ICRA Lanka assigns [SL]A- rating for proposed subordinated debentures program of LOLC Finance PLC

April 05, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]A (Stable); Outstanding
Subordinated unsecured redeemable debentures	5,000	[SL]A- (Stable); Outstanding
Proposed subordinated unsecured redeemable debentures	4,500 (3,500 Mn with the option to issue up to a maximum of 4,500 Mn)	[SL]A- (Stable); Assigned

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has assigned the issue rating of [SL]A- (Pronounced SL A minus) with stable outlook for the proposed LKR 4,500 Mn (LKR 3,500 Mn with the option to issue up to a maximum of LKR 4,500 Mn) subordinated unsecured redeemable debentures of LOLC Finance PLC (LOFC or the Company) to be listed on the Colombo Stock Exchange.

ICRA Lanka has the issuer rating of [SL]A (Pronounced SL A) with a stable outlook and issue rating of [SL]A- (Pronounced SL A minus) with stable outlook on the LKR 5,000 Mn subordinated unsecured redeemable debentures of LOFC, presently listed on the Colombo Stock Exchange.

Rationale

Lanka Orix Leasing Company PLC ("LOLC"/ "HoldCo") has 90% effective holding in LOFC. The ratings reflect the significant operational and financial linkages with LOLC and other peer subsidiaries and associates, especially entities in the financial services business. The contribution of financial services entities and other investments in financial services entities was about 81% of the consolidated PBT in 9MFY2018 and accounted for 96% total group assets as on December 31, 2017.

At group level, the rating factors in LOLC group's long track record, and leadership position in the Sri Lankan retail finance market, its experienced management team, commensurate risk management systems, its comfortable asset quality and adequate profitability indicators. ICRA Lanka takes note of the increase in group gearing and increase in the share of microfinance loans in the overall group lending portfolio post acquisition of PRASAC, thereby increasing the overall portfolio vulnerability considering the modest credit profile of the target borrowers. While ICRA Lanka takes cognisance of the diversification to newer geographies (Cambodia, Myanmar and Pakistan) over the recent past, the ability to manage country specific risks across business and regulatory cycles would be crucial from a rating perspective. Further, ICRA Lanka would continue to monitor the performances of the non-financial services entities and their contribution to the overall group going forward.

The rating continues to factor in LOFC's robust franchise, good competitive position and its professional and experienced management team. However, the company's gearing is relatively high and asset quality is moderate; it would therefore be crucial for it to undertake recoveries and control incremental slippages to keep NPAs within reasonable levels. ICRA Lanka takes note of the moderation in LOFC's earnings profile with RoA reducing to 1.4% in FY2017 from 1.6% in FY2016; it further reduced to 0.9% for 9MFY2018. The moderation in 9MFY2019 was partly because of the increased short-term liquid investments for LOLC Micro Credit Limited (LOMC) acquisition.

In January 2018, LOFC acquired LOMC by purchasing LOLC's 80% stake and FMO's (The Netherlands Development Finance Company) 20% stake for a consideration of LKR 12.2 Bn. The purchase consideration was settled using its internal resources. Between, January 29, 2018 to March 31, 2018, LOMC will be a subsidiary of LOFC. As a result, LOFC's regulatory capital adequacy would be significantly stretched on account of the LKR 12 Bn investment in LOMC; the total capital base of LOFC was LKR 13.1 Bn in Jun-17 (Tier I: LKR 10.8 Bn and Tier II: LKR 2.3 Bn).

LOMC is expected to be merged with LOFC by March 31, 2018. LOFC's and LOMC's provisional gearing (adjusted for revaluation reserve) stood at 10.4 times and 6.2 times respectively in December 2017. LOFC is expected to raise LKR 5.9 Bn via a proposed rights issue; LOLC is expected to invest part of the proceeds received from sale of LOMC in the proposed right issue. The company also intends to issue the proposed LKR 3.5 Bn (with option to increase upto LKR 4.5 bn) subordinated debenture, which is currently being rated, to augment its regulatory capital adequacy position. ICRA Lanka expects the above to adequately support the overall capitalisation profile of the merged entity.

ICRA Lanka does not expect any significant operational changes, as LOFC and LOMC have been sharing the branch network. However, operational level synergies and leverage are expected to improve post the merger. ICRA Lanka expects the asset quality of the merged entity to improve with the merger, as the reported asset quality of LOMC (GNPAs at 1.27% in Jun-17) was better than LOFC. However, the customer profile and target asset classes of LOMC are relatively moderate as compared with LOFC, which could expose the company to higher portfolio vulnerability during adverse business and economic cycle. The profitability of the merged entity is expected to improve, as LOMC reported better profitability (RoA at 2.98% in 8MFY2018 vis a vis LOFC's 0.9% in 9MFY2018) indicators on account of its higher business yields.

