

ICRA Lanka assigns the issuer rating of [SL]AA- with Stable outlook for DFCC Bank PLC

December 01, 2020

Instrument*	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	[SL]AA- (Stable); assigned

Rating action

ICRA Lanka Limited has assigned the issuer rating of [SL]AA- (Pronounced SL double A minus) with Stable outlook to DFCC Bank PLC (DFCC or the Bank).

Rationale

The rating factors in DFCC Bank's established track record as the pioneer development bank in Sri Lanka (the Bank became a fully-fledged commercial bank in 2015), healthy asset quality indicators, and the adequate capitalization profile. The Bank has a strong corporate banking focus, with about 44% of the total portfolio comprising of corporate lending as in June 2020. The rating also takes cognizance of the healthy asset quality indicators of the Bank, with gross NPA (GNPA) of 4.8% as in June 2020, which was lower than the systemic average of 5.3%. DFCC's portfolio concentration is relatively high with top 20 exposures accounting for about 40% of total exposures as in June 2020. However, ICRA Lanka notes that most of these top exposures comprise of State owned entities and well established business groups in the country; and these exposure limits are well within the defined internal risk parameters of the Bank. The rating factors in the adequate capitalization profile of DFCC, with the Tier 1 capital adequacy ratio at 11.1% as in June 2020, above the regulatory requirement of 8.5%.

However, the rating factors the limited retail franchise of the Bank, resulting in moderate CASA indicators; CASA ratio of DFCC was about 21.1% as in June 2020, compared to the systemic average of about 33.9%. ICRA Lanka also takes cognizance of the muted profitability indicators of the Bank, with NIMs of 2.8% in H1 CY2020 and 3.7% in CY2019, compared to the LCB sector NIM of 3.3% and 3.7%, respectively during the same period. ICRA Lanka also notes that the increase in credit cost (loan provisioning cost/ATA increased to 0.7% in H1 CY2020, from 0.4% in CY2019 and 0.3% in CY2018), marked-to-market losses on equity investments have also affected the overall profitability of the Bank. DFCC's overall return on assets (PAT / Average Total Assets) stood at about 0.7% in H1 CY2020, compared to 0.5% in CY2019 and 0.8% in CY2018.

Outlook: Stable

The Stable outlook factors in the healthy asset quality indicators and the adequate capitalization profile of the Bank. The outlook may be revised to "Positive" if DFCC is able to augment its capital profile through a sizable equity infusion or significantly improve its overall profitability. The outlook may be revised to "Negative" in case of a sharp deterioration of asset quality indicators, further moderation of profitability, and diminishing capital buffers.

Key rating drivers

Credit strengths:

Established track-record, especially in long-term financing: DFCC Bank has an established track record of long term financing, as the first development bank in Sri Lanka, having been established in 1955, and as one of the pioneering development banks in the Asian region. The Bank has a strong corporate banking focus, with about 44% of the total portfolio comprising of corporate lending, followed by the SME and retail segments, contributing to 33% and 18% of the overall portfolio as in June 2020. Some of the most established corporate groups in the country are DFCC's top clients, as the Bank has provided long-term funding for these groups since the inception. As in June 2020, DFCC Bank has a total market share of about 4% (in terms of the asset size) with a total asset base of about LKR 435 Bn. Currently, the Bank has 140 branches, island-wide. However, ICRA Lanka notes that the franchise strength of the Bank in the retail segment is somewhat moderate (about 18% of the total portfolio in June 2020), resulting in lower CASA indicators and moderate NIMs. CASA ratio of DFCC was 21.1% in June 2020 (22.5% in December 2019), compared to the LCB sector average of 33.9% (32.8% in December 2019).

