

ICRA Lanka upgrades the ratings of First Capital Treasuries PLC

November 4, 2020

Instrument	Rated Amount (LKR Mn)	Outstanding Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	Upgraded to [SL]A from [SL]A-; Stable outlook
Subordinated Unsecured Redeemable Debenture programme	750	750	Upgraded to [SL] A- from [SL]BBB+; Stable outlook
Subordinated Unsecured Redeemable Debenture programme	500	-	[SL]BBB+ with Stable outlook; Withdrawn

Rating action

ICRA Lanka Limited, has upgraded the issuer rating of First Capital Treasuries PLC (FCT or “the Company”) to [SL]A (pronounced SL A) from [SL]A- (pronounced SL A minus). ICRA Lanka has also upgraded the issue rating of the LKR 750 Mn Subordinated, Unsecured, Redeemable Debenture programme of FCT to [SL]A- (pronounced SL A minus) from [SL]BBB+ (pronounced SL triple B plus). The issue rating of [SL] BBB+ (pronounced SL triple B plus) with stable outlook for the LKR 500 Mn Subordinated, Unsecured, Redeemable Debenture programme of the company has been withdrawn as the said debentures have matured and there is no amount outstanding against the rated instrument. The outlook on the long-term ratings remains Stable.

Rationale

ICRA Lanka has taken a consolidated view of the First Capital group (comprising of First Capital Holdings PLC and its subsidiaries), which is involved in a range of financial services such as primary dealership, equity trading, corporate advisory, debt structuring and asset management. There is a strong interlink between the entities, through sharing of a common brand, management team, systems and group treasury functions.

The ratings upgrade considers the healthy performance of FCT (a subsidiary of First Capital Holdings PLC rated [SL]A), following the robust earnings of LKR 1,208 Mn and LKR 1,356 Mn in FY2020 and Q1 of FY2021, respectively, in comparison to LKR 96 Mn in FY2019 (LKR 1,671 Mn in FY2018). The improvement in profitability has enhanced its capital profile with the company’s net worth increasing to LKR 4.6 Bn June 2020 (LKR 3.7 Bn in March 2020 and LKR 3.2 Bn in March 2019). ICRA Lanka expects the higher net worth of the company to provide a cushion/buffer against adverse interest rate movements. The capital adequacy ratio stood at 26.23% in June 2020 (14.89% in June 2019), above the regulatory minimum of 10%; the portfolio duration stood at 2.44 (years) in the same period (2.12 in June 2019). The ratings also take note of the gearing which stood at 3.91 times in June 2020 vis a vis 8.8 times in March 2020 (9.0 times in March 2019). The ratings factor in FCT’s position as the leading standalone primary dealer (PD) in Sri Lanka with an established track record, franchise and clientele. The ratings also take comfort from the company’s expectation of maintaining a healthy capital buffer going forward above regulatory limits (about LKR 4.0 Bn in net worth).

The ratings also takes cognizance of the short-term nature of the borrowings profile and the short-term asset liability mismatch, with the overnight negative mismatch at 2.7% of the total earning assets in June 2020 vis-à-vis 35.0% in June 2019, and the 90-day negative cumulative mismatch at 3.9% of the total earning

assets in June 2020 vis-à-vis 8.9% in June 2019. Nevertheless, the highly liquid nature of the portfolio and access to funding lines, provide comfort from a liquidity perspective.

Outlook: Stable

The Stable outlook factors in FCT's healthy capital and earnings profiles and its track record as one of the leading primary dealers in Sri Lanka. The outlook may be revised to "Positive" based on FCT's ability to continue operating profitably across cycles whilst maintaining a comfortable level of capitalization and liquidity. The outlook may be revised to "Negative" in case of significant weakening in the earnings, liquidity and capitalization profile or in case its exposure profile shifts away from government securities.

Key rating drivers

Credit strengths

Position as the leading stand-alone primary dealer in Sri Lanka: FCT is the leading standalone primary dealer in Sri Lanka currently, with close to 40% market share in terms of total assets. The company has an established track-record as a PD, a large client base, and repo funding arrangements with most of the leading banks in Sri Lanka.

