

“All Doom & Gloom for NBFIs”

Oct 2020 | Sri Lanka

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First Capital
First Capital Research

Executive Summary

01 Stagnant NBFI's market share due to crippling economic conditions

02 Credit growth to struggle with further hits to NPLs

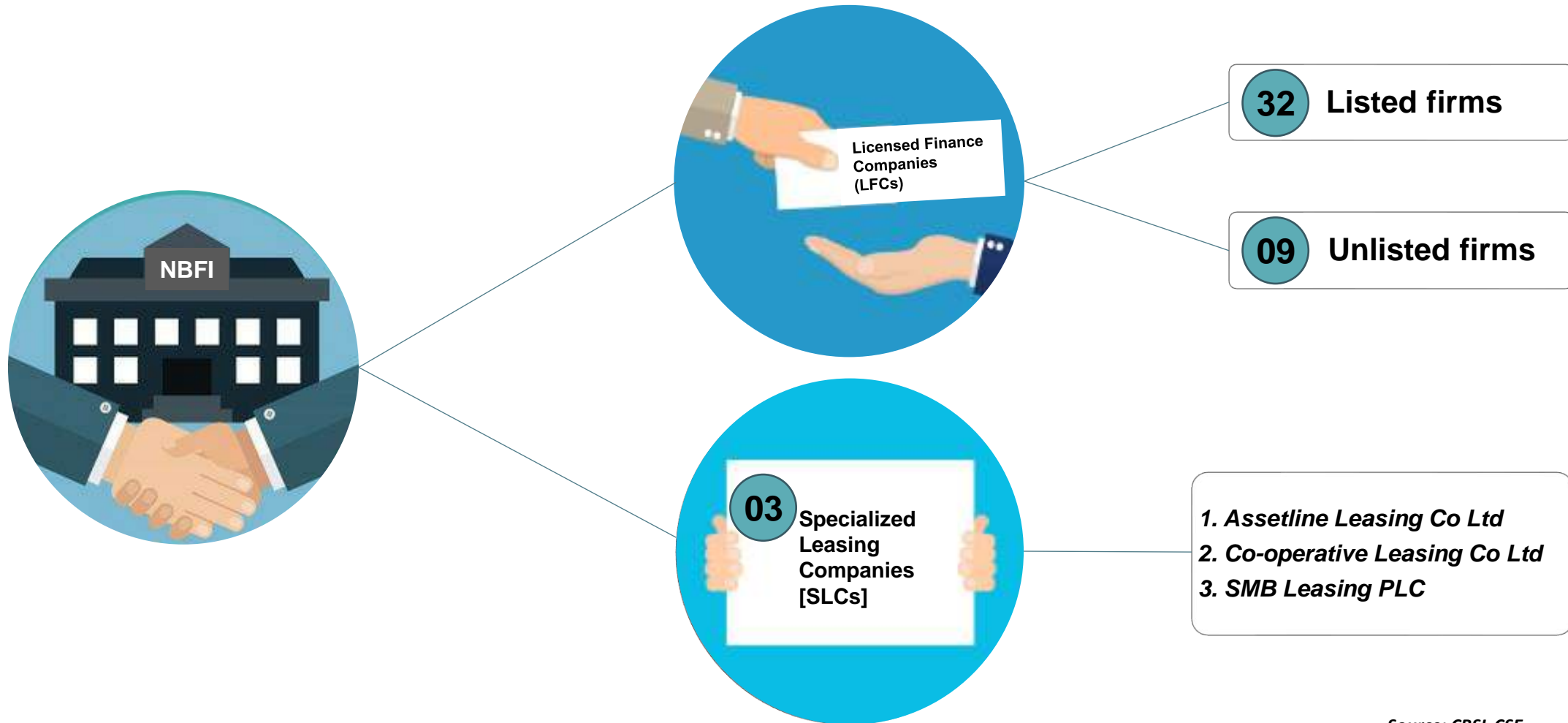
03 NBFIs require to raise LKR 20.0Bn by 2021E to stay alive

