

ICRA Lanka Reaffirms the long term ratings of Merchant Bank of Sri Lanka and Finance PLC (MBSL)

July 11, 2017

Instrument	Amount	Rating Action
Issuer Rating	N/A	[SL]A (Stable); reaffirmed
Subordinated Unsecured Redeemable Debentures	LKR 2,000 Mn	[SL]A-(Stable); reaffirmed
Unsecured Redeemable Debentures	LKR 1,514.76 Mn (reduced from LKR 2000 Mn)	[SL]A (Stable); reaffirmed
Unsecured Redeemable Debentures	LKR 485.24 Mn	[SL]A (Stable); withdrawn
Unsecured Redeemable Debentures	LKR 703.78 Mn (reduced from LKR 1,000 Mn)	[SL]A (Stable); reaffirmed
Unsecured Redeemable Debentures	LKR 296.22 Mn	[SL]A (Stable); withdrawn
Unsecured Redeemable Debentures	LKR 2,000 Mn	[SL]A (Stable); reaffirmed

ICRA Lanka Limited, subsidiary of ICRA Limited, group company of Moody's Investors Service, has reaffirmed the issuer rating of [SL]A (pronounced SL A) with stable outlook assigned to Merchant Bank of Sri Lanka and Finance PLC (MBSL or the Company). ICRA Lanka has also reaffirmed the issue rating of [SL]A- (pronounced SL A minus) with stable outlook assigned to the LKR 2,000 Mn subordinated unsecured redeemable debentures issued on May 03, 2017. ICRA Lanka has also reaffirmed the issue rating of [SL]A (pronounced SL A) with stable outlook assigned to the LKR 2,000 Mn unsecured redeemable debentures issued on November 13, 2014

ICRA Lanka has withdrawn the issue rating of [SL]A (pronounced SL A) with stable outlook for LKR 485.24 Mn unsecured redeemable debentures issued on March 28, 2013, at the request of the company, as the same has been fully redeemed on March 27, 2017 and reaffirmed the issue rating of [SL]A (pronounced SL A) with stable outlook for the LKR 1,514.76 Mn outstanding against the rated instrument.

ICRA Lanka has also withdrawn the issue rating of [SL]A (pronounced SL A) with stable outlook for the LKR 296.22 Mn unsecured redeemable debentures issued on December 17, 2013, at the request of the company, as the same has been fully redeemed on December 16, 2016 and reaffirmed the issue rating of [SL]A (pronounced SL A) with stable outlook for the LKR 703.78 Mn outstanding against the rated instrument.

The issuer and other issue ratings are upheld by MBSL's about 81% effective shareholding by Bank of Ceylon (BOC; rated [SL]AAA (Stable) by ICRA Lanka); the company is expected to derive operational, managerial and financial support from the strong parent. ICRA Lanka continues to factor in the company's weak asset quality indicators (gross NPA ¹at 8.91% as on March 31, 2017) and subdued profitability indicators (RoA² at 0.28% for CY2016), notwithstanding the improvement witnessed in the recent past. The capitalisation is stretched with gearing at 9.2 times as on March 31, 2017, the same is expected to increase with the envisaged portfolio growth of 20-25% over the period CY2017-CY2019, as internal generation would remain relatively moderate. ICRA Lanka also takes

¹ Gross NPA including interest in suspense

² RoA-return on average assets

cognizance of the highly competitive nature of the vehicle financing business in Sri Lanka, which is accentuated by the recent regulatory changes; this is expected to exert some pressure on the margin and business expansion of all players, including MBSL, over the medium term. ICRA Lanka takes note of the expected sale of the weak performing insurance subsidiary, MBSL Insurance Company Limited (MBSI) in the near term, on which MBSL holds an impairment provision of LKR 438 Mn. Timely divestment of the subsidiary is crucial in the near term to avoid any funding support from MBSL for meeting MBSI's contingency liabilities (estimated at LKR 484 Mn) and other regulatory requirements. ICRA Lanka observes that MBSI is not meeting some key regulatory requirements, including solvency and is currently on a forbearance from the Insurance Board of Sri Lanka. ICRA Lanka expects BOC to provide timely support to MBSL in the event of any devolvement of contingent liabilities or meeting other requirements.

