

ICRA Lanka reaffirms the issuer rating of [SL]A- for Capital Alliance Limited

April 08, 2021

Instrument	Rated Amount (LKR Mn)	Outstanding Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	[SL]A- (Stable); Reaffirmed

Rating action

ICRA Lanka Limited has reaffirmed the issuer rating of [SL]A- (pronounced SL A minus) for Capital Alliance Limited (CAL or “the Company”). The outlook on the rating remains Stable.

Rationale

The rating factors in the healthy performance of CAL, which earned a net profit of LKR 997 Mn in the 9M ended December 2021 and LKR 737 Mn in FY2020 vis-à-vis LKR 37 Mn in FY2019, supported by a highly favourable interest rate environment. The Company’s core capital had grown to LKR 2.8 Bn in January 2021, aided by its strong earnings, compared to LKR 2.0 Bn in March 2020 (LKR 1.4 Bn in March 2019). The comfortable capital buffer of LKR 1,847 Mn (the current regulatory minimum capital threshold is LKR 1.0 Bn) is expected to provide a cushion against adverse interest rate movements. The risk weighted Capital Adequacy Ratio (CAR) stood at 30.72% in December 2020 (15.57% in December 2019) above the regulatory minimum of 10%, whilst portfolio duration stood at 2.72 times (4.17 times in December 2019). The rating continues to factor in CAL’s position as one of the leading primary dealers in the industry and its healthy track record. The rating also notes the good control processes along with robust IT systems, and the synergies arising from group entities which offer other financial services such as equity broking, asset management and financial advisory. ICRA Lanka is cognizant that while the portfolio carries minimal credit risk (as in December 2020 about 99% of the total investments consisted of GoSL treasury securities), same however is susceptible to market risk from adverse interest rate movements. The rating notes the short term asset liability mismatch as investment positions are funded by short term repo borrowings; liquid nature of the portfolio, access to CBSL funding and availability of bank funding, however provide comfort.

ICRA Lanka is cognizant of the Company’s goal of building its core capital to about LKR 5.0 Bn in the medium term, in order to meet the higher absolute minimum capital thresholds expected to be implemented by the Central Bank of Sri Lanka (CBSL). ICRA Lanka expects the accumulation of future internal generation for this purpose to limit/restrict future dividends to the parent entity, Capital Alliance Holdings Limited (CALH). The ability of CAL to maintain healthy earnings and capitalization going forward, commensurate with the risks inherent to a primary dealer business, would be a key monitorable.

Outlook: Stable

ICRA Lanka believes that CAL’s current capitalization and earnings profile supports its medium-term growth plan. The outlook may be revised to “Positive” based on further improvement in CAL’s capital profile and its ability to operate profitably across cycles, whilst maintaining comfortable liquidity. The outlook may be revised to “Negative” in case of significant weakening in the earnings, liquidity and capitalization profile or in case its portfolio shifts away from government securities.

Key rating drivers

Credit strengths

One of the leading stand-alone primary dealers in Sri Lanka: As one of the largest stand-alone primary dealers in Sri Lanka, CAL had a total asset base of LKR 11.7 Bn in January 2021 (LKR 14.4 Bn as on March 2020). Further, CAL has an experienced management team headed by the group MD (founder) and department head, who each have 30 plus years of experience in the PD industry. The trading operations are backed by an in-house research team as well robust IT and risk management systems. In addition, the presence of group entities offering various related financial services such as equity trading, asset management, and corporate advisory brings in synergistic benefits.

Modest credit risk profile: CAL's portfolio comprises solely of government securities (treasury bills, bonds and reverse repos on treasury securities). Hence, the portfolio is susceptible to interest rate risk stemming from adverse market interest rate movements. Company has so far not ventured into corporate debt given the illiquidity of this segment in Sri Lanka; therefore, it currently has no exposure to credit risk.

Improvement in capital profile, mainly due to strong internal generation: Due to strong internal generation, with a return on equity of 48.18% (9M FY2021), compared with 36.68% and 2.64% in FY2020 and FY2019, respectively, the net worth of the company has grown to LKR 2,758 Mn in December 2020 (LKR 2,010 Mn in March 2020). Due to a highly favourable interest rate environment, CAL was able to earn a healthy net profit of LKR 997 Mn in the 9M ended December 2020, compared with LKR 737 Mn in FY2020 (LKR 37 Mn in FY2019). ICRA Lanka expects the total profits in FY2021 to stand in the range of LKR 1.1 Bn, which is expected to improve CAL's net worth to around LKR 3.0 Bn. The risk weighted CAR stood at 30.72% in December 2020 (above the regulatory limit of 10%), compared with 15.57% in December 2019; gearing stood at 3.5 times in December 2020, compared with 5.9 times in March 2020 and 5.4 times in December 2019.