NBFIs
Sector
outlook



1. Stagnant NBFI's market share due to crippling economic conditions

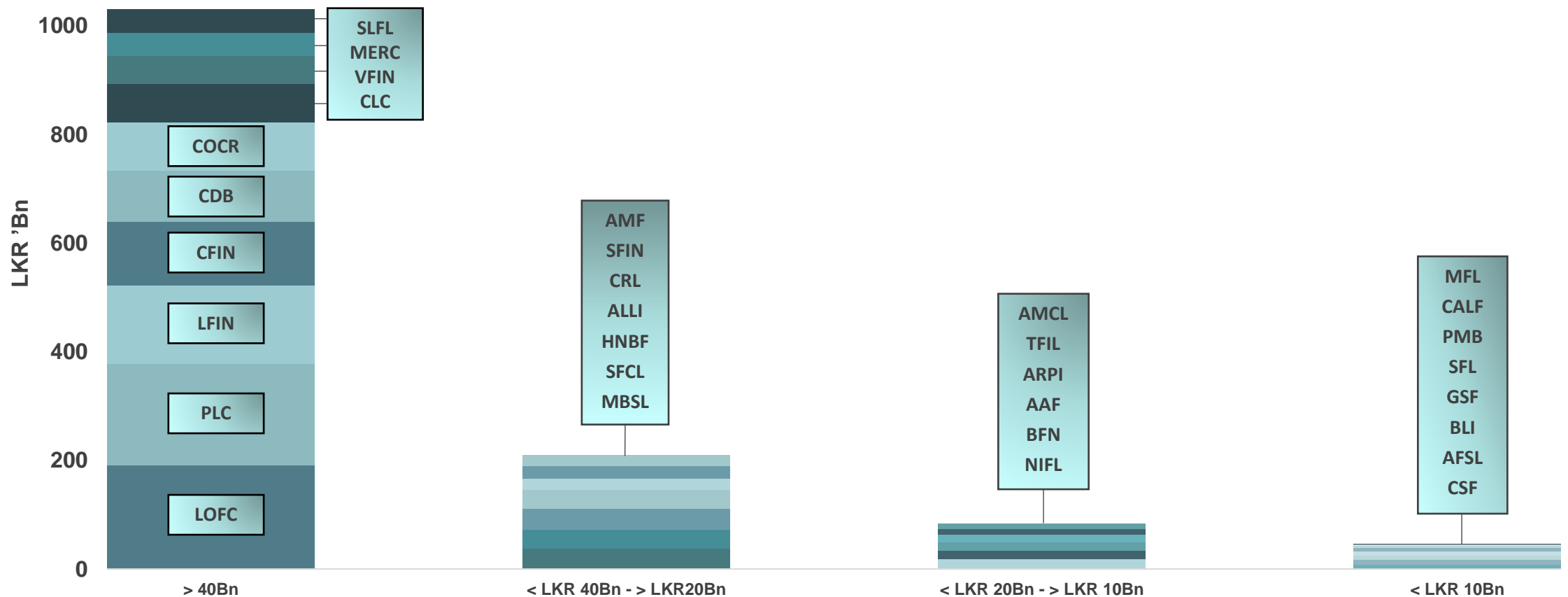
NBFI Sector consists of LFCs and SLCs with bulk of them in the listed space...



Source: CBSL, CSE

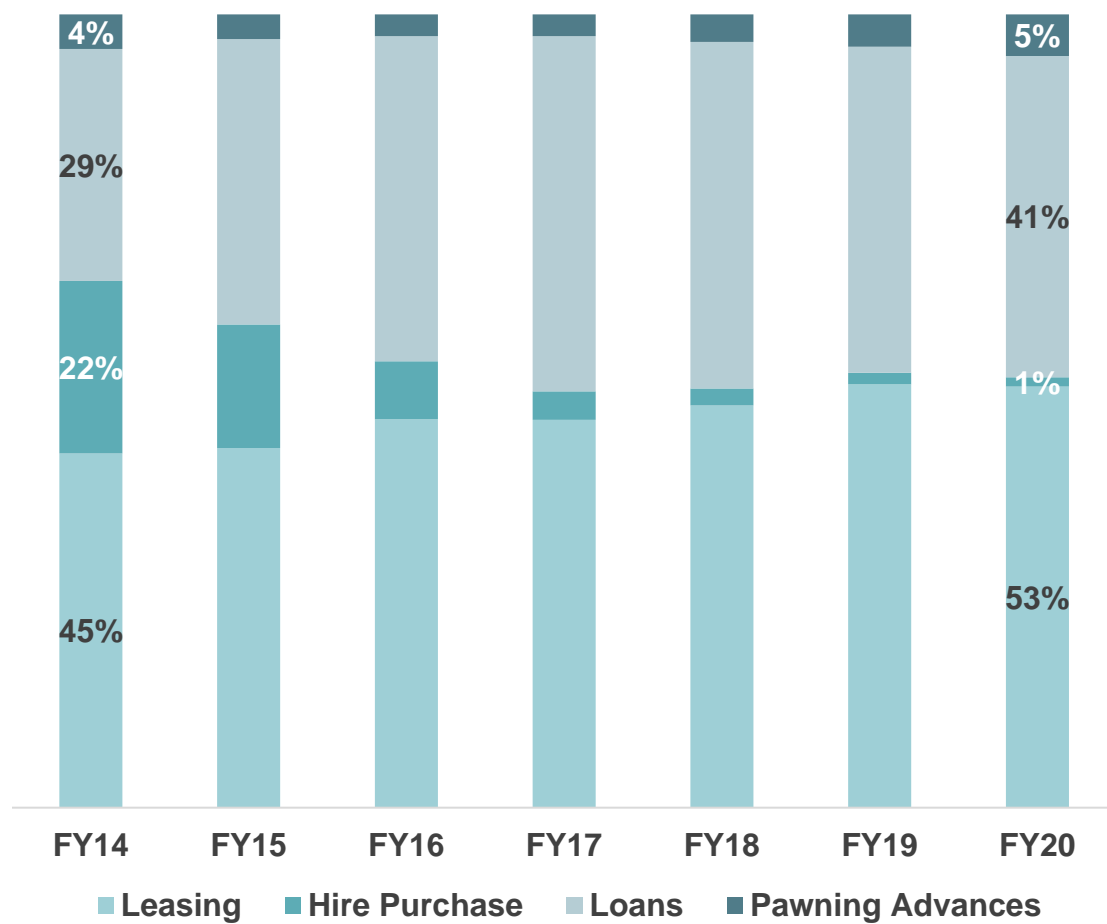
...but, over 70% of the LFC asset base is skewed towards the 10 largest LFCs

