

ICRA Lanka revises the issuer rating of Nation Lanka Finance PLC and put on watch with developing implications

November 10, 2020

Instrument	Rated Amount (LKR Mn)	Outstanding Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	Revised to [SL]C+ from [SL]B-; placed on rating watch with developing implications

Rating action

ICRA Lanka Limited has revised the issuer rating of Nation Lanka Finance PLC (NLF or the Company) to [SL]C+ (pronounced S L C plus) from [SL]B- (pronounced S L B minus). The rating has been placed on rating watch with developing implications.

Rationale

The rating revision factors in NLF's weak capital ratio which is below regulatory requirement, deteriorating asset quality, weak earnings profile and stretched liquidity profile. The Company's core capital was about LKR 835 Mn as of Jun-20, below the regulatory minimum capital requirement of LKR 1.5 Bn effective from Jan-19, as a result of weak profitability and inability of the Company to raise fresh equity capital. The failure to meet the regulatory capital had 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 has significantly constrained NLF's funding profile. As of Jun-20, NLF's deposit base was about LKR 6.1 Bn. In addition, the CBSL has directed the Company to reduce the lending portfolio by LKR 50 Mn per month since Sep-19 and the same is expected to limit the Company's operational flexibility. Further, NLF is required to increase its minimum capital to LKR 2.0 Bn by Jan-21 and LKR 2.5 Bn by Jan-22. 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. Management is also planning to merge with another non banking financial institution (NBFI) to meet the regulatory capital requirements. The ability of the Company to raise commensurate capital on a timely basis would be crucial from a rating perspective.

NLF's liquidity position is stretched thereby making it vulnerable to any large ticket deposit outflow given the Company's limited resource profile (~88% public deposits as of Jun-20), the imposed restriction on deposits, limited access to bank funding and non-availability of contingent liquidity lines. The Company's ability to manage the short-term liquidity (less than 1 year) would be a key rating sensitivity in the near term. NLF's asset quality profile continued to remain weak with high gross NPA ratio of 27.29% in Jun-20 as compared to Licensed Finance Company (LFC) sector's average of 14.31% for the same period. Elevated slippages witnessed on Business loans and Micro Finance loans and declining loan portfolio contributed to the higher NPA ratio. The rating continues to factor in NLF's small scale of operations (net portfolio at LKR 5.3 Bn as of Jun-20) and its moderate profitability indicators. Going forward, the Company's ability to meet regulatory capital, improvement in liquidity, asset quality and other financial indicators would be crucial, from a rating perspective.

The rating is placed under watch with developing implications due to the announcement of the proposed amalgamation of NLF with Sinhaputhra Finance PLC (SINF). On October 29, 2020, NLF made a disclosure

to the CSE, announcing that the Company has executed a Term Sheet agreeing to seek an amalgamation of NLF and SINL. The proposed amalgamation is subjected to valuations which have been commissioned for the two entities and the receipt of approval from the Monetary Board of Sri Lanka. Further, ICRA Lanka expects the announced amalgamated entity is likely to have weak capitalisation levels and its ability to raise additional capital to meet the current and upcoming regulatory requirements on a timely basis will remain monitorable. As in Jun-20, NLF and SINL reported Capital Adequacy Ratios of 7.55% and 2.35% respectively, as compared to the regulatory requirement of 10.50%. The minimum regulatory core capital of NLF and SINL stood at LKR 834 Mn and LKR 305 Mn as compared to the regulatory minimum of LKR 1,500 Mn. The ability of the new promoters of the amalgamated entity to infuse commensurate capital on a timely basis would be crucial from a rating perspective. The asset quality of the amalgamated entity would continue to remain weak as the gross NPA ratio of NLF and SINL stood at 27.29% and 34.78% in Jun-20 respectively.

Key rating drivers

Credit challenges

Capital ratios below regulatory requirement; inadequate and timely capital support from the promoters remains a concern; The company's Tier I capital ratio of 6.83% in Jun-20 (6.70% in Mar-20) remains marginally above the regulatory minimum of 6.50%. However, the company total capital ratio of 7.55% in Jun-20 (in 7.36% in Mar-20) remains below the regulatory capital requirement of 10.50%. The company continues to breach the total capital ratio from Mar-19. Also, the company reported core capital of LKR 835 Mn which remained below the regulatory minimum requirement of LKR 1.5 Bn as on 01 January 2019. ICRA Lanka noted that the promoters infused 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 from FY2016. However, the same was inadequate to meet the regulatory requirement. Management is considering the option of merger with another NBFIL to meet the regulatory capital requirements. ICRA Lanka estimates that around LKR 1,400 Mn to LKR 1,500 Mn (111%¹ of market capitalisation) fresh capital infusion is needed till FY2021. ICRA Lanka will closely monitor the progress and timeliness of the capital raising plans.

Modest loan portfolio capped with regulatory restrictions; NLF reported a modest net portfolio of LKR 5.3 Bn as of Jun-20, with exposures towards loans² (25%), micro finance (24%), leasing (18%), pawning (10%) and a substantial legal stock (13%). NLF curtailed micro finance and discontinued the unsecured Business Loan portfolio due to the poor quality experienced on the products. NLF's portfolio growth has been restricted due to the restrictions imposed by the CBSL. The Regulator has directed to reduce the loan portfolio by LKR 50 Mn per month since Sep-19. The Company reported Y-o-Y portfolio de-growth of 33.33% in FY2020 as compared to the muted growth of 2.87% reported in the previous year. The portfolio continued to report a de-growth of 31.75% in 3MFY2021. Going forward, the company's focus will be vehicle financing and pawning segments. ICRA Lanka expects the portfolio to de-grow in the short to medium term, as a result of regulatory constraints imposed by the CBSL.