ICRA Lanka would continue to monitor the developments with regards to the proposed merger.

Outlook: Stable

ICRA Lanka expects continuous operational, management and financial support from the LOLC group. The outlook maybe revised to "Positive" in case of steady improvement in the group' business and financial risk profile. The outlook maybe revised to "Negative" in case of a significant weakening in the capital adequacy, asset quality and significant deterioration in earnings of LOFC or, in case of weakening in the group's performance.

Key rating drivers

Credit strengths

Long track record and established retail franchise of the group: At the group level, the rating factors in LOLC Group's long track record of more than 30 years, and leadership position in the Sri Lankan retail finance market. At group level, its financial subsidiaries have a branch network of 293 covering all 25 districts of the country. The group employs close to 5,300 employees. At company level, the rating factors, LOFC's more than 10 years track record of successful operations as one of the largest NBFIs in the country and accounted for 18% of the total assets of the LOLC group in December 2017. LOFC operates with 135 branches in the country. The company shares its branch network with LOMC. LOFC and LOMC have already been experiencing operational synergies, which is expected to enhance post-merger.

Experienced management team and good risk management systems: LOFC's board comprises of 6 directors including 3 non-executive directors. The LOLC group has an experienced senior management team, with knowledge in retail lending and banking, for managing its group entity operations including LOFC. The group has centralised the key business functions like IT & MIS, human resource, finance & accounts and risk management. The centralised model gives competitive advantage to LOLC group entities by optimising the overall operating costs. The group has a prudent loan origination policy and effective loan monitoring process, which provides them with early warning signals and helps them in adjusting the loan policies in line with the evolving credit trends. LOFC uses an IT system developed by sister group company- Lanka ORIX Information Services Limited (LOITS). While LOFC leverages and adheres to group level internal controls and risk management policies, it has also implemented company specific measures to address the core business requirements. LOFC has a prudent provisioning policy which is stringent than the regulatory requirement.

Comfortable group asset quality: LOLC group maintains a comfortable consolidated gross NPA of 3.2% in December 2017 when compared with the systematic average of 5.4% reported during the same period. LOLC's subsidiaries, Commercial Leasing and Finance PLC ("CLC"), LOMC and BRAC Lanka PLC ("BRAC") maintained a gross NPA of less than 3.0% in December 2017, while LOFC' asset quality was relatively moderate with gross NPA ratio at 6.3%. LOFC's ability to maintain a comfortable asset quality would be a key monitorable going forward.

Diverse funding profile of the group: LOLC group has a fairly diverse funding profile, with funding from various sources including, foreign funding agencies, local banks and public deposits. As of December 2017, 50% of the group's funds were sourced through short and long-term bank facilities and 43% was through fixed deposits.

Adequate earnings profile: In the 9MFY2018, LOLC's consolidated RoA moderated to an extent on account of higher credit cost, largely on account of LOFC and, the increase in the systemic rates; the overall group profitability was however adequate at about 2.5%. Consolidated RoA which stood at about 3.0% in FY2016, improved to 4.1% in FY2017 on account of one-time extraordinary gains.

Credit challenges

Increase in LOLC group's leverage: ICRA Lanka notes that the group level gearing increased to 6.1 times as on March 31, 2017 from 4.7 times as on March 31, 2016; it stood at 6.3 times as on December 31, 2017. The increase was mainly because of the leveraged acquisition of the controlling stake in PRASAC Micro Finance Institution Ltd (PRASAC) in Cambodia and the consolidation of the same into the group. The standalone gearing of PRASAC stood at 6.5 times as on June 30, 2017. In addition, the sizeable long-term foreign currency funding secured by the group's financial services entities (namely LOFC, CLC, LOMC and BRAC) during the period, which were invested in deposits and government securities for hedging against exchange rate movements and the local currency borrowings secured against these deposits resulting in higher balance-sheet liabilities. The gearing adjusted for the above stood at 5.8 times as on March 31, 2017 (4.7 times as on March 31, 2016).