Negligible credit risk: FCT's portfolio stood at about LKR 23.3 Bn as in June 2020 vis a vis LKR 37.0 Bn in March 2020 and LKR 31.4 Bn in March 2019. Due to the sharply declining interest rate environment that was experienced since March 2020, the PD had exited some of its positions in order to benefit from trading gains. The portfolio comprises of treasury bills, bonds and reverse repos on government securities (which are highly liquid assets), and therefore carries no significant credit risk. However, FCT is exposed to interest rate risk as the trading portfolio is marked to market based on systemic interest rates; the weighted average portfolio duration stood at about 4.18 (in years) in September 2020 (duration stood around 2.12 in June 2019) and has increased from 1.67 in March 2020 and 1.58 in December 2019.

Improvement in capitalization profile due to healthy earnings, but dividend pay-out increases: The capital base of the company stood at LKR 4.6 Bn in June 2020, compared with LKR 3.7 Bn in March 2020 (LKR 3.2 Bn in March 2019). As in June 2020, the capital adequacy ratio (CAR) stood at a healthy 26.23% (Tier 1 CAR stood at 21.24%), which is above the regulatory minimum of 10%. Reported gearing stood at 3.9 times in June 2020, compared with 8.8 times in March 2020 and 9.0 times in March 2019; gearing adjusted for the deferred tax asset stood at 3.9 times in June 2020, compared with 9.5 times in March 2020 (12.0 times in March 2019). On account of the favourable market environment, company has earned a healthy profit after tax of LKR 1,208 Mn in FY2020 vis a vis a net profit of LKR 96 Mn in FY2019. In the 3 months ended June 2020, company earned a further profit after tax of LKR 1,356 Mn, primarily from trading gains due to the declining market interest rates. Currently the capitalization profile remains comfortable and management intends to maintain the total capital of the PD at around LKR 4.0 Bn going forward (which is well above the current regulatory minimum of LKR 1.0 Bn as well as the future proposed minimum threshold of LKR 3.0 Bn which may be effective from Jan 2023). The deterioration in the company's net worth from the expected LKR 4.0 Bn level in the future would be a key rating sensitivity.

Credit challenges

Vulnerability to interest rate risk: Notwithstanding the negligible credit risk, FCT's portfolio is exposed to market risk due to its susceptibility to adverse movements in the interest rates, where the company could make trading losses and fair valuation losses based on systematic rate movements. Accordingly, based on the portfolio as at June 2020, ICRA Lanka estimates that a 100 bps rise in interest rates would reduce the CAR by close to 200 bps, with gearing standing at around 4 times. Nonetheless, we take comfort from the

healthy capital profile of the company which is expected to enable it to withstand negative interest rate movements. In FY2020, company achieved a trading gain of LKR 1,236 Mn (trading loss of LKR 77 Mn in FY2019) and a fair valuation gain of LKR 363 Mn (LKR 76 Mn loss in FY2019) in the context of falling interest rates, whereas net interest income during the period stood at LKR 416 Mn (LKR 414 Mn in FY2019). In the 3 months ended June 2020, the company made a trading gain of LKR 1,612 Mn, a fair valuation gain of LKR 342 Mn and earned net interest income amounting to LKR 162 Mn on its portfolio.

Short-term asset liability mismatch (ALM): The Company is subject to a short-term ALM mismatch due to the medium-term portfolio that is held (about 2-4 years maturity), funded by short-term repo borrowings. As in June 2020, the negative overnight mismatch was 3% of total assets compared to 35% in June 2019. However, the highly liquid nature of the portfolio and access to about LKR 1.5 Bn in unutilized funding lines in August 2020, provide comfort. Further, as a licensed primary dealer, FCT has access to overnight liquidity lines from the Central Bank of Sri Lanka (CBSL), as the lender of last resort.

