

ICRA Lanka revises the outlook of Merchant Bank of Sri Lanka & Finance PLC to negative

July 19, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	Reaffirmed the rating [SL]A; Outlook revised to Negative from Stable
Senior Unsecured Redeemable Debenture Programme	LKR 1,514.76 Mn	[SL]A (Stable); withdrawn
Senior Unsecured Redeemable Debenture Programme	LKR 703.78 Mn	[SL]A (Stable); withdrawn
Senior Unsecured Redeemable Debenture Programme	LKR 2,000 Mn	Reaffirmed the rating [SL]A; Outlook revised to Negative from Stable
Subordinated Unsecured Redeemable Debenture Programme	LKR 2,000 Mn	Reaffirmed the rating [SL]A-; Outlook revised to Negative from Stable
Asset Backed Trust Certificate Programme of MBSL Trust - 01	LKR 1,463 Mn (Reduced from LKR 2,000 Mn)	[SL]A+(SO) rating outstanding; Outlook revised to Negative from Stable

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Merchant Bank of Sri Lanka & Finance PLC (MBSL or the Company) at [SL]A (Pronounced SL A). ICRA Lanka has reaffirmed the rating on LKR 2,000 Mn Senior Unsecured Redeemable Debentures at [SL]A (Pronounced SL A). ICRA Lanka has also reaffirmed the rating of LKR 2,000 Mn Subordinated Unsecured Redeemable Debenture at [SL]A- (Pronounced SL A minus). The outlook on the ratings have been revised to negative from stable.

ICRA Lanka has an A+(SO) rating outstanding on the LKR 1,463 Mn (reduced from LKR 2,000 Mn) Trust certificates of MBSL Trust-01. The outlook on the rating is revised to negative from stable. Please refer to our detailed rationale dated July 19, 2018.

ICRA Lanka has withdrawn the issue ratings of [SL]A (pronounced SL A) on the LKR 1,514.76 Mn senior unsecured redeemable debentures and LKR 703.78 Mn senior unsecured redeemable debentures, at the request of the company, as the same have been fully redeemed.

Rationale

The revision in the outlook factors in the expected weakening in MBSL' capital profile because of the increased provision requirements under the new accounting policy (IFRS-9) and poor internal generation in the near term. ICRA Lanka notes that MBSL' capital structure is already stretched with gearing at 9.4 times as on March 31, 2018. The company reported modest profitability of 0.3% ROA in CY2017 and a loss of -10.4% (annualized) for Q1CY2018 as credit costs increased because of high slippages reported on micro finance and personal loan portfolios. ICRA Lanka notes that the above along with MBSL's weak asset quality profile (GNPA at 10.97% in March 2018) is expected to adversely impact its solvency (Net NPA/networth) further, which currently stands subdued at 58%.

The ratings however continue to factor in the 81% effective shareholding by Bank of Ceylon (BOC; rated [SL]AAA (Stable) by ICRA Lanka); the company is expected to derive managerial and financial support from the parent. ICRA Lanka takes note of the steady capital requirement by MBSL, till July 2021, to meet the regulatory capital ratios. The ratings also factor in the continued weakness in MBSL Insurance Company Limited's (MBSI) performance (presently not meeting the regulatory solvency). ICRA Lanka notes that MBSI would require additional capital to meet any contingent liabilities and to improve its overall risk profile going forward, as MBSL is expected to retain MBSI as its subsidiary. The ratings take cognisance of the changes in the senior management team and other organizational changes undertaken by the company and would monitor the impact of the same on MBSL's performance and its risk profile. ICRA Lanka expects BOC to provide timely support to MBSL in the event of any managerial or funding related requirements

Outlook: Negative

The negative outlook reflects expected moderation in MBSL's financial risk profile characterized by a weakening in its capital and earnings profile. The outlook may be revised to 'stable' in case of steady improvement in MBSL's capital profile, asset quality and earnings profile. The ratings may be downgraded in case of the further deterioration in the financial risk profile of the company.

Key rating drivers

Credit strengths

Strong financial and managerial support from the parent: MBSL is 81.6% subsidiary of Bank of Ceylon (BOC, rated [SL]AAA (stable) by ICRA Lanka). The company derives strategic and financial support from its parent company. MBSL's board consist of 8 directors, out of which 4 directors are BOC representatives.

MBSL offers leasing, term loans, personal loans, microfinance, and gold loan facilities to its customers. The company has its own corporate advisory division which provides transaction advisory services to its clients. The company has a network of 49 branches around the country and over 900 employees. MBSL recorded a loan portfolio of LKR 30.4 Bn in Mar-18. Vehicle leases accounted for 52% of the portfolio, followed by personal loans (17%) and SME loans/term loans (12%) respectively. Going forward, the company is expected to focus on asset backed lending and reduce the share of unsecured lending, which currently stands at 25%. MBSL also plans to revamp its corporate advisory division to improve its fee-based income. ICRA Lank expects timely support from BOC to support its operations and portfolio growth going forward.

Credit challenges

Weak asset quality because of high slippages in unsecured loan category: MBSL's gross NPA increased from 9.27% in Dec-16 to 10.10% in Dec-17 and stood at 10.97% in Mar-18. The portfolio quality deteriorated due to poor performance of the micro finance and personal loans portfolios. The company has taken action to curtail its unsecured products and streamline its recovery activities in order to control further slippages. Solvency (Net NPA/Networth) of the company deteriorated from 51% in Dec-16 vis-a-vis 56% in Dec-17 and stood at 58% in Mar-18. ICRA Lanka expects the solvency to weaken further as asset quality pressures persists and as its capital profile could witness deterioration in CY2018.

