ICRA Lanka reaffirms the issuer rating at [SL]A- for Capital Alliance Limited; revises outlook to Negative

March 19, 2019

Instrument*	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	[SL]A-reaffirmed; outlook revised to Negative from Stable

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, 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 has been revised to Negative from Stable.

Rationale

The revision in outlook factors in the weakening in CAL's capital profile following the sizeable share buyback in FY2018 and the losses incurred in 9MFY2019. The Tier-1 capital adequacy ratio stood at 13.8% in December 2018, reduced from 43.7% in March 2018 (23.4% in March 2017) because of a deterioration in its capital base (to LKR 1,158 Mn in December 2018 from LKR 1,384 Mn in March 2018) and increase in the portfolio duration. The portfolio duration increased to 4.2 times in January 2019 from 1.3 times in March 2018 (2.3 times in September 2017; 3.7 times in March 2017). While ICRA Lanka takes note of the trading gains made in January 2019 as CAL scaled-down its portfolio by about LKR 4Bn, which partly offset the losses incurred during 9MFY2019; expectation of upstreaming future surplus generations, over and above the current capital buffer of about LKR 300 Mn over the minimum regulatory capital, to the shareholders would keep CAL's capital profile moderate in relation to the interest rate risk as the portfolio grows going forward. Although ICRA Lanka is cognizant of the downward pressure on systemic interest rates in the near term; any future adverse movements of systemic interest rates and the corresponding impact on the Company's risk profile is a key monitorable going forward.

The rating continues to factor in CAL's position as one of the leading standalone primary dealers in Sri Lanka with an established track record. The rating also factors in CAL's modest portfolio risk, its good internal control & robust IT systems, and synergies emerging from group entities which offer other financial services such as equity brokering, asset management and financial advisory. The rating takes cognizance of the significant short-term asset liability mismatches, as the long-term investment positions are funded by short-term repo borrowings; liquid nature of the portfolio, access to Central Bank of Sri Lanka (CBSL) funding and availability of funding lines however provide comfort.

Outlook: Negative

The Negative outlook factors in the moderation in CAL's capital profile in relation to the interest rate risk. The outlook may be revised to "Stable" if CAL is able to improve its capital profile, register adequate earnings and maintain a comfortable liquidity. The rating may be revised downwards in case the capital profile continues to remain moderate in relation to the risk or in case of significant weakening in earnings or liquidity position.

Key rating drivers

Credit strengths

Position as one of the leading stand-alone primary dealers in Sri Lanka: CAL is one of the leading standalone primary dealers in Sri Lanka with a total asset base of LKR 10.5 Bn as in December 2018 (LKR 6.6 Bn in January 2019). Trading operations are supported by an in- house research team as well as robust IT and risk management systems. The presence of group entities offering various related financial services such as equity trading, asset management and investment banking 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) and therefore carries no significant credit risk. However, the portfolio is susceptible to market risk stemming from adverse interest rate movements.

Credit challenges

Vulnerability to adverse interest rate movements: CAL's portfolio as in January 2019 stood at LKR 6.4 Bn (reduced from LKR 10.5 Bn in December 2018), in comparison to LKR 10.7 Bn in March 2018 and LKR 7.5 Bn in March 2017; weighted average portfolio duration stood at 4.2 times in January 2019 (1.26 times in March 2018 and 3.68 times in March 2017). CAL's portfolio therefore is susceptible to adverse interest rate movements, which could impact its earnings and capital profiles.

For the 9M ended December 2018, CAL reported a net loss of LKR 210Mn, largely because of trading losses (LKR 295 Mn) incurred during the period. However, in January 2019, as systemic interest rates moderated vis a vis the highs witnessed in Q4 CY2018, the Company was able to recognise some trading gains (about LKR 150 Mn; provisional) by selling some of its exposures, which helped to reverse some of the overall losses incurred. Although domestic interest rates have eased somewhat currently, interest rate risk continues to remain a key monitorable.

Weakened capital profile: ICRA Lanka takes note of the sizable share buyback of LKR 373 Mn by Capital Alliance Holdings in FY2018, which resulted in a moderate decrease in CAL's networth during the year, although it generated net profits of LKR 555 Mn for the period. As in December 2018, CAL's total capital base reduced to LKR 1,158 Mn (LKR 1,384 Mn in March 2018 and LKR 1,279 Mn in March 2017) due to trading losses incurred during 9MFY2019. Moreover, gearing increased from 6.7 times in March 2018 (4.9 times in March 2017) to about 8 times in December 2018, because of the deterioration in networth. However, following trading gains realised during the month of January 2019, total networth increased to LKR 1.3 Bn (provisional) as at 31st January 2019, while gearing improved to about 4 times; CAL unwound its portfolio by around LKR 4 Bn in order to record the above mentioned trading gains.

Any adverse interest rate movements, considering the high portfolio duration, is expected to impact CAL's capital profile, as it currently has a modest capital buffer of LKR 300 Mn above the regulatory minimum capital requirement (LKR 1,000 Mn). ICRA Lanka expects upstreaming of future surplus generations by CAL, over and above the current capital buffer, which would keep its capital profile vulnerable to adverse interest rate movements.

Sizable asset liability maturity (ALM) mismatch in short-term buckets: CAL's longer duration portfolio funded by shorter duration repo borrowings creates a sizeable short-term mismatch in the ALM profile. As in September 2018, the ALM mismatch stood at negative 42% in the less than 7-day bucket and negative 76% in the less than one year bucket, exposing the portfolio to short-term liquidity risk. However, the highly liquid nature of the portfolio and availability of bank funding lines (as in December 2018, CAL had unutilized credit lines totalling LKR 1.8 Bn) provide comfort from a liquidity perspective.

Vulnerability to unfavourable regulatory changes: Any adverse regulatory changes, such as increasing capital requirements for primary dealers and controls on repo/reverse repo transactions, has the potential to impact primary dealer performances, including CAL.

Analytical approach: For arriving at the ratings, ICRA Lanka has applied its rating 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 90.4% held by Capital Alliance Holdings, which is the holding company of the group, offering financial and investment solutions including fixed income trading, stock broking, asset management and financial advisory.

For the year ended March 31, 2018, CAL reported a net profit of LKR 555 Mn on a total asset base of LKR 10.8 Bn vis-a-vis a net profit of LKR 307 Mn on a total asset base of LKR 7.5 Bn on March 31, 2017.

During the 9 months ended December 31, 2018, the Company reported a net loss of LKR 210 Mn on a total asset base of LKR 10.5 Bn.

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