ICRA Lanka assigns [SL]A1 rating to the Commercial Paper programme of LOLC PLC

May 31, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Commercial Paper Programme	1,000	[SL]A1; assigned
Issuer rating	N/A	[SL]A (Stable); rating outstanding
Listed Senior Unsecured Redeemable Debenture Programme	5,000	[SL]A (Stable); rating outstanding
Unlisted Senior Unsecured Redeemable, Debenture Programme	2,750	[SL]A (Stable); rating outstanding

Rating action:

ICRA Lanka Limited, Subsidiary of ICRA Limited, group company of Moody's Investors Service, has assigned [SL]A1 (pronounced SL A one) rating to the LKR 1,000 Mn commercial paper programme of Lanka ORIX Leasing Company PLC ("LOLC"/ "the Company").

Rationale:

LOLC is the holding company of the LOLC group. While arriving at the ratings of LOLC, ICRA Lanka had taken a consolidated performance of the group, which has interest in financial services, insurance, manufacturing and trading, plantation and renewable energy, and leisure.

The ratings factor in the 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. The ratings also take note of the increase in the group leverage and the increase in the share of unsecured credit in the overall group's lending business. While ICRA Lanka takes cognisance of the diversification to newer geographies (Cambodia, Myanmar and Pakistan) over the recent past, 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 nonfinancial services entities and their contribution to the overall group going forward.

Key rating drivers:

Credit strengths

Long track record and established franchise of the group in the financial services business: At the group level, the ratings factor 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 in Sri Lanka. The contribution of all financial services subsidiaries and other investments in financial services entities by the group was about 81% of the total PBT in 9MFY2018 and accounted for 96% total group assets as on December 31, 2017

Experienced management team and good risk management systems: LOLC's board comprises of 5 directors including 2 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. The group has centralised the key business functions like IT & MIS, human resources, finance & accounts and risk management. The centralised model gives competitive advantage to LOLC group entities by optimising the overall operating cost. 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.

Comfortable group asset quality: LOLC group maintained 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"), LOLC Micro Credit Limited ("LOMC") and BRAC Lanka PLC ("BRAC") maintained a gross NPA less than 3.0% in December 2017, while LOFC's asset quality was relatively weaker with gross NPAs at 6.3%. LOLC's ability to maintain a comfortable asset quality would be a key monitorable going forward.

Healthy liquidity position backed by 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. LOLC group's NBFI subsidiaries maintain a positive short-term (< 1 year) mismatch except for LOFC. LOFC reported a negative 12.3% ALM mismatch on December 31, 2017 which was below the industry averages. LOLC, being a holding company of the group, is expected to have limited and lumpy cash flows, it therefore has LKR 3.0 Bn contingent funding lines from two licensed commercial banks. This, along with good financial flexibility of LOLC's subsidiaries, provides comfort from a liquidity perspective.

Credit challenges

Increase in group leverage: ICRA Lanka notes that the group level adjusted gearing [1]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 resulted in higher balance-sheet liabilities. The gearing adjusted[2] for the above stood at 6.0 times as on December 31, 2017 as compared to 5.8 times as on March 31, 2017 (4.7 times as on March 31, 2016).

Increase in the share of unsecured lending portfolio: ICRA Lanka takes note of the increase in the share of microfinance loans in the overall lending portfolio of LOLC post acquisition of PRASAC and the growth witnessed in LOMC's and BRAC's portfolios, thereby increasing the overall portfolio vulnerability considering the modest credit profile of the target borrowers. As on December 31, 2017 (11% in December 2016) share of microfinance loans stood at 9% of the total LOLC group assets.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below**.**

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[1] Gearing adjusted for revaluation reserves and goodwill on acquisition

[2] Gearing adjusted for revaluation reserves, goodwill on acquisition and double financing effect of the foreign currency borrowings

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 ORIX Corporation of Japan which had 30% of LOLC since its inception, has presently divested the same. 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 for 9MFY2018.

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