Weak asset quality indicators, unlikely to improve in the near term; The Company reported a 30.73% gross NPA as of Mar-20 as compared to 12.94% as of Mar-19. The gross NPA ratio marginally improved to 27.29% in Jun-20, although it remained higher than the industry average of 14.31%. High slippages witnessed on business and microfinance loans and declining lending portfolio were the main contributors

¹ Market capitalization as on 29th October 2020

² Includes business loans, property loans, fixed deposit backed loans and personal loans

to high NPA ratio. As of Jun-20, business loans reported a standalone NPA of 60.00% before adjusting for moratorium, as compared to 54.82% in Mar-20 (5.59% in Mar-19) due to poor credit underwriting norms practised by the company in the past. Microfinance reported a standalone Gross NPA of 35.21% before adjusting for moratorium, as compared to 32.39% in Mar-20 (18.23% in Mar-19). NLF has curtailed its microfinance operations and discontinued the unsecured business loans and is taking legal action to recover the outstanding dues. ICRA Lanka envisages the poor asset quality trend to continue in the medium term due to the effects of the Covid-19 pandemic.

Modest profitability indicators, likely to remain muted in near term; NLF reported a net loss of LKR 44 Mn in 3MFY2021 as compared to the net profit of LKR 9 Mn in FY2020 and LKR 167 Mn in FY2019. The Company reported a loss in 3MFY2021 mainly due to moderation in yield on advances to 4.64% from 10.59% in FY2020 and 14.02% in FY2019. The yield moderated in 3MFY2021 due to concessionary interest rate charged during the moratorium. The yield moderated in FY2020 due to the shift in the portfolio towards low yielding asset backed lending and imposition of interest rate cap on Micro Finance product by the CBSL. In 3MFY2021, NLF reported a credit cost of (0.47)% as compared to 1.44% in FY2020 and 0.93% in FY2019. The Company has rationalised its operating expenses. As a result, operating expenses to average assets ratio reduced to 7.44% in 3MFY2021 as compared to 11.54% in FY2020 and 12.31% in FY2019. The company reported a negative Return on Assets (RoA) and Return on Equity (RoE) of 2.05% and 16.71% in 3MFY2021 as compared to positive RoA and RoE of 0.10% and 0.80% respectively in FY2020 (1.85% and 18.96% in FY2019). The Company's ability to control the credit costs and rationalise its operating expenses will provide comfort on the earnings profile.

Weak liquidity and funding profile; NLF reported a negative cumulative asset and liability mismatch (less than 1 year) of 11.70% in Jun-20 as compared to negative cumulative mismatch of 2.03% in Mar-20. The shift towards short term funding sources has increased the negative cumulative short term mismatch of the Company's liquidity. Close to 88% of the funding were from deposits as in Jun-20 and the LKR 7.3 Bn deposit cap (deposit base of LKR 6.1 Bn as in Jun-20) imposed by the regulator has put pressure on the funding profile of the Company. Going forward, ICRA Lanka anticipates further weakening of the liquidity profile in the short term given the likely muted collections due to the pandemic and the imposition of CBSL's deposit cap.

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%) as in Jun-20, representing the Nawaloka Group.

During the year ended March 31, 2020, NLF reported a Profit After Tax (PAT) of LKR 9 Mn on a total asset base of LKR 8.7 Bn as compared to a PAT of LKR 167 Mn on a total asset base of LKR 8.9 Bn in the previous fiscal year. For the three months ended June 2020, the Company reported a net loss of LKR 44 Mn on a total asset base of LKR 8.4 Bn compared to net profit of LKR 34 Mn in the three months ended June 2019.

Key financial indicators (Audited)

Amount in LKR Mn	FY2019	FY2020	Q1FY2020*	Q1FY2021*
Net Interest Income	1,262	908	240	98
Profit after Tax	167	9	34	(44)
Net worth	1,181	1,171	1,215	1,127
Loans and Advances	6,506	5,949	6,248	5,606
Total Assets	8,975	8,738	8,957	8,416
Return on Equity	18.96%	0.80%	12.46%	(16.71%)
Return on Assets	1.85%	0.10%	1.52%	(2.05%)
Gross NPA	12.94%	30.73%	15.68%	27.29%
Net NPA	0.87%	7.62%	(3.32%)	1.68%
Capital Adequacy Ratio	7.97%	7.36%	7.63%	7.55%
Gearing adjusted to revaluation (times)	6.45	6.27	6.22	6.26

*Unaudited

Rating history for last three years:

Instrument	Type	Current Rating (FY2021)		Chronology of Rating History for the past 3 years		
		Amount Rated (LKR Mn)	Date & Rating	Date & Rating	Date & Rating in	Date & Rating in
			Nov-20	Oct-19	Sep-18	-
Issuer rating	N/A	N/A	[SL]C+; placed on rating watch with developing implications	[SL]B- (Negative)	[SL]B (Stable)	N/A



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