LOFC' moderate asset quality and earnings profile: LOFC's standalone asset quality indicators deteriorated as gross NPA increased from 4.2% reported as on March 31, 2016 to 4.4% as on March 31, 2017 and 5.9% as on December 31, 2017. Higher delinquencies reported on the factoring portfolio which contributed 18% of the portfolio on March 31, 2017 was the key contributor for increase. LOFC has slowed its factoring business and has conservatively provided for exposures overdue for more than 30 days. ICRA Lanka noted that the deteriorating asset quality exerted pressure on LOFC's profitability. The above along with increase in the systemic rates and higher short-term liquid investments in anticipation of the acquisition of LOMC, impacted its net profitability, which moderated to 0.9% for 9MFY2018 from 1.4% in FY2017. The company's ability to maintain healthy interest margins and keep its asset quality under control would be crucial for maintaining a healthy earnings profile.

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 LOLC:

Setup in 1980, Lanka Orix Leasing Company PLC (LOLC) has evolved itself from a financial services provider to a holding company which has interests in trading, plantation, leisure and energy. The group has diversified geographically into Cambodia, Myanmar and Pakistan. As of December 31, 2017, financial services contributed to about 81% of PBT of the group and 96% of total assets of the group.

During the FY2017, LOLC group reported net profit of LKR 21 Bn on a total Asset base of LKR 641 Bn compared to net profit of LKR 9 Bn on a total Asset base of 380 Bn in the previous fiscal. The Group reported a net profit of LKR 13 Bn on a total asset base of LKR 770 Bn in 9MFY2018.

Key financial indicators – LOLC (Consolidated)

In LKR Mn	FY2016	FY2017	9MFY2018 (Unaudited)
Net Interest Income	20,366	24,776	32,146
Profit after Tax	9,331	20,921	13,244
Net worth	62,942	96,014	109,307
Loans and Advances	291,445	556,597	657,952
Total Assets	379,595	640,925	770,224
Return on Equity	28.3%	43.3%	28.1%
Return on Assets	3.0%	4.1%	2.5%
Gross NPA	5.1%	4.9%	N/A
Net NPA	0.4%	`0.0%	N/A
Capital Adequacy Ratio	N/A	N/A	N/A
Gearing (times)	4.7	6.1	6.3

About LOFC:

LOLC Finance PLC (LOFC), (set up in 2001) established initially as a wholly owned subsidiary of LOLC (Lanka Orix Leasing Company PLC), has a strong Retail Franchise among Licensed Finance Companies (LFCs) in Sri Lanka. In July 2011, as per the Central Bank of Sri Lanka (CBSL) directions, LOLC divested 10% of its stake in LOFC and was listed on the Colombo Stock Exchange (CSE). The LOLC Group is one of the largest business groups in the country and the holding company being among the first leasing company to be established in Sri Lanka. LOFC offers savings and deposits in local and foreign currency, extends loans mainly for auto finance and Islamic finance.

During the year ended March 31, 2017, LOFC reported a net profit of LKR 1.6 Bn on a total asset base of LKR 123 Bn as compared to a net profit of LKR 1.4 Bn on a total asset base of LKR 110 Bn in the previous financial year. The company reported a net profit of LKR 904 Mn for the 9MFY2018 on a total asset base of LKR 141 Bn.

Key financial indicators-LOFC

In LKR Mn	FY2016	FY2017	9MFY2018 (Unaudited)
Net Interest Income	6,758	7,030	5,766
Profit after Tax	1,427	1,587	904
Net worth	9,198	11,026	12,051
Loans and Advances	84,562	90,512	94,452
Total Assets	110,385	122,623	141,572
Return on Equity	16.6%	15.7%	10.5%
Return on Assets	1.6%	1.4%	0.9%
Gross NPA	4.2%	4.4%	6.0%
Net NPA	0.5%	0.5%	1.4%
Capital Adequacy Ratio	13.5%	13.3%	12.2%
Gearing (times, adjusted for revaluation reserves)	10.6	10.0	10.4

Rating history for last three years:

Instrument	Current Rating (FY2018)				Chronology of Rating History for the past 3 years		
	Type	Amount Rated (LKR Mn)	Amount Outstanding (LKR Mn)	Date & Rating Feb 2018	Date & Rating in FY2017 Jan 2017	Date & Rating in FY2016 Nov 2015	Date & Rating in FY2015 Aug 2014
Issuer rating	N/A	N/A		[SL]A (Stable)	[SL]A (Stable)	[SL]A (Stable)	[SL]A- (Stable)
Issue rating	Subordinated unsecured redeemable debenture	5,000	5,000	[SL]A- (Stable)	[SL]A- (Stable)	[SL]A- (Stable)	[SL]BBB+ (Stable)
Issue rating	Subordinated unsecured redeemable debenture	4,500	-	[SL]A- (Stable)			

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