ICRA Lanka revises the issuer rating outlook of Sanasa Development Bank to stable

September 20, 2018

Summary of rated instruments

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	Issuer rating of [SL] BBB- reaffirmed; Outlook revised to Stable from Positive
Guaranteed Redeemable Debentures, type A and type B, guaranteed by Sampath Bank PLC	LKR 2,000 Mn	[SL]A+(SO) with Stable Outlook reaffirmed
Guaranteed Redeemable Debentures, type C and type D, guaranteed by Seylan Bank PLC	LKR 2,000 Mn	[SL]A-(SO) with Stable Outlook Reaffirmed

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Sanasa Development Bank (SDB or the Bank) at [SL]BBB- (Pronounced SL triple B minus) while revising the outlook to stable from positive.

ICRA Lanka has also reaffirmed the [SL]A+(SO) (pronounced SL A Plus Structured Obligation) rating with stable outlook for the type A and type B redeemable guaranteed debentures of SDB amounting to LKR 2,000 Mn, which are guaranteed by Sampath Bank PLC (Sampath). ICRA Lanka has also reaffirmed the [SL]A-(SO) (pronounced SL A minus Structured Obligation) rating with stable outlook for the type C and type D redeemable guaranteed debentures of SDB amounting to LKR 2,000 Mn, which are guaranteed by Seylan Bank PLC (Seylan). The letters SO in parenthesis suffixed to a rating symbol stand for Structured Obligation. A SO rating is specific to the rated issue, its terms, and its structure. The SO ratings do not represent ICRA Lanka's opinion on the general credit quality of the issuer concerned.

The ratings for the redeemable guaranteed debentures are based on the strength of the unconditional and irrevocable guarantees from Sampath Bank PLC (Sampath) for the type A and type B redeemable guaranteed debentures and from Seylan Bank PLC (Seylan) for the type C and type D redeemable guaranteed debentures covering the principal and two interest instalments (Semi Annual). As the guarantor, Sampath Bank undertakes the obligation to pay on demand from the trustee, the total principal amounting to LKR 2,000 Mn, and two semi-annual interest instalments of type A and type B redeemable guaranteed debentures. Seylan Bank also undertakes the obligation to pay on demand from the Trustee, the total principal amounting to LKR 2,000 Mn, and two semi-annual interest instalments of type C and type D redeemable guaranteed debentures. The ratings also assume that the guarantees will be duly invoked by the Trustee, as per the terms of the underlying Trust Deed and guarantee agreements.

Rationale

The revision in the issuer rating outlook factors in SDB's weakening earnings profile (RoA[1] was 0.5% in H1CY2018 vis a vis 0.7% in CY2017) characterised by high cost of funds and operating expenses. The bank's

[1] Profit after tax / average total assets

borrowing cost stood at 10.3% and 10.4% for H1CY2018 and CY2017 respectively, when compared to 8.6% for CY2016. Further, the operating costs remained high above 4% over the last 3-years (4.25% in H1CY2018) largely because of the investments in augmenting the bank's systems and human resource over the period. SDB's capitalisation is adequate currently with Tier-I at 11.7% in Jun-18. However, as the envisaged capital raising of about LKR 1.3 Bn did not materialise, it would need to raise about LKR 2.8 Bn equity capital over the next 3-years (CY2018-20) to support portfolio CAGR of 20% for maintaining a comfortable tier-I ratio[2], considering the subdued annual internal generation of about 5-6%.The rating takes cognizance of the moderate deposit profile with low share of saving account (SA) deposits at about 17% (of total deposits) and the high asset liability mismatches (<1-year mismatch at -16.2% of the total asset base as of Jun-18). Good deposit renewal rate, granular nature of the deposits and its established franchise provides comfort from a liquidity perspective.

The issuer rating continues to factor in SDB's established operations and comfortable asset quality indicators. SDB has 93 branches out of which about 55 are in the semi-urban and rural areas. SDB has access to more than 1 Mn SANASA society members as it is the key financial institution of SANASA Federation. The bank maintained better than industry asset quality indicators over the last 3-years. Gross NPA ratio was at 2.53% in Jun-18 (2.08% in Dec-17 and 2.09% in Dec-16). Going forward, SDB's ability to maintain superior asset quality indicators, given its target customer segment (SMEs) and plans to move into larger tickets would be a key monitorable.

Outlook: Stable

The stable outlook reflects SDB's established operations and franchise and, comfortable asset quality indicators. The outlook may be revised to 'positive' in case of a steady improvement in the profitability indicators while maintaining a comfortable capitalisation and asset quality profile as portfolio expands. The outlook may be revised to negative in case of a further weakening in profitability or a significant deterioration in the asset quality and capitalization profile.

