 51 Mn on a total asset base of LKR 9.1 Bn in the previous fiscal year.

For the three months ended June 2019, the Company reported a PAT of LKR 34 Mn on a total asset base of LKR 8.9 Bn

Key financial indicators (Audited)

Amount in LKR Mn	FY2018	FY2019	Q1FY2019*	Q1FY2020*
Net Interest Income	1,277	1,262	292	240
Profit after Tax	(51)	167	19	34
Net worth	686	1,181	705	1,215
Loans and Advances	6,009	6,506	6,496	6,248
Total Assets	9,075	8,975	9,727	8,957
Return on Equity	(7.17)%	18.96%	11.03%	12.46%
Return on Assets	(0.59)%	1.85%	0.82%	1.52%
Gross NPA	11.09%	12.94%	12.85%	15.68%
Net NPA	(1.35)%	0.87%	0.74%	(3.32)%
Capital Adequacy Ratio	13.15%	7.97%	11.59%	7.63%**
Gearing adjusted to revaluation (times)	13.74	6.45	15.77	6.22

*Unaudited **CAR improved to 10.50% in Aug-19 with the deferment of IFRS I day 1 adjustment for four years for CAR calculation

Rating history for last three years:

Instrument	Current Rating (FY2020)			Chronology of Rating History for the past 3 years		
	Type	Amount Rated (LKR Mn)	Date & Rating Oct-19	Date & Rating in FY2019 Sep-18	Date & Rating in FY2018 -	Date & Rating in FY2017 -
Issuer rating	N/A	N/A	[SL]B- (Negative)	[SL]B (Stable)	N/A	N/A

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