Healthy asset quality indicators, however the portfolio concentration remains relatively high: As in June 2020, DFCC Bank recorded a GNPA ratio of 4.8% (GPNA 4.8% in December 2019 and 3.3% in December 2018) compared to the systemic average of 5.3%. ICRA Lanka notes that the Banks' asset quality indicators marginally deteriorated over the last two years, due to the macro-political challenges in the country. DFCC Bank's GNPA ratio has increased to 3.3% in December 2018 from 2.8% December 2017, and increased further to about 4.8% in December 2019, due to the Easter events and the instability that ensued. However, the Bank's asset quality deterioration is somewhat moderate compared to the systemic average and the peers banks. The rating also factors that DFCC's loan portfolio is concentrated, with top 20 exposures accounting for about 40% of the total loan portfolio as in June 2020. However, ICRA Lanka notes that, among the top 20 exposures of the Bank, state-owned entities accounted for about 14%, and the rest comprises some of the well-established business groups in Sri Lanka. In addition, there is a high degree of diversity within the large group exposures, thus somewhat reducing the concentration risk. The rating also takes cognizance of DFCC's relatively high exposure towards the construction and real estate segments (about 21% as in June 2020), segments which experienced liquidity stress during the recent past.

In terms of the COVID-19 impact, ICRA Lanka notes the Bank has offered debt moratoriums of about LKR 80 Bn (about 26% of the gross portfolio as in June 2020) for businesses and individuals affected by the pandemic; moratorium on majority of these facilities expired in September 2020, and the repayments are to resume beginning October 2020. Repayment performance of these affected borrows, post moratorium, will be a monitorable, going forward. Also, the rating takes comfort from the adequate provisioning coverage of the Bank, where the provisioning coverage on the Stage 3 portfolio stood at about 52.5% ¹as in June 2020 and December 2019. Net NPA ratio of the Bank stood at about 1.8% as in June 2020 (2.1% in December 2019), compared to the LCB sector average of 2.9% during the same period.

Adequate capitalization profile with lower gearing indicators: DFCC Bank maintains an adequate capitalization profile, with capital adequacy indicators remaining above the regulatory minimum levels. The Bank's regulatory core capital ratio stood at 11.1% in June 2020 (11.3% in December 2019) as compared to the regulatory requirement of 8.5%. The total capital adequacy ratio stood at 15.3% in June 2020 (15.8%

¹ Stage 03 provision coverage = Stage 03 provisions/ (Stage 03 portfolio – Sovereign exposures in stage 03)

in December 2019) as compared to the regulatory requirement of 12.0%. ICRA Lanka noted that the Bank has been able to maintain a comfortable buffer of about 2.5% over the last three years through internal generation and a capital infusion in FY2019. DFCC Bank raised LKR 2.8 Bn in March 2019 through a rights issue and ICRA Lanka also takes cognizance of the medium-term capital augmentation plans of the bank. Going forward, the Bank's ability to maintain adequate capital buffers over the regulatory requirement will be crucial from a rating point of view.

DFCC bank comfortably meets the minimum core capital requirement set by the CBSL with a reported net worth of about LKR 48 Bn as in June 2020, against the regulatory minimum of LKR 20 Bn by December 2020. DFCC's gearing remained relatively low at 7.8 (x) as at June 2020 compared to the industry gearing level of 9.4 (x). The Bank has consistently maintained low gearing levels over the last 5 years, compared to the systemic average.

Credit challenges

Moderate retail franchise affecting CASA levels: The CASA ratio of DFCC has historically remained low. However, DFCC has managed to improve the CASA ratio from 15.8% in December 2016 to 22.5% in December 2019 and 21.1% in June 2020 (LCB sector - 33.9%). ICRA Lanka notes that it has been challenging for the Bank to grow its retail franchise and improve CASA indicators due to its legacy as a development bank, and as of now, the portfolio remains largely focused on corporate and SME segments. Also, ICRA Lanka notes that the low CASA and overall low deposit dependence of DFCC (deposits accounted for about 73% of the total debt funding, compared to the LCB sector average of about 85% as in June 2020) are due to the Bank's access to long term funding lines from multilateral and Development Finance Institutions (DFIs²). This helps to moderate the assets and liability mismatch stemming from the relatively long-tenured lending profile of the Bank. However, going forward, the management intends to improve its CASA base by increasing its retail footprint through digital banking initiatives and channel developments.