The company currently has a comfortable capital buffer of about LKR 1,847 Mn above the regulatory minimum capital requirement (LKR 1,000 Mn) in January 2021. Nonetheless, the recent directive by the CBSL to increase the minimum capital thresholds of PDs on a staggered basis (LKR 1.5 Bn, LKR 2.0 Bn and LKR 3.0 Bn in Jan-21, Jan-22 and Jan-23, respectively), imposes a need for the company to accumulate capital in the future from internal generation. The company expects to grow its capital base to around LKR 5.0 Bn in the medium term through internal generation; hence the dividend payouts to the parent entity, CALH may be restricted/ moderate, going forward. The envisaged higher capitalization is expected provide a healthy buffer against adverse market movements.

Credit challenges

Vulnerability to adverse market rate movements: CAL's portfolio in December 2020 stood at LKR 12.6 Bn (having reduced from LKR 24.1 Bn in July 2020), in comparison to LKR 14.3 Bn in March 2020; the weighted average portfolio duration stood at 2.72 (years) in December 2020 (1.88 in March 2020). Due to a falling interest rate environment in 9M FY2021, CAL intermittently grew and de-grew its portfolio in order benefit from capital gains; a key trading strategy of the company. However, ICRA Lanka notes that market interest rates have bottomed out currently, and are expected to rise in CY2021. Accordingly, based on the portfolio as of December 2020, a 100 bps rise in interest rates is expected to reduce total CAR by around 173 bps and increase gearing to around 3.8 times. Thus, CAL remains vulnerable to future trading losses and fair value losses, which may impact its earnings and capital profile.

Exposure to liquidity risk due to short term asset- liability maturity (ALM) mismatch: CAL's longer duration portfolio funded by shorter duration repo borrowings creates a sizeable short -term mismatch in the ALM profile. As in December 2020, the ALM mismatch stood at negative 27.4% in the less than 7-day bucket and negative 50.4% in the less than one year bucket, exposing the portfolio to liquidity risk. However, the highly liquid nature of the underlying securities, availability of bank funding lines (as in January 2021, CAL had unutilized credit lines totaling LKR 500 Mn) and access to CBSL funding, provide comfort from a liquidity perspective.

Analytical approach: For arriving at the ratings, ICRA has applied its ratings methodologies as indicated below: **Links to applicable criteria:** [ICRA Lanka Rating Methodology for Primary Dealers](#)

About the Company:

CAL is a licensed primary dealer in government securities in Sri Lanka. The Company is 90.8% held by Capital Alliance Holdings Limited, which is the holding company of the group, offering various financial and investment solutions including fixed income trading, stock broking, asset management and financial advisory. For the year ended March 31, 2020, CAL reported a net profit of LKR 737 Mn on a total asset base of LKR 14.4 Bn vis-à-vis a net profit of LKR 37 Mn on a total asset base of LKR 11.1 Bn in March 31, 2019. During the 9 months ended December 31, 2020, the Company reported a net profit of LKR 997 Mn on a total asset base of LKR 12.7 Bn vis-à-vis a net profit of LKR 795 Mn on a total asset base of LKR 14.1 Bn in the same period of the previous fiscal.

Key financial indicators of CAL - Audited

	FY2019	FY2020	9M FY2020*	9M FY2021*
Net Interest Income	222	339	254	313
Net Trading Profit	(31)	963	815	1,203
Net Operating Income	202	1,313	1,080	1,521
Profit after Tax	37	737	795	997
Net worth	1,419	2,010	2,178	2,758
Trading Portfolio	10,575	14,294	13,966	12,383
Total Assets	11,133	14,370	14,083	12,677
Return on Equity	2.64%	36.68%	48.65%	48.18%
Return on Average Assets	0.34%	5.79%	8.42%	9.83%
Capital Adequacy Ratio	17.81%	22.20%	15.57%	30.72%
Gearing (times)	6.80	5.92	5.27	3.45
Stock in Trade/ Net worth (times)	7.45	7.11	6.41	4.49

*Unaudited

Rating history for last three years:

Instrument	Amount Rated (LKR Mn)	Current Rating FY2021 Mar-20	Chronology of Rating History for the last 3 years		
			FY2020	FY2019	FY2018
			Feb-20	Feb-19	Jan-18
Issuer rating	N/A	[SL]A-(Stable)	[SL]A-(Stable)	[SL]A-(Negative)	[SL]A-(Stable)



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