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 Primary Dealers](#)

About First Capital Group:

Incorporated in year 1992, First Capital Holdings PLC (FCH) is a public limited company listed on the Colombo Stock Exchange. FCH's equity stake of 83.02% was held by Janashakthi PLC (JPLC) in June 2020. Previously, FCH was held by Dunamis Capital PLC (DCP). With JPLC's acquisition of DCP in December 2018, JPLC became the ultimate parent of FCH. On December 06, 2019, DCP was amalgamated with JPLC, resulting in DCP ceasing to exist and all of its subsidiaries (namely, FCH and Kelsey Development PLC) becoming the immediate subsidiaries of JPLC.

FCH is engaged in strategic investments and managing its subsidiaries i.e. First Capital Treasuries PLC (FCT) which is a Primary Dealer in Government Securities, First Capital Limited (FCL) engaged in structuring and placement of corporate debt, corporate finance advisory services and investments, First Capital Asset Management Limited (FCAM) engaged in unit trust and portfolio management, First Capital Trustee Services (Pvt) Limited (FCTS) which is a trustee services provider for corporate debt securities and First Capital Equities (Pvt) Limited (FCE) which is engaged in stock broking activities.

For the financial year ended March 31, 2020, FCH on a stand-alone basis reported a net profit of LKR 1,006 Mn, on a total asset base of LKR 10.2 Bn, vis-à-vis net profit of LKR 2 Mn on a total asset base of LKR 11.3 Bn during the previous fiscal. For the financial year ended March 31, 2020, FCH group (consolidated) reported a net profit of LKR 1,073 Mn, on a total asset base of LKR 45.6 Bn, vis-à-vis a net profit of LKR 8 Mn on a total asset base of LKR 41.3 Bn during the previous fiscal. For the 3 months ended June 30, 2020, FCH reported a stand-alone net profit of LKR 1,382 Mn on a total asset base of LKR 11.6 Bn and a consolidated profit of LKR 1,457 Mn on a total asset base of LKR 32.5 Bn.

About the Company:

Incorporated in year 1982, FCT is a licensed primary dealer of government securities in Sri Lanka. The company is 94.44% held by First Capital Limited, while First Capital Limited is in-turn 100% held by First Capital Holdings PLC. For the financial year ended March 31, 2020, FCT reported a net profit of LKR 1,208Mn on a total asset base of LKR 37.4Bn, vis-à-vis net profit of LKR 96Mn on a total asset base of LKR 32.3Bn during the previous fiscal. For 3 months ended June 30, 2020, FCT reported a net profit of LKR 1,356Mn on a total asset base of LKR 23.4Bn.

Key financial indicators:

LKR Mn	FY19	FY20	Q1 FY2021*
Net Interest Income	414	416	162
Net Trading Gain/Fair Valuation Gain	(153)	1,599	1,954
Other Income	8	1	(6)
Net Operating Income	269	2,016	2,110
Profit after Tax	96	1,208	1,356
Net worth	3,225	3,737	4,555
Trading Portfolio	29,533	36,212	20,183
Total Assets	32,323	37,383	23,391
Return on Equity	2.97%	32.31%	119.08%
Return on Average Assets	0.33%	3.47%	17.85%
Total Capital Adequacy Ratio (%)	15.69%	26.19%	26.23%
Gearing (times)	9.0	8.8	3.9
Adjusted Gearing (times)**	12.0	9.5	3.9

* Unaudited; Ratios for Q1 FY2021 are annualized ** Gearing adjusted for one-off gains

Rating history for last three years:

Instrument	Amount Rated (LKR Mn)	Current Rating	Chronology of Rating History for the last 3 years			
			FY2021	FY2020	FY2019	FY2018
			Oct-20	Dec-19	Nov-18	Sep-17
Issuer rating	N/A	[SL]A (Stable)	[SL]A- (Stable)	[SL]A- (Stable)	[SL]A- (Stable)	
Subordinated unsecured redeemable debentures	500	[SL]BBB+ (Stable); Withdrawn	[SL]BBB+ (Stable)	[SL]BBB+ (Stable)	[SL]BBB+ (Stable)	
Subordinated unsecured redeemable debentures	750	[SL]A- (Stable)	[SL]BBB+ (Stable)	NA	NA	



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