Key rating drivers

Credit strengths

Established franchise: Established position on the back of the SANASA movement, especially in the rural and semi urban segments due to the various credit plus activities; the bank has about 93 branches out of which about 55 are in the semi urban and rural areas. This link to SANASA provides a competitive edge for the bank in the rural and SME segment.

Comfortable asset quality indicators: SDB's asset quality remained above the industry average over the last 3-years. Gross NPA ratio stood at 2.08% in Dec-17 vis a vis 2.12% in Dec-16. Good overall NPAs are largely driven by the close monitoring of delinquencies and granular nature of portfolio. However, during H1CY2018, gross NPA ratio slightly increased to 2.53% as of Jun-18, because of increased slippages witnessed in the retail portfolio (which accounted for 69% of total portfolio). The retail segment's gross NPA ratio increased to 2.08% in Jun-18 vis a vis 1.44% in Dec-17 largely because of slippages witnessed in personal loans granted to lower-grade staff in government departments. The SME segment, which accounted for about 25% of the total portfolio had a relatively high gross NPA of about 4.32% (4.56% in Dece-17 and 4.47% in Dec-16). Co-operative segment had a gross NPA of about 0.45%, as in June 30, 2018.

[2] 10.5% (buffer of 2.0% over the minimum requirement of 8.5%)

The bank is expected to increase the share of SME loans and loans to cooperatives in the overall portfolio. The ability to keep asset quality under control, in view of the above, would be crucial going forward considering the stress emanating from the SME segment and, the larger loan sizes.

Adequate capital structure; however, would require fresh capital infusion to support growth: SDB's gearing has increased to 11.1 times as of Jun-18 vis a vis 10.1 times as of Dec-17 (10.8 times in Dec-16) because of the increased term borrowings of about LKR 4.2 Bn from IFC and FMO during H1CY2018. The core and total capital adequacy ratios (CAR) of the company was adequate at 11.7% and 13.8% respectively as of Jun-18 supported by the capital infusion of about LKR 1.5 Bn in CY2017. The bank was not able to raise capital to the extent of LKR 1.3 bn as envisaged because of the unfavorable share market conditions. ICRA Lanka estimates that the company may need to raise additional equity capital of about LKR 2.8 Bn over the next 3 years, to grow at 15-20% per annum during this period and maintain a comfortable cushion over the minimum capital adequacy ratio.

Credit challenges

Weakening profitability: SDB's ROA has moderated to 0.5% in H1CY2018 vis a vis 0.7% in CY2017 (0.6% in CY2016). The NIM of the bank contracted during H1CY2018 to 5.0% from 5.2% in CY2017 and 5.3% in CY2016 primarily because of increase in the cost of borrowings at a higher pace than that of the lending yields. The average lending yields of the bank has increased during the period to about 16%, largely because of the increase in variable rate lending in its portfolio. The bank's core fee-based income has remained moderate at about 0.3%. SDB's cost to income ratio[3] has remained high at about 80% over the last two and half years as the bank has expanded its operations and implemented new marketing and operational initiatives. The credit cost has increased to 0.66% in H1CY2018 vis a vis 0.40% in CY2017 (0.20% in CY2016) because of increased provision coverage. Going forward, SDB's ability to improve profitability indicators would be key rating sensitivity.

Moderate resource profile: SDB's funding profile is largely characterized by fixed deposits, which accounted for about 65% of the total borrowings as on June 30, 2018; proportion of savings has remained moderate at about 14-15% over the last three and half years, while debt instruments and other borrowings represented the balance. SDB's ALM profile is characterized by sizeable mismatches in the <1-year bucket due to the short-term nature of the deposits (about 62% of the deposits mature in 1-year or less), while the assets have an average tenure of about 5-7 years. However, good deposit renewal rate of 75-80%, granular nature of the deposit base and the long-standing relationships with banks & other financial institutions provide comfort on SDB's overall liquidity profile.

Modest scale and vulnerable customer base: In CY2017, SDB recorded a loan growth of 24% and for the 6 months ended June 30, 2018 the bank recorded 18% (annualised) loan growth to reach a total loan portfolio value of LKR 73.5 Bn. SDB's lending is largely towards customer segments with modest credit profile. The portfolio broadly consists of three target segments namely retail segment, SME segment and co-operative segment. The retail segment consisting of consumer lending products such as pensioner loans, housing loans, personal loans to salaried employees and pawning, is the largest segment, representing about 70% of the portfolio as on June 30, 2018. SME segment is the second largest segment (25% of the loan portfolio), followed by loans to co-operatives which was about 6% of the loan portfolio. Going forward, SDB expects

[3] Operating cost (including VAT) over operating income

to maintain a portfolio growth of 20% per annum over next 2-3 years and increase the share of SME loans and loans to cooperatives to about 20-30% in each segment.

