ICRA Lanka revises the outlook of Citizens Development Business Finance PLC to Negative

October 26, 2018

Instrument*	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	[SL]BBB+ reaffirmed; outlook revised to Negative from Stable
Subordinated, unsecured, listed redeemable debentures program	N/A	1,250	[SL]BBB (Negative); assigned
Trust Certificates Programme of Citizens Development Business Finance PLC Trust-03	628	628	[SL]A-(SO) reaffirmed; outlook revised to Negative from Stable
Subordinated, unsecured, listed redeemable debentures program	2,000	2,000	[SL]BBB reaffirmed; outlook revised to Negative from Stable
Subordinated, unsecured, listed redeemable debentures program	1,000	1,000	[SL]BBB reaffirmed; outlook revised to Negative from Stable
Subordinated guaranteed listed redeemable debentures	1,000	1,000	[SL]A-(SO) (Stable); reaffirmed
Total	**4,628**	**5,878**	

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Citizens Development Business Finance PLC (CDB or the company) at [SL]BBB+ (pronounced SL triple B plus) while revising the outlook to negative from stable. ICRA Lanka also reaffirmed the issue ratings of [SL]BBB (pronounced SL triple B) assigned to the LKR 2,000 Mn and LKR 1,000 Mn subordinated, unsecured, listed redeemable debentures programs while revising the outlook to negative from stable. ICRA Lanka has assigned the issue rating of [SL]BBB (Pronounced SL triple B) with a negative outlook to the proposed LKR 1,250 Mn subordinated, unsecured redeemable debentures program of CDB, which is to be listed on the Colombo Stock Exchange.

ICRA Lanka also reaffirmed the issue rating of [SL]A-(SO) (pronounced SL A minus structured obligation) for the Trust Certificates Programme of Citizens Development Business Finance PLC Trust-03, while revising the outlook to negative. The letters SO in parenthesis suffixed to a rating symbol stand for structured obligation. A 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.

ICRA Lanka has also reaffirmed the [SL]A-(SO) (pronounced SL A minus structured obligation) rating with stable outlook for the LKR 1,000 Mn subordinated guaranteed listed redeemable debentures of the company, guaranteed by Seylan Bank PLC (Seylan). The rating for the subordinated guaranteed redeemable debentures programme is based on the strength of the unconditional and irrevocable guarantee from Seylan Bank PLC (Seylan) covering the principal and two interest instalments (semi-annual) of the rated issue. The guarantor undertakes the obligation to pay, on demand from the trustee, the total principal sum of LKR 1,000 Mn and, two half yearly interest instalments of the proposed redeemable debentures. The rating also assumes that the guarantee will be duly invoked by the trustee, as per the terms of the underlying trust deed and guarantee agreement, in case there is a default in payment by CDB.

Rationale

The revision in the outlook of the issuer rating, trust certificate rating and the issue ratings for the subordinated debentures, factor in the weakening of CDB's capitalisation and asset quality profiles in H1FY2019. CDB's gearing (adjusted for revaluation reserve) ratio increased to 9.9 times as of Sep-18 (provisional) vis a vis 9.5 times as of Mar-18 and 8.0 times as of Mar-17 largely because of the aggressive portfolio growth of 26% (annualised) during H1FY2019 (38% FY2018). The company's provisional core and total capital adequacy ratios stood at 7.44% and 10.20% as of Sep-18. Further, CDB's gross NPA ratio (6 months lagged basis[1]) increased to 7.1% (provisional) as of Sep-18 vis a vis 3.7% in Mar-18, because of macro-economic challenges. CDB's NPAs excluding repossessed assets stood at 4.8% (6 months lagged basis) as of Sep-18. The ratings however, continue to factor in CDB's established track record and experienced senior management team, efficient internal controls and overall risk management systems, and exposure to relatively safer asset classes, namely cars and vans (63% of the portfolio in June 2018).

ICRA Lanka further takes cognizance of the company's sizable asset liability mismatches in the short-term because of high dependence on short-term public deposits, and decline in CDB's profitability indicators. Going forward, the company's ability to improve its capitalization, asset quality and earnings profile would be crucial from a rating perspective.

Outlook: Negative

The outlook may be revised to "Stable" based on CDB's ability to improve its capitalisation and asset quality profiles while maintaining healthy profitability indicators. The ratings may be downgraded in case of further weakening in the capital structure or deterioration in the asset quality indicators from current levels.