MBSL's portfolio³ increased from LKR 23.2 Bn in December 31, 2015 to LKR 28.2 Bn in December 31, 2016; a growth of about 21%. As at March 31, 2017, the portfolio stood at LKR 29.4 Bn. MBSL's credit portfolio is dominated by leasing, which accounted for 50% of the portfolio, with other loans at 47% and hire purchase at 3% as in March 2017. The key asset classes include car (15%) lorry (14%) and cab (14%).

MBSL's asset quality improved during CY2016 with gross NPA at 9.3% in December 31, 2016 (13.3% in December 31, 2015). Gross NPAs moderated further to 8.9% in March 31, 2017 with improvement in recoveries. The company's NPA coverage [(gross NPA-net NPA) / gross NPA] however reduced to 39.4% as on December 31, 2016 from 42.3% as on December 31, 2015, it remained at 39.4% as on March 31, 2017 on account of reversals in some provisions.

MBSL mainly depends on public deposits; the share of deposits in the overall funding however increased from 62% in March 2016 to 72% in March 2017. The company is taking initiatives to increase the share of retail deposits going forward, on the back of its strong and established franchise. ICRA Lanka takes note of the unutilised bank facilities maintained by the company and expects timely funding support from BOC, which provides comfort from a liquidity perspective.

The overall capital adequacy ratio (CAR) of the company was marginally above the regulatory requirement (10%) at 10.4% (Tier-I⁴ at 10.3%) as on March 31, 2017. The same improved post the LKR 2 Bn subordinated debenture issuance in May 2017. The gearing however stood high at 9.2 times as on March 31, 2017. ICRA Lanka expects the gearing to remain elevated, as the envisaged growth of about 20-25% over the 3-year period ended December 31, 2019 would remain higher than the pace of internal generation (5.7% for CY2016).

The company's overall earnings profile is characterized by moderation in the NIMs to about 6.4% for the Q1CY2017 (CY2016 - 6.7%, CY2015 - 8.3%) with increase in the cost of funds and the gearing levels. MBSL's profitability is constrained as it was faced with higher operational costs and provisions made against its subsidiary. The credit cost nevertheless moderated to 1.0% in CY2016 from 2.9% in CY2015. The company reported a PAT of LKR 86 Mn in CY2016 vis-à-vis loss of LKR 78 Mn in the previous year. Going forward, ability to rationalise the operating costs by way of optimal business growth and, its ability to control credit costs would be critical for the improvement in the profitability indicators.

³ Credit Assets for FY 2014 included the combined figures of MBSL,MSB and MCSL

⁴ Tier-I regulatory requirement is 5%

Company Profile

MBSL was established in 1982 as a merchant bank. The Company had two subsidiaries, MBSL Savings Bank Ltd (MSB, Licensed Specialised Bank) and MBSL Insurance Company (Composite Insurer) and two associate companies, Lanka Securities (Pvt) Ltd (registered stockbroker) and MCSL Financial Services Ltd (a licensed finance company). Pursuant to the Master Plan on Consolidation of the Financial Sector proposed by the Central Bank of Sri Lanka (CBSL), in January 2015, MBSL Savings Bank Limited (MSB) and MCSL Financial Services Limited (MCSL) was merged with MBSL. MBSL offers leasing & HP, long and short term loans, microfinance and pawning to its clients. The company has 49 branches and employs more than 900 staff members.

MBSL Insurance Company Limited (MBSI) is 84% owned subsidiary of MBSL. The company offers life and general insurance products to its customers. MBSI has close to 50 branches and window offices covering Sri Lanka.

For the Q1CY2017, MBSL reported a PAT of LKR 50 Mn (CY2016: LKR 86 Mn) with a total asset base of LKR 33,158 Mn on March 31, 2017 (LKR 31,934 Mn in December 31, 2016). The company operated with a net worth of LKR 3,158 Mn and a gearing of 9.21 on March 31, 2017.

MBSL group reported a PAT of LKR 42 Mn for the Q1CY2017 (CY2016: LKR 81 Mn) with a total asset base of LKR 34,856 Mn in March 31, 2017 (LKR 33,641 Mn in December 31, 2016). The group operated with a net worth of LKR 3,170 Mn and a gearing of 9.18 on March 31, 2017.

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