ICRA Lanka revises the rating outlook of Asia Asset Finance PLC

May 04, 2021

Instrument*	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]BBB+; Reaffirmed, Outlook revised to Stable from Negative
Asset backed secured debenture program	1,000	[SL]A- (SO); Reaffirmed, Outlook revised to Stable from Negative

Rating action

ICRA Lanka Limited has reaffirmed the issuer rating of Asia Asset Finance PLC (AAF or the Company) at [SL]BBB+ (pronounced SL triple B plus). ICRA Lanka has also reaffirmed the issue rating of [SL]A-(SO) (pronounced SL A minus Structured Obligation) assigned for the LKR 1,000 Mn asset backed secured debenture programme of AAF. The letters SO in parenthesis suffixed to a rating symbol stand for Structured Obligations. The SO rating is specific to the rated issue, its terms, and its structure. The SO rating does not represent ICRA Lanka's opinion on the general credit quality of the issuer concerned. The outlook on the long term ratings is revised to Stable from Negative.

Rationale

The ratings factor in the operational, financial and managerial support which AAF derives from being a 73% owned subsidiary company of Muthoot Finance Limited (MFL or the parent) rated by ICRA Limited of India at [ICRA]AA+ (Stable). Further, ICRA Lanka notes that, while the capital adequacy ratios remain adequate, buffer over minimum capital requirement (set by the CBSL) remains modest. AAF reported tangible net worth (adjusted for revaluation reserves and deferred tax gains) of LKR 1,991 Mn and reported net worth of LKR 2,189 Mn, respectively as of Dec-20, which was close to minimum regulatory core capital requirement of LKR 2 Bn by January 2021. Further, the Company is required to have a minimum core capital requirement of LKR 2.5 Bn by January 2022, which is likely to be met through internal generation and capital infusion by the parent company. The ratings take into account MFL's consent to provide capital support in the future as well to meet the growth and regulatory requirement.

The credit strengths are, however, partly offset by the sustained deterioration of AAF's asset quality indicators, with high gross NPA ratio of 21.17% in Dec-20, in comparison to 16.21% in Mar-20 and 9.20% in Mar-19, mainly on account of higher slippages in the micro and SME related lending. ICRA Lanka is cognizant of the challenging macro-economic conditions that prevailed during the period, particularly affecting SMEs and other weaker segments of the economy. The ratings, however, factor the increasing exposure to asset backed products such as gold loans and leasing, from unsecured products such as microfinance and SME lending; exposure to asset backed lending has increased to about 75% as in Dec-20, compared to 63% in Mar-19 and 48% in Mar-18. The ratings also take cognizance of moderation in overall profitability, mainly on account of lending margin compression.

Outlook: Stable

The outlook revison to "Stable" from "Negative" reflects the improvement of the parent entity's rating and the additional support extended by the parent. The outlook revision also factors the increase in exposure to asset backed lending, including gold loans. The outlook may be revised to "Negaitve" in case of further deterioration in AAF's asset quality indicators, weakening profitability and also, in case of lower than expected support from MFL. The outlook may be revised to "Positive" in case of improvement in capitalization and asset quality indicators of the Company.

Key rating drivers

Credit strengths

Operational, managerial and financial support from the parent: AAF is a 73% owned subsidiary of MFL, which has demonstrated a track record of providing both financial and operational support to AAF over the past few years. In FY2019, MFL infused about LKR 470 Mn via rights issue; which increased its stake to 73%. Furthermore, ICRA Lanka notes the initiatives taken by the parent to infuse fresh capital in the near-term. MFL is represented by three board members on the nine-member board. Operationally, MFL also provides support in staff training, internal controls, and internal audit functions. Going forward, timely support from the parent company, in order to meet future regulatory and growth capital requirements will be crucial, from a rating point of view.

Increasing exposure to asset backed lending: As in December 2020, AAF reported a gross portfolio of LKR 13,308 Mn vis-à-vis LKR 13,871 Mn in March-20 and LKR 12,586 Mn in March-19. ICRA Lanka notes that, over the last three years, the Company has shifted its exposures towards asset backed lending, with gold loans being the key asset class; and the Company has discontinued its clean lending products typically with high asset quality risks such as micro-finance and working capital financing. Exposure to asset backed lending has increased to about 75% as in Dec-20, compared to 63% in Mar-19 and 48% in Mar-18. As in Dec-20, gold loans accounted for about 40% of the total portfolio with an average loan to value (LTV) ratio of about 70% on gold loans. The management intends to further increase its gold loan exposure over the medium term. ICRA Lanka takes cognizance of the relatively low credit risk and higher liquidity of these gold loans while taking note of the vulnerability to market risk stemming from gold price fluctuations.

Adequate capitalisation ratios, while buffer over core minimum capital may remain modest: As in December 2020, AAF had a total reported net worth of LKR 2.19 Bn (LKR 1.99 Bn adjusted for deferred tax), which puts the NBFI close to the minimum capital requirement of LKR 2 Bn as of January 2021. However, ICRA Lanka notes that internal generation remains modest in relation to additional core capital required to meet the January 2022 capital target of LKR 2.5 Bn set by the CBSL; but capital support, from the parent company is expected to be forthcoming. The parent entity aims to provide a capital infusion of LKR 500 Mn in Q1 of FY2022 followed by another capital infusion of LKR 300 Mn within the next year. From a risk weighted capital adequacy point of view, AAF remained comfortable, where the core CAR and total CAR stood at 16.5%, as in December 2020 against the regulatory minimum of 6.5% and 10.5%, respectively.