Key rating drivers

Credit strengths

Established track record and experienced senior management team: CDB was established in 1995; it has a robust franchise and an experienced management team. The company has about 71 outlets (including service centres) and has access to about 600+ ATM machines (in alliance with Commercial Bank) across the island as on June 30, 2018. CDB is one of the relatively large non-banking financial institution with an asset base of LKR 79 Bn as of June 2018. The senior management team holds about 16% stake in the company and are experienced professionals in the retail financing business. The management team has been associated with the company for over a decade and there has not been any significant attrition in the senior management over the last 5-6 years.

Efficient internal controls and risk management systems: CDB has a comprehensive core-banking system, which seamlessly integrates the key business functions including loan origination, appraisal, monitoring and accounting & finance and thus, providing access to timely management information system and monitoring. CDB's branches and its dealer network operate as the primary business generation unit (about 97% of new business) and online channel also provide business leads (about 3%). The company's loan appraisal includes field verifications, income estimation of the borrowers and CRIB report checks to evaluate loan eligibility. Collections are mainly in the form of cash and direct bank deposits. For recoveries, CDB employs a dedicated call centre and recovery officers. CDB's accounting policies are in line with

[1] Current gross NPA/ 6-months lagged gross portfolio

industry practices and in Mar-18, the company has early adopted the SLFRS9 standard on Financial Instruments.

Exposure to relatively safer asset classes; About 98% of CDB's portfolio is backed by assets (vehicles/property), with 87% being as lending for vehicles. Cars and vans accounted for about 60-63% of the total portfolio since Mar-17. CDB's exposure to 3-wheelers stood at 16% as of Mar-18 and Jun-18 vis a vis 20% in Mar-17 and 26% in Mar-16. Cars and vans are the core asset classes of CDB, while relatively risky 3-wheeler is expected to be about 15-20% of the portfolio going forward. The company's loan segment, which accounted for 12% of the total portfolio as of Jun-18, largely comprised of property backed lending to SME and retail segments (5% of total portfolio), loans against fixed deposits (2%), personal loans (2%) and pawning (2%). CDB envisages to achieve a portfolio mix with 75% being motor loans and 25% as non-motor loans, going forward.

Credit challenges

Weakening capital profile: CDB' gearing (adjusted for revaluation reserve) is relatively high when compared to peers; it increased to 9.9 times as of Sep-18 (provisional) from 9.5 times as of Mar-18 (8.0 times as of Mar-17), as internal generation was moderate at about 18% in relation to the business growth of about 26% (annualised) during H1FY2019. CDB's provisional core and total capital adequacy ratios stood at 7.44% and 10.20% as of Sep-18 (based on new CBSL guidelines and factoring in the IFRS 9 adjustments). While core CAR ratio is above the regulatory threshold of 6%, CDB's total CAR stood marginally above the requirement of 10%. However, including H1FY2019 provisional profits, the same improved to about 8.30% and 11.33% respectively. ICRA Lanka takes note of the initiatives taken by the company to secure equity and tier II capital. Further, ICRA Lanka estimates the company may need to raise about LKR 2.0-2.4 Bn as fresh equity over the period FY2019-FY2021 to support the envisaged growth of 20% per annum, while maintaining an adequate buffer (2%) to Tier-I minimum requirement, during the above-mentioned period. CDB's ability to secure external capital and maintain a comfortable and risk-adjusted capital profile would be crucial, given the envisaged relatively aggressive growth in relation to internal generation.

Deteriorated asset quality: CDB's delinquencies in 90+dpd increased to 14.1% in Jun-18 from 11.2% in Mar-18 and 9.5% in Mar-17. The company's gross NPA ratio (6 month lagged basis) stood high at 7.09% (provisional) in Sep-18, vis a vis 5.43% in Jun-18 and 3.67% in Mar-18 (3.34% in Mar-17). However, the same when adjusted for repossessed stock stood moderate at 4.78%, 3.62% and 2.36% respectively. The increased slippages were witnessed largely because of macro-economic challenges, such as modest economic growth and increased indirect taxation that affected the disposal income of its borrowers. CDB's collateralized nature of lending (98% of portfolio asset backed as of Jun-18) provides comfort with regard to the recoverability of NPA facilities. Going forward, the company's ability to curtail future slippages, while recovering from current NPA portfolio would be critical going forward.

