Fitch Ratings

Fitch Downgrades Melsta Regal Finance; Affirms Nine Sri Lankan Finance Companies

Fitch Ratings-Singapore/Colombo-17 July 2018: Fitch Ratings Lanka has downgraded Melsta Regal Finance Ltd.'s (MRF) National Long-Term Rating to 'B(lka)' from 'A+(lka)' and removed the Rating Watch Evolving (RWE). A Stable Outlook has been assigned. The agency has also affirmed the ratings of the following nine finance companies:

- Central Finance Company PLC (CF)
- LB Finance PLC (LB)
- Senkadagala Finance PLC (Senka)
- Singer Finance (Lanka) PLC (SFL)
- Mercantile Investments and Finance PLC (MIF)
- People's Leasing & Finance PLC (PLC)
- HNB Grameen Finance Limited (HGL)
- AMW Capital Leasing And Finance PLC (AMWCL)
- Siyapatha Finance PLC (Siyapatha)

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, NATIONAL RATINGS
The rating actions follow Fitch's periodic review of Sri Lanka's large and mid-sized finance companies.

Fitch expects the credit profiles of the country's licensed finance company sector to remain under pressure in the medium term. Competition in leasing from banks and a deceleration in vehicle financing has pushed finance companies to look beyond their core businesses and venture into term financing, microfinance and lending against gold. Fitch believes the shift in business mix has raised the companies' risk profiles in the absence or poor quality of collateral, challenges to the recoverability of collateral and a lack of experience in the new segments. This has already resulted in the industry's reported non-performing loan (NPL) ratio (based on six month arrears) increasing to 5.8% at end-March 2018 (FYE18), from 4.9% at FYE17. The sector also faces more stringent capital requirements and potential earning headwinds stemming from higher credit costs.

The ratings of the finance companies in the peer group are driven by their business models and franchises. Risk appetite, another rating driver, reflects the companies' predominant exposures to more vulnerable customers and non-core business segments.

Finance Companies with Intrinsic Strength-Driven Ratings

The resolution of the RWE and downgrade of MRF's rating to reflect its standalone profile is because the agency views that support from the parent, Fairfax Financial Holdings Limited (Fairfax), cannot be relied upon. Fitch believes Fairfax's stake in MRF is part of its portfolio of investments and does not have a strategic significance. Fairfax is MRF's largest shareholder, with effective control of 70% via Bluestone1 (Private) Limited, an SPV established for the acquisition of MRF. As such, MRF's standalone profile is characterised by an evolving business model and small franchise (0.5% of sector assets at end-March 2018). The rating also captures potential pressure on MRF's asset quality from its unseasoned loan book.

CF's rating reflects its modest franchise and strong capitalisation, which is supported by above-industry profitability and earnings retention. These factors counterbalance its weaker asset quality compared with similarly rated peers, owing to its higher exposure to the risky three-wheeler segment. CF remains the highest capitalised among peers, with regulatory Tier 1 and total capital ratios of 32.9% and 32.1%, respectively, at FYE18. It has demonstrated an ability to maintain better-than-industry net interest margins through the interest-rate cycle and its profitability ratio, as measured by pre-tax net income/average assets, improved to 10.5%, from 7.9% in FYE15, on wider net interest margins, better cost efficiency and lower credit costs.

LB's rating reflects its established franchise and satisfactory capital level, which is supported by sound profitability from high-yielding products. This is counterbalanced by the company's higher risk appetite due to high exposure to gold-backed lending and elevated liquidity risk, with gross loans accounting for 87% of total assets at FYE18 (FYE17: 89%). LB has the highest leverage ratio among peers, with debt/tangible equity of 6.6x (FYE17: 6.9x). However, its Tier 1 ratio was a satisfactory 17.3% at FYE18 (FYE17: 16.1%). Fitch believes risk from gold-backed lending (FYE18: 19% of gross loans, FYE17: 18%) has been managed through active monitoring and risk-control measures, but a sharp decline in gold prices could pressure asset quality.

Senka's rating reflects its strong franchise and well-matched maturity gaps. This is counterbalanced by a low proportion of deposit funding compared with higher-rated peers. We expect Senka's Tier-1 ratio of 17.0% at FYE18 to come down in the absence of capital infusion, as internal capital generation has not kept pace with above-industry loan growth. The company's reported NPL ratio increased to 2.3%, from 1.6% at FYE17, but remained below higher-rated peers amid challenging operating conditions.

SFL's rating reflects its small franchise and overall stable financial indicators. Capitalisation has been supported through rights issues, the most recent being in FY18. The company's reported NPL ratio increased, like that of peers, to a still-modest level of 2.1% at FYE18 and asset-quality pressure is likely to persist. SFL's profitability is better than that of peers', supported by higher-yielding assets. The rating is underpinned by Fitch's view that the rating of SFL's parent, retailing company Singer (Sri Lanka) PLC (A-(lka)/Stable), provides a floor for SFL's rating that is two notches lower. This reflects Singer's majority ownership in SFL and the common Singer brand.