Steady reduction in dependence on deposits supports liquidity profile: AAF has a fairly diversified funding profile comprising of retail fixed deposits, debentures, term loans from banks, and securitised borrowings. The funds from fixed deposits have moderated over the years with 50% of the funding base consisting of fixed deposits as in Dec-20 in comparison to 52% in Mar-20, 57% in Mar-19 and 85% in Mar-18. Going forward, with the expected expansion in the gold loan portfolio, AAF expects to further reduce the dependency on public funds and improve the long-term funding sources such as securitisation. Gearing has remained fairly constant with 5.90 times reported in Dec-20 in comparison to 5.86 times in Mar-20 and 5.93 times in Mar-19.

Credit challenges

Weak asset quality indicators, however the portfolio shift towards secure asset backed lending provides some comfort: AAF witnessed deteriorating asset quality indicators from Q1FY20 in line with the industry trend. The GNPA ratio increased to 21.17% as in Dec-20 in comparison to 16.21% in Mar-20 and 9.20% in Mar-19. ICRA Lanka notes that, close to 70% of total GNPAs of the Company are from the discountinued clean lending portfolio, as SME and micro-segments were significantly affected since April 2019. In addition, ICRA Lanka notes that bulkf of these non-performing clean lending facilities are fully provided for, thus the GNPA adjusted for these fully provided facilities would be around 13% as in Dec-20. Going forward, ICRA Lanka envisages the GNPA ratios to improve mainly due to the portfolio shift towards relatively better asset quality segments, such as Gold loans and the discontinuation of the unsecured lending. The Net NPA ratio of AAF has moderated over the years as a result of the moderation in the provision coverage. The Net NPA ratio moderated to 6.75% in Dec-20 from 6.65% in Mar-20 and 0.90% in Mar-19. The provision coverage has reduced due to the increased portfolio of the gold loans which require lower provisioning. The Company's ability to arrest incremental slippages and improve overall asset quality will remain a key monitorable, going forward.

Margins likely to remain moderated driven by increased focused on asset-backed lending: With the portfolio being shifted away from the unsecured lending to asset-backed products such as gold loans, the lending margins have moderated over the years and is likely to remain moderated in near term. Furthermore, the sharp decline in the systemic interest rates has also affected AAF's yields. As a result, the Company witnessed a decline in annualised NIMs to 6.06% in Dec-20 compared to 9.22% in Mar-20 and 10.08% in Mar-19. The credit cost (loan provisioning/average total assets - ATA) was 2.63% for FY2020 vis-à-vis 2.79% in FY2019; for the 9MFY21, AAF reported a credit cost of 2.39%. The credit cost slightly moderated on account of the expansion in the gold loan portfolio which requires lower provisioning. During the 9M ended Dec-20 the cost to income ratio has moderated to 65%, from about 68 – 70% in the previous years. Going forward, it is crucial for the Company to manage its operating and credit costs, as room for lending margin expansion will be limited. ROA (PAT/ ATA) has also moderated to 0.15% in 9MFY2021, compared to 0.48% in FY2020 and 0.79% in FY2019

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.
Links to applicable criteria: ICRA Lanka's Credit Rating Methodology for Non-Banking Financial Institutions

About the Company:

Asia Asset Finance PLC is a registered finance company setup in 1970 as "Finance and Land Sales Company". In 2004, Asia Capital PLC (ACP) acquired AAF. In August 2014, MFL acquired about 30% of the Company and in December 2014, MFL increased its stake up to 51%. During FY2020, MFL has further increased its stake to about 73% via a rights issue. AAF offers gold loans, SME loans, vehicle finance (2 wheelers, 3 wheelers, cars & vans etc.), loan against property, fixed deposits and other personal credit facilities.

During FY2020, AAF reported a PAT of LKR 70 Mn on an asset base of LKR 15.16 Bn, as compared with a PAT of LKR 101 Mn on a total asset base of LKR 13.9 Bn in the previous financial year.

During 9M ended December 2020, AAF reported a profit after tax of LKR 18 Mn on an asset base of LKR 15.32 Bn, as compared to a PAT of LKR 91, during the 9M ended December 2019.

Key financial indicators (audited)

	FY2019	FY2020	9MFY2021 (Unaudited)
Net Interest Income	1,289	1,339	693
Profit after Tax	101	70	18
Reportred net worth	1,953	2,171	2,189
Loans and Advances (Net)	11,707	12,857	13,077
Total Assets	13,899	15,155	15,316
Return on Equity	5.3%	3.4%	1.1%
Return on Assets	0.8%	0.5%	0.2%
Gross NPA	9.2%	16.2%	21.2%
Net NPA	0.9%	6.7%	6.8%
Core Capital Adequacy Ratio	15.6%	16.2%	16.5%
Gearing (times)	6.8	6.5	6.5

Rating history for last three years:

Instrument	Current Rating			Chronology of Rating History for the past 3 years			
	Type	Amount Rated (LKR Mn)	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019	Date & Rating in FY2018
			Apr-21	Jul-20	Dec-19	Nov-18	Feb-18
Issuer rating	N/A	N/A	[SL]BBB+ (Stable)	[SL]BBB+ (Negative)	[SL]BBB+ (Negative)	[SL]BBB+ (Negative)	[SL]BBB+ (Stable)
Asset Backed Secured Debenture	Long Term	1,000	[SL]A-(SO) (Stable)	[SL]A- (SO) (Negative) ; assigned	N/A	N/A	N/A

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