Sizeable short-term mismatches, however good deposit renewal rates provide comfort; Fixed deposits, accounted for about 66% of the total debt as on September 30, 2018 (66% as on March 31, 2018); proportion of savings has remained range bound at about 3-4%, while debt instruments and bank borrowings accounted for the balance. CDB's ALM profile is characterized by sizeable mismatches in the < 1-year bucket (19.2% as on August 31, 2018) because of the near-term maturity profile of its deposits. However, good deposit renewal rate of about 75% and the long-standing relationships with banks and other financial institutions provide comfort on CDB's overall liquidity profile.

Moderation in profitability indicators: ICRA Lanka takes note of the moderation of CDB's RoA to 1.7% as of Sep-18 (provisional) vis a vis 2.2% as of Mar-18 (1.9% as of Mar-17) largely on account of sharp increase in credit cost (1.9% in Sep-18 vis a vis 0.6% in Mar-18; based on SLFRS9 standard), because of deterioration in the asset quality of the portfolio. The company's operating expenses (operating expenses/ATA) remained stable at about 4.7-4.9% since March 2017. CDB's fee and non-interest income improved to 1.5% in FY2018 from 1.0% in FY2017. Going forward, CDB's ability to manage credit cost, as competitive pressures are expected to limit margin expansion going forward, would be crucial for incremental profitability.

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:

Citizens Development Business Finance PLC, a registered finance company, offers leasing, hire purchase, mortgage loans, gold loans and other personal loans apart from accepting deposits (fixed and savings). The company was established in 1995 as Ceylinco Development Bank Limited. In 2009 CDB was registered under the Finance Companies Act and re-branded as Citizens Development Business Finance PLC. It was listed on the Colombo Stock Exchange in September 2010. As of Jun-18, CDB's largest shareholder were Ceylinco Insurance PLC (with an effective holding of 40%), CDB's corporate management (about 16%) and Janashakthi group (about 12%). The company operates 71 outlets (including service centres) and has access to over 600 ATMs (in alliance with Commercial Bank) across the island as of June 2018. The company acquired controlling stake in Unison Capital Leasing (previously known as Laughs Capital Limited) in October 2014 and currently holds about 90% shares of the company.

During the year ended March 31, 2018 CDB (stand-alone) reported a net profit of LKR 1401 Mn on a total asset base of LKR 75.5 Bn as compared to net profit of LKR 1,007 Mn on a total asset base of LKR 53.9 Bn in the previous fiscal year.

For the three months ended June 30, 2018 CDB reported a net profit of LKR 321 Mn on a total asset base of LKR 79.0 Bn.

Guarantor Profile:

Seylan Bank PLC (Seylan) with total asset base of LKR 413 Bn as in March 31, 2018 (LKR 408 Bn in December 31, 2017) accounted for about 3.9% of sector assets; it also accounted for 4.4% of sector loans and advances and 4.0% of the sector deposits as in March 31, 2018. The bank was incorporated in the year 1987. Sri Lanka Insurance Corporation Ltd (15.0%), Browns and Company PLC (13.9%), Employee Provident Fund (9.9%), LOLC Investments Limited (9.6%), NDB Bank (8.7%) and Bank of Ceylon (7.5%) are the major voting shareholders of the bank.

The bank recorded a total income of LKR 23,267 Mn for the H1CY2018 and LKR 49,174 Mn for CY2017 (LKR 37,753 Mn for CY2016). The net profits of the bank amounted to LKR 2,001 Mn during H1CY2018 and LKR 4,430 Mn for the CY2017 (LKR 4,010 Mn for CY2016), which resulted in RoA (PAT as a proportion of average assets) of 0.96% and 1.16% (1.23% in CY2016) for the respective periods. The bank had a gross NPA ratios of 5.50% and 4.42% as of Jun-18 and Dec-17 (4.47% as of Dec-16) and net NPA ratios of 3.96% and 3.10% respectively for the said periods (3.07% as of Dec-16). The bank had a net worth of LKR 35,609 Mn as on June 30, 2018 with tier 1 capital adequacy ratio of 10.13% and total capital adequacy ratio of 13.78%.

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