ICRA Lanka assigns [SL]BBB rating for the proposed Subordinated debenture programme of CDB Finance PLC

March 06, 2018

Instrument*	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Subordinated, Unsecured, Redeemable, Debentures program	N/A	LKR 1,000 Mn (with the option to increase up to LKR 2,000 Mn)	[SL]BBB (Stable); assigned
Issuer rating	N/A	N/A	[SL]BBB+ (Stable); outstanding
Subordinated unsecured redeemable debentures	1,000	1,000	[SL]BBB (Stable); outstanding
Subordinated guaranteed redeemable debentures	1,000	1,000	[SL]A-(SO) (Stable); outstanding
Total	**2,000**	**4,000**	

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has assigned the issue rating of [SL]BBB (Pronounced SL triple B) with a stable outlook to the proposed subordinated, unsecured, redeemable debentures programme of Citizens Development Business Finance PLC (CDB or the company) to be listed on the Colombo Stock Exchange.

Rationale

The rating takes cognizance of CDB's comfortable and stable asset quality indicators with the improvement in the portfolio risk profile. CDB has also been able to grow its portfolio in the competitive car-van segment (about 62% of the total portfolio as on December 31, 2017) with reasonable overall profitability indicators, notwithstanding some compression in business margins. The rating continues to factor in CDB's established franchise (asset base of about LKR 63 Bn as on September 30, 2017 with over 69 outlets), professional and experienced management team and its adequate appraisal and monitoring systems. ICRA Lanka however, takes cognizance of the competitive operating environment in the traditional vehicle financing space. CDB's relatively high gearing (about 8.36 times as in December 2017, after adjusting for revaluation reserve) and sizable asset liability mismatches in the short-term are largely because of high dependence on public deposits. Going forward, the company's ability to maintain a comfortable capitalization profile, healthy asset quality and adequate profitability profile would be crucial from a rating perspective.

Outlook: Stable

The outlook may be revised to "Positive" based on CDB's ability to successfully diversify its portfolio in the non-auto segments, while maintaining healthy asset quality and earnings profile. The outlook may be revised to "Negative" in case of steady weakening in the capital structure or any sizeable 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. CDB has about 69 branches and about 600+ ATM machines (in alliance with Commercial Bank) across the island as on December 31, 2017. The senior management team holds about 15% stake in the company and has a proven track record of strategic agility in transforming CDB to one of the relatively large non-banking financial institution with an asset base of LKR 63 Bn as of September 2017.

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 finance. This has improved the management information system and augmented the monitoring. CDB's 69 branches operate as the primary business generation unit while its dealer network and online channel also provide business leads. The company's loan appraisal includes 100% 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 (typically above 90% of the total collections) and PD cheques. For recoveries, CDB employs a dedicated call centre and recovery officers. CDB's accounting policies are in line with industry practices combined with adequate provisioning.

Steady shift to relatively safer asset classes- Cars and vans, which are relatively safe asset classes accounted for about 60% of the total portfolio as of March 2017 and December 2017. Cars and vans have been the core asset classes for CDB, as the company steadily shifted its portfolio from the riskier 3-wheelers over the last 2-3 years. CDB has significantly reduced the exposure to 3-wheelers (from 43% as in March 2014 to 17% as of December 2017) with corresponding increase in cars and vans (over 60% of the loan portfolio as of December 2017 vis-à-vis 32% as in March 2014).

Comfortable asset quality indicators: Asset quality of CDB remains better than systemic levels, because of its increased focus on safer asset classes and prime borrower segments; gross NPA was 3.2% as in September 2017 vis-à-vis 3.1% in March 2017 and 3.6% in March 2016. The asset quality is supported by relatively low NPAs (gross NPA at 3.2% as in September 2017) in the core asset segment, namely cars and vans. Going forward, CDB's ability to maintain good asset quality levels, in the light of envisaged high portfolio growth and diversification to other asset classes would be critical.

Credit challenges

Stretched capital structure: CDB' gearing is relatively high when compared to peers and the Industry. It has increased to 8.36 times as of September 2017 from 7.45 times as of March 2017 as internal generation was moderate at 15.6% in relation to the business growth of about 33% during the period. Going forward, company is expected to grow the portfolio at 25-30% per annum over the medium term; CDB's ability to secure external capital and maintain a comfortable & risk-adjusted capital profile would be crucial, given the relatively aggressive envisaged growth in relation to internal generation.

Sizeable short-term mismatches, however good deposit renewal rates provide comfort- CDB's funding profile is largely characterized by fixed deposits, which account for about 70% of the total debt as on September 30, 2017 (67% as on March 31, 2017); 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 (17.2% as on March 31, 2017) because of the short-term nature of the deposits. However, good deposit renewal rate of about 75% and the long-standing relationships with banks & other financial institutions provide comfort on CDB's overall liquidity profile.

Highly competitive nature of vehicle finance segment exert pressure on earnings: ICRA Lanka takes note of the moderation in lending margins (NIM 5.2% in H1FY2018 vis-à-vis 5.5% in FY2017 and 6.9% in FY2016) as CDB shifted its focus to low-risk asset classes, which are more competitive, and because of the increase in systemic rates during CY2016 to 1HCY2017. CDB's credit cost reduced over the last few years (credit provisions & write offs/ATA at 0.1% for H1FY2018 vis-à-vis 0.4% in FY2017 and 0.9% in FY2016), as the asset quality indicators were largely stable; operating expenses (operating expenses/ATA) also remained stable (5.3% in 1HFY2018, 4.7% in FY2017 and 5.1% in FY2016). CDB's fee and non-interest income stood at 2.4% in H1FY2018 (1.9% in FY2017) and RoA was 1.8% (1.9% in FY2017). Going forward, CDB's ability to manage the operating and credit expenses will be key drivers of profitability, as the scope for expanding lending yields because of competition is expected to be limited.

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 (CDB), set up in 1995 was initially named as Ceylinco Development Bank Limited. In 2009 CDB obtained RFC license and re branded itself as Citizens Development Business Finance PLC. CDB's largest shareholder is Ceylinco life insurance limited with an effective 33.5% stake as of September 30, 2017, while the company's ESOP owned about 25-28% of the shareholding, before the ESOP was distributed among the employees in March 2016. Currently, as one of the relatively large NBFIs in the Sri Lankan non-banking financial institutions sector, CDB offers leasing, hire purchase, deposits (fixed and savings) and other personal credit facilities. CDB was initially listed in the secondary board of the Colombo Stock Exchange and was transferred to the main board in December 2010. CDB operates 69 outlets and over 600 ATMs (in alliance with Commercial Bank) across the island as of September 2017. The company acquired controlling stake in Unison Capital Leasing (previously known as Laughs Capital Limited) and currently holds over 90% shares of the company.

During the year ended March 31, 2017 CDB (stand-alone) reported a net profit of LKR 1,007 Mn on a total asset base of LKR 53.9 Bn as compared to net profit of LKR 1,005 Mn on a total asset base of LKR 50.6 Bn in the previous fiscal year.

For the six months ended September 30, 2017 CDB reported a net profit of LKR 516 Mn on a total asset base of LKR 63.1 Bn.

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