MIF's rating reflects its long operating history and satisfactory capitalisation. It also captures MIF's high risk appetite, stemming from relatively weak underwriting standards, evolving risk controls that have affected asset quality and high reliance on concentrated short-term funding that has led to considerable negative maturity mismatches. We expect MIF's relatively weaker profitability to improve marginally in the medium term, aided by its high-yielding, non-lease products, and for the reported NPL ratio (FYE18: 7.6%) to remain elevated until the resolution of its single-largest NPL account (backed by collateral), which forms half of total NPLs. We attribute MIF's below-peer NPL provision coverage to the low allowances set aside for its largest NPL account.

Finance Companies with Institutional Support-Driven Ratings

PLC's Issuer Default Rating (IDR) and National Long-Term Rating reflect Fitch's view that its parent, the state-owned and systemically important People's Bank (Sri Lanka) (AA+(lka)/Stable), would provide PLC with extraordinary support, if required. People's Bank's propensity to support PLC stems from PLC's group role as a strategically important subsidiary and the high reputational risk to People's Bank should PLC default, as the bank owns 75% of PLC and shares a common brand. People's Bank's ability to provide support to PLC is limited and stems from Sri Lanka's rating of 'B+'/Stable.

PLC plays an important role in the group, accounting for 10.3% of People's Bank's assets and 11.6% of loans at FYE18. PLC also has 101 window offices within People's Bank branches and board representation from People's Bank. PLC's reported NPL ratio increased to 2.7% at FYE18, from 1.3% at FYE17, due to unsecured term loans - a segment PLC has aggressively grown over FY15-FY17. Nevertheless, its NPL ratio remained better than that peer average.

HGL's rating reflects Fitch's expectation of support from its parent, Hatton National Bank PLC (HNB; AA-(lka)/Stable), Sri Lanka's fourth-largest domestic commercial bank. This view is based on HNB's majority 51% shareholding, its involvement in HGL's strategic direction through board representation and the common HNB brand. The two-notch differential reflects HGL's limited role in the group. HGL is mainly engaged in microfinance, which is not a significant product for HNB. Furthermore, there is limited operational integration between the entities.

AMWCL's rating reflects Fitch's view that support would be forthcoming from Associated Motorways Private Limited (AMW), which owns 90% of AMWCL, given the finance company's strategic importance to its parent, a large importer of motor vehicles in Sri Lanka. This is based on AMWCL's role in the group, the common AMW brand and the existence of common creditors, which contribute to high reputational risk for AMW if AMWCL were to default. Fitch sees the synergies between the two companies as high, since almost half of AMWCL's advances comprise facilities that are provided to clients who purchase AMW products. AMWCL also benefits from business referrals from its parent.

Siyapatha's rating reflects Fitch's expectation that support would be forthcoming from its 100% parent, Sampath Bank PLC (A+(lka)/Stable), which is involved in the strategic direction of the subsidiary through board representation. Siyapatha is rated two notches below its parent because of its limited role to the group's core business and different branding. Sampath Bank's leasing book accounted for just 7% of group loans at FYE18, of which half came from Siyapatha. Siyapatha also only accounted for 5% of group pre-tax profit in 2017.

DEBT RATINGS
The ratings on the senior debentures of PLC, CF, LB, Senka, SFL, MIF and Siyapatha are in line with the companies' National Long-Term Ratings, as they constitute their direct, unconditional, unsecured and unsubordinated obligations.

Fitch has not provided any rating uplift for the collateralisation of CF's and SFL's secured notes, as we consider recovery prospects as average and comparable with that of unsecured notes in a developing legal system.

Subordinated debentures of LB, Senka and Siyapatha are rated one notch below the companies' National Long-Term Ratings to reflect their subordination to senior unsecured creditors.

RATING SENSITIVITIES
IDRS, NATIONAL RATINGS
Finance Companies with Intrinsic Strength-Driven Ratings

MRF's ratings could be upgraded if the company increased its operating scale while maintaining asset quality and capitalisation at levels of higher-rated peers. However, a significant reduction in loss absorption buffers owing to asset-quality slippage could lead to a rating downgrade.

CF's ratings could be upgraded if its risk appetite moderates, which Fitch does not expect in the medium term. However, the rating could be downgraded if capital buffers are substantially eroded due to weakening asset quality and a prolonged rapid growth in the more vulnerable customer segments.

Downgrade triggers for LB include capital pressure from weaker profitability, increased liquidity risk or heightened risk appetite. This could be indicated through aggressive loan growth or deterioration in asset quality. An upgrade of LB's rating is contingent on the company achieving stronger capitalisation, lower risky asset exposure and a more comfortable liquidity position.