Stretched capital position; likely to weaken further: The overall capital adequacy ratio (CAR) of the company was above the regulatory requirement of 10% and stood at 15.7% (Tier-I at 10.5%) as on March 31, 2018. The same improved post the LKR 2 Bn subordinated debenture issuance in May 2017. The gearing however stood high at 9.4 times as on March 31, 2018. ICRA Lanka expects the gearing to remain elevated, due to poor earnings performance expected in CY2018 and the significant provision adjustment required to

comply with IFRS-9. Further, the company would require steady capital infusion of about LKR 1 Bn, over the next 3 years, to meet the enhanced capital adequacy requirements for LFCs. ICRA Lanka expects timely support from BOC to meet its capital requirements.

Poor profitability: The company's credit cost increased to 2.7% for the Q1CY2018 (CY2017 - 1.0%, CY2016 - 1.0%) with increase in slippages of personal loans and micro finance. MBSL's profitability was further impacted by the increase in staff costs, which was affected during CY2017. The company reported a loss of LKR 83 Mn for the Q1CY2018 as compared to PAT of LKR 101 Mn in CY2017. Going forward, ability to control credit cost and rationalise the operating costs by way of optimal business growth would be critical for the improvement in its earnings.

Moderate liquidity; The company reported a short term (less than 1 year) ALM mismatch of -18% (mismatch as % of total assets) in Mar-18. MBSL mainly depends on public deposits; the share of deposits in the overall borrowings increased from 53% in December 2016 to 62% in March 2018. The company's liquidity is supported by its 80% deposit renewal rate and funding support from BOC. The company has close to LKR 1.8 Bn unutilised funding lines available from other commercial banks.

Analytical approach: For arriving at the ratings, ICRA Lanka has applied its rating methodologies as indicated below. The ratings also factor in the timely capital support from BOC, which uplifted the credit risk profile of MBSL.

Links to applicable criteria: [ICRA Lanka's Credit Rating Methodology for Non-Banking Financial Institutions](#)

About the company:

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 gold loans 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 CY2017, MBSL reported a PAT of LKR 101 Mn (CY2016: LKR 79 Mn) with a total asset base of LKR 35,645 Mn as at December 31, 2017 (LKR 31,926 Mn as at December 31, 2016). For the Q1CY2018, MBSL reported a loss of LKR 83 Mn with a total asset base of LKR 33,965 Mn. The company operated with a net worth of LKR 3,150 Mn and a gearing ratio of 9.41 times as at December 31, 2017.

MBSL group reported a PAT of LKR 103 Mn for the CY2017 (CY2016: LKR 74 Mn) with a total asset base of LKR 36,917 Mn as at December 31, 2017 (LKR 33,614 Mn as at December 31, 2016). For the Q1CY2018, MBSL reported a loss of LKR 123 Mn with a total asset base of LKR 35,355 Mn. The group operated with a net worth of LKR 3,134 Mn and a gearing ratio of 9.46 times as at March 31, 2018.

Key financial indicators

	CY2016	CY2017	Q1CY2018
Net Interest Income	2,028	2,448	603
Profit after Tax	79	101	(83)
Net worth	3,107	3,234	3,150
Loans and Advances (Gross)	27,052	28,754	28,858
Total Assets	31,926	35,645	33,961
Return on Equity	2.58%	3.18%	-10.42%
Return on Assets	0.26%	0.30%	-0.96%
Gross NPA	9.27%	10.10%	10.97%
Net NPA	5.87%	6.06%	6.02%
Capital Adequacy Ratio	10.69%	15.27%	15.70%
Gearing (times)	8.8	9.7	9.4

Rating history for last three years:

Chronology of Rating History for the past 3 years						
Instrument	Type	Amount Rated (LKR Mn)	Date & Rating FY2019	Date & Rating in FY2018	Date & Rating in FY2017	Date & Rating in FY2016
			Jul 2018	Jul 2017	May 2016	-
Issuer rating	N/A	N/A	[SL]A (Negative)	[SL]A (Stable)	[SL]A (Stable)	N/A
Senior Unsecured Redeemable Debentures	Long Term	1,514.76	[SL]A (Stable) Withdrawn	[SL]A (Stable)	[SL]A (Stable)	N/A
Senior Unsecured Redeemable Debentures	Long Term	703.78	[SL]A (Stable) Withdrawn	[SL]A (Stable)	[SL]A (Stable)	N/A
Senior Unsecured Redeemable Debentures	Long Term	2,000	[SL]A (Negative)	[SL]A (Stable)	[SL]A (Stable)	N/A
Subordinated Unsecured Redeemable Debentures	Long Term	2,000	[SL]A- (Negative)	[SL]A- (Stable)	[SL]A- (Stable)	N/A
Asset Backed Trust Certificates	Long Term	1,463	[SL]A+(SO) (Negative)	[SL]A+(SO) (Stable)	N/A	N/A

ANALYST CONTACTS

Mr. Dasith Fernando
+94 11 4339907
dasith@icralanka.com

Mr. Vidura Welathanthri
+94 11 4339907
vidura@icralanka.com

Mr. A.M Karthik
+91 44 45964308
a.karthik@icraindia.com

RELATIONSHIP CONTACT

Mr. W. Don Barnabas
+94 11 4339907
wdbarnabas@icralanka.com



Subsidiary of

ICRA Limited

A Group Company of Moody's Investors Service

CORPORATE OFFICE

Level 10, East Tower, World Trade Center, Colombo 01, Sri Lanka

Tel: +94 11 4339907; Fax: +94 11 2333307

Email: info@icralanka.com; Website: www.icralanka.com

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