Moderate NIMs and high credit cost affecting overall profitability: With lower CASA ratios resulting in higher cost of funds and lower yields on advances due to corporate focus, net interest margins of the Bank had tended to be lower than peers. DFCC Bank's reported NIMs of 2.8% in H1 CY2020, and 3.7% in CY2019, is lower compared to the LCB sector NIMs of 3.3% and 3.7%, respectively during the same period. Further, during CY2019, DFCC Bank experienced an increase in its credit cost (loan provisioning/ average total assets - ATA) to 0.4%, from 0.3% in CY2018. The credit cost increased further during the H1 CY2020, to about 0.7%, due to the asset quality deterioration during the period. In addition, ICRA Lanka notes that the overall profitability of the Bank was also affected by mark-to-market losses on its equity portfolio. However, the profitability was supported by the improvement in operating expenses, where the cost to income ratio of the Bank has moderated to 50.8% in H1 CY2020 and 55.3% in CY2019, compared to 73.3% in CY2018. DFCC's overall return on assets (PAT / Average Total Assets) stood at about 0.7% in H1 CY2020, compared to 0.5% in CY2019 and 0.8% in CY2018. Going forward, the Bank's ability to improve its overall profitability by expanding lending yields and improving CASA will be crucial from a rating point of view.

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

Links to applicable criteria: [ICRA Lanka's Credit Rating Methodology for Banks](#)

² DFIs: Development Finance Institutions

About the Bank:

DFCC Bank was set up in 1955 as Sri Lanka's first Development Finance Institution on the recommendation of the World Bank and is one of the oldest development banks in Asia. In October 2015, DFCC Bank and its 99% owned subsidiary, DFCC Vardhana Bank amalgamated to become a commercial bank. DFCC Bank is now a Licensed Commercial Bank offering a range of development banking and commercial banking products and services.

The Bank is involved in commercial lending activities such as project financing, and trade finance, and SME finance, while also providing the full range of retail banking products, such as housing loans, personal loans, leases, and credit cards.

During the calendar year ended December 2019, DFCC Bank reported a Profit after tax of LKR 2.1 Bn on a total asset base of LKR 405 Bn, vis-à-vis a Profit after tax of LKR 2.7 Bn on a total asset base of LKR 375 Bn during the previous fiscal. During the 6M ended June 2020, the Bank reported a Profit after tax of LKR 1.4 Bn on a total asset base of LKR 435 Bn.

Key financial indicators (Audited)

LKR Mn	CY2018	CY2019	H1 CY2019*	H1 CY2020*
Net Interest Income	12,415	12,662	6,402	5,919
Profit after Tax	2,728	2,074	737	1,444
Net worth (adjusted)	43,846	47,480	47,480	48,573
Loans and Advances (gross)	262,589	285,225	269,038	305,457
Total Assets	374,908	404,897	399,988	435,199
Return on Equity	5.95%	4.54%	4.20%	6.01%
Return on Assets	0.77%	0.53%	0.37%	0.69%
Gross NPA ratio	3.28%	4.85%	4.63%	4.85%
Core Capital Adequacy Ratio	11.33%	11.34%	11.40%	11.14%
Gearing (times)	7.41	7.39	7.61	7.80

*Unaudited

Rating history for the last three years:

Instrument	Current Rating (CY2020)			Chronology of Rating History for the past 3 years		
	Type	Amount Rated (LKR Mn)	Date & Rating	Date & Rating in CY2019	Date & Rating in CY2018	Date & Rating in CY2017
Issuer rating	N/A	N/A	Oct - 20 [SL]AA-(Stable)	-	-	-
				N/A	N/A	N/A



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