An upgrade of Senka's rating is contingent upon the company sustaining stronger capital levels and a more robust deposit franchise. Senka's rating could be downgraded if asset quality weakens, leading to a significant decline in capitalisation or excessive asset encumbrance.

We do not expect an upgrade of SFL's ratings from an improvement in its standalone strength, as its franchise is likely to remain significantly weaker than that of its more established, higher-rated peers. The more likely upgrade driver would be a stronger relationship with its parent, in particular, its strategic importance to Singer. A sustained deterioration in SFL's standalone credit profile in terms of capitalisation and asset quality relative to similarly rated peers would not result in a downgrade of SFL's rating, unless our assessment of parental support also changed.

MIF's ratings could be downgraded if its large maturity mismatches were to increase or if it experiences higher capital impairment risk due to sustained deterioration in profitability and asset quality. An upgrade of MIF's ratings is contingent upon a moderation of its risk appetite, as seen through better underwriting standards and risk controls alongside sustained improvement in asset quality and profitability.

Finance Companies with Institutional Support-Driven Ratings

A downgrade of PLC's IDR and National Ratings would occur if People's Bank's ability to support PLC was to weaken, if People's Bank's was to cede its majority ownership in PLC or if PLC's strategic importance to its parent was to diminish over time, reflecting a reduced propensity to support PLC. However, Fitch does not anticipate this in the foreseeable future. PLC's ratings are also sensitive to changes in the sovereign rating, as this would affect People's Bank's ability to provide support to PLC.

The ratings on HGL, AMWCL and Siyapatha are similarly sensitive to changes in Fitch's assessment of their respective parents' ability and propensity to provide support, none of which Fitch expects to change significantly in the short to medium term.

DEBT RATINGS
The ratings on the senior debt of CF, LB, Senka, SFL, MIF, PLC and Siyapatha will move in tandem with the companies' National Long-Term Ratings.

The assigned subordinated debt ratings will move in tandem with the National Long-Term Ratings.

FULL LIST OF RATING ACTIONS

Melsta Regal Finance Ltd.:
National Long-Term Rating downgraded to 'B(lka)' from A+(lka); off RWE; Outlook Stable

Central Finance Company PLC:
National Long-Term Rating affirmed at 'A+(lka)'; Outlook Stable
Senior secured National Long-Term Rating affirmed at 'A+(lka)'
Senior unsecured National Long-Term Rating affirmed at 'A+(lka)'

LB Finance PLC:
National Long-Term Rating affirmed at 'A-(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'A-(lka)'
Subordinated debt National Long-Term Rating affirmed at 'BBB+(lka)'

Senkadagala Finance PLC
National Long-Term Rating affirmed at 'BBB+(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'BBB+(lka)'
Subordinated debt National Long-Term Rating affirmed at 'BBB(lka)'

Singer Finance (Lanka) PLC
National Long-Term Rating affirmed at 'BBB(lka)'; Outlook Stable
Senior secured National Long-Term Rating affirmed at 'BBB(lka)'
Senior unsecured National Long-Term Rating affirmed at 'BBB(lka)'

Mercantile Investments and Finance PLC
National Long-Term Rating affirmed at 'BBB-(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'BBB-(lka)'

People's Leasing & Finance PLC:

Long-Term Foreign-Currency Issuer Default Rating affirmed at 'B'; Outlook Stable
Long-Term Local-Currency Issuer Default Rating affirmed at 'B'; Outlook Stable
National Long-Term Rating affirmed at 'AA-(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'AA-(lka)'

HNB Grameen Finance Limited:
National Long-Term Rating affirmed at 'A(lka)'; Outlook Stable

AMW Capital Leasing And Finance PLC
National Long-Term Rating affirmed at 'BBB+(lka)'; Outlook Stable

Siyapatha Finance PLC
National Long-Term Rating affirmed at 'A-(lka)'; Outlook Stable
Senior unsecured National Long-Term Rating affirmed at 'A-(lka)'
Subordinated debt National Long-Term Rating affirmed at 'BBB+(lka)'

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Note to editors: Fitch's National ratings provide a relative measure of creditworthiness for rated entities in countries with relatively low international sovereign ratings and where there is demand for such ratings. The best risk within a country is rated 'AAA' and other credits are rated only relative to this risk. National ratings are designed for use mainly by local investors in local markets and are signified by the addition of an identifier for the country concerned, such as 'AAA(lka)' for National ratings in Sri Lanka. Specific letter grades are not therefore internationally comparable.

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Additional information is available on www.fitchratings.com
Applicable Criteria
National Scale Ratings Criteria (pub. 07 Mar 2017)
Non-Bank Financial Institutions Rating Criteria (pub. 22 Jun 2018)

Additional Disclosures
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