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

Links to applicable criteria: **ICRA Lanka's Credit Rating Methodology for Banks**

About the Bank:

Established in the year 1997, SANASA Development Bank PLC (SDB) is a Licensed Specialised Bank. The bank has a primary listing on the Colombo Stock Exchange. Close to about 31% of the total shareholding is with SANASA affiliated entities as in June 2017, which includes, cooperative societies, trusts and other institutions. The other top shareholders include FMO (collectively 13% holding), Dr. Thirugnanasambandar Senthilverl (12.3%) and Ayenka Holdings (Pvt) Ltd. (12% holding). SDB had a network of 93 branches and over 1,000 employees.

In CY2017, SDB reported a PAT of LKR 508 Mn on a total asset base of LKR 82.4 Bn. In CY2016, the bank reported a PAT of LKR 404 Mn on a total asset base of LKR 66.0 Bn. The bank's net worth as of Dec-17 stood at LKR 7.3 Bn (LKR 5.5 Bn as of Dec-16). For the six months ended Jun-18, the bank reported a PAT of LKR 227 Mn (un-audited) on a total asset base of LKR 90.8 Bn.

Guarantor Profiles:

Sampath Bank PLC
Sampath Bank PLC is one of the larger private sector commercial banks in the country with total assets of LKR 846 Bn as at March 31, 2018. Sampath accounted for 7.9% of the banking industry assets, 9.1% of the sector loans and advances and 8.3% of sector deposits as of March 31, 2018. The bank commenced operations as a licensed commercial bank in 1987 and was noted for introducing technology to the banking sector. Major institutional shareholders include Vallibal One PLC with a 14.95% and Employee Provident Fund with a 9.97% stake. The Sampath group companies includes Sampath Centre Ltd (97.14%), SC Securities (Pvt) Ltd (100%), Siyapatha Finance PLC (100%) and Sampath Information Technology Ltd (100%).

The bank recorded a total income of LKR 26,416 Mn for the 3MCY2018 and LKR 92,590 Mn for CY2017 (LKR 66,120 Mn for CY2016). The net profits of the bank amounted to LKR 3,310 Mn during 3MCY2018 and LKR 12,104 Mn for CY2017 (LKR 9,125 Mn for CY2016), which resulted in ROAA (PAT as a proportion of average assets) of 1.61% and 1.67% (1.54% in CY2016) for the respective periods. The bank had gross NPA ratios of 1.95% and 1.02% as at 3MCY2017 and CY2016 (1.61% in CY2016) and net NPA ratios of 1.02% and 0.75% respectively for the said periods (0.62% in CY2016). The bank had a net worth of LKR 65,381 Mn as on March 31, 2018 with tier 1 capital adequacy ratio of 9.48% and total capital adequacy ratio of 14.42%.

Seylan Bank PLC
Seylan Bank PLC (Seylan) with total asset base of LKR 413 Bn as in March 31, 2018 (LKR 408 Bn in December 31, 2017) accounted for about 3.9% of sector assets; it also accounted for 4.4% of sector loans and advances and 4.0% of the sector deposits as in March 31, 2018. The bank was incorporated in the year 1987. Sri Lanka Insurance Corporation Ltd (15.0%), Browns and Company PLC (13.9%), Employee Provident Fund (9.9%), LOLC Investments Limited (9.6%), NDB Bank (8.7%) and Bank of Ceylon (7.5%) are the major voting shareholders of the bank.

The bank recorded a total income of LKR 12,805 Mn for the 3MCY2018 and LKR 49,174 Mn for CY2017 (LKR 37,753 Mn for CY2016). The net profits of the bank amounted to LKR 1,053 Mn during 3MCY2018 and LKR 4,430 Mn for the CY2017 (LKR 4,010 Mn for CY2016), which resulted in ROAA (PAT as a proportion of average assets) of 1.03% and 1.16% (1.23% in CY2016) for the respective periods. The bank had a gross NPA ratios of 5.41% and 4.42% as at 3MCY2018 and CY2017 (4.47% in CY2016) and net NPA ratios of 4.07% and 3.10% respectively for the said periods (3.07% in CY2016). The bank had a net worth of LKR 34,536 Mn as on March 31, 2018 with tier 1 capital adequacy ratio of 10.37% and total capital adequacy ratio of 14.29%.

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