Top 10 entities account for over LKR 1.0Tn assets out of LKR 1.4Tn total sector asset base



Source: CBSL, Company Reports

Leasing dominates the sector lending portfolio closely followed by Loans...

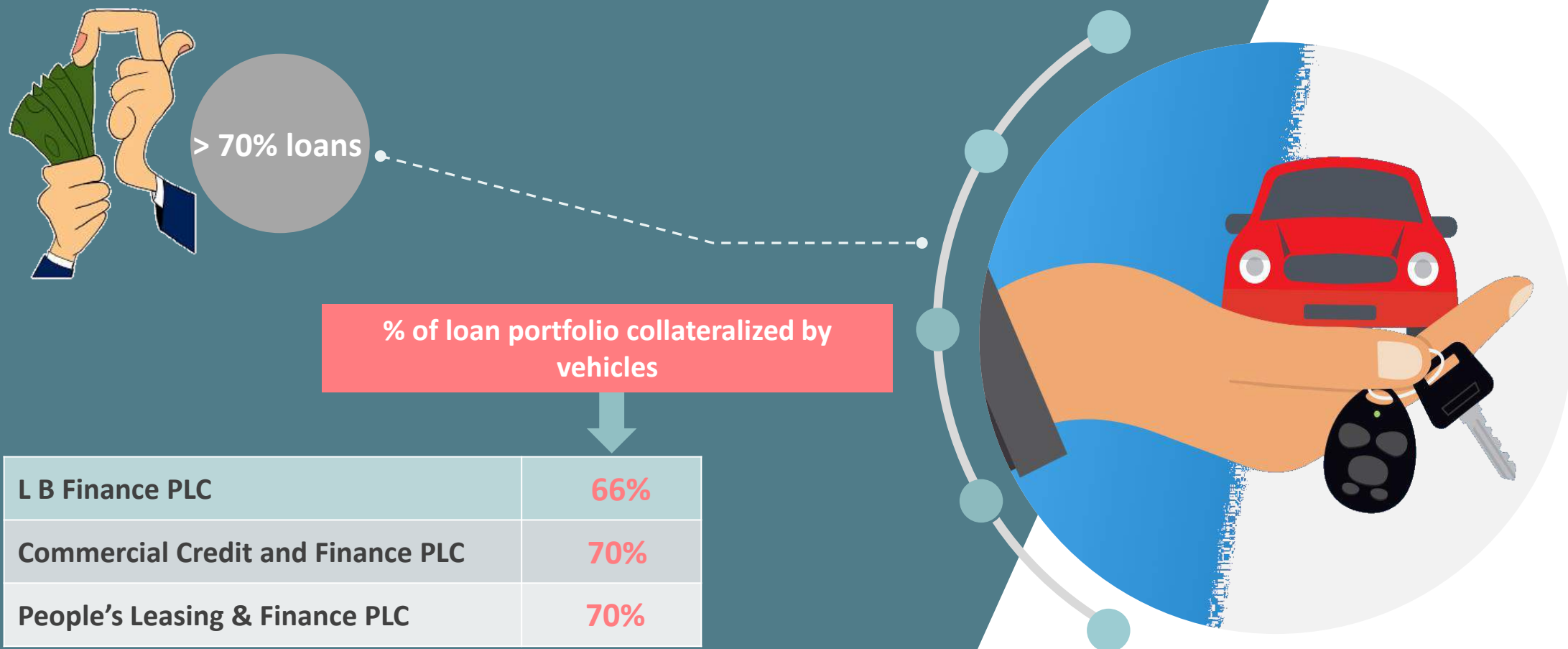


Source: CBSL, Company Reports

...whereas HP shrinks next to nothing due to removal of tax advantage...



...however, over **70%** of the sector lending book including loans are Asset-Backed *via vehicles*



Source: Company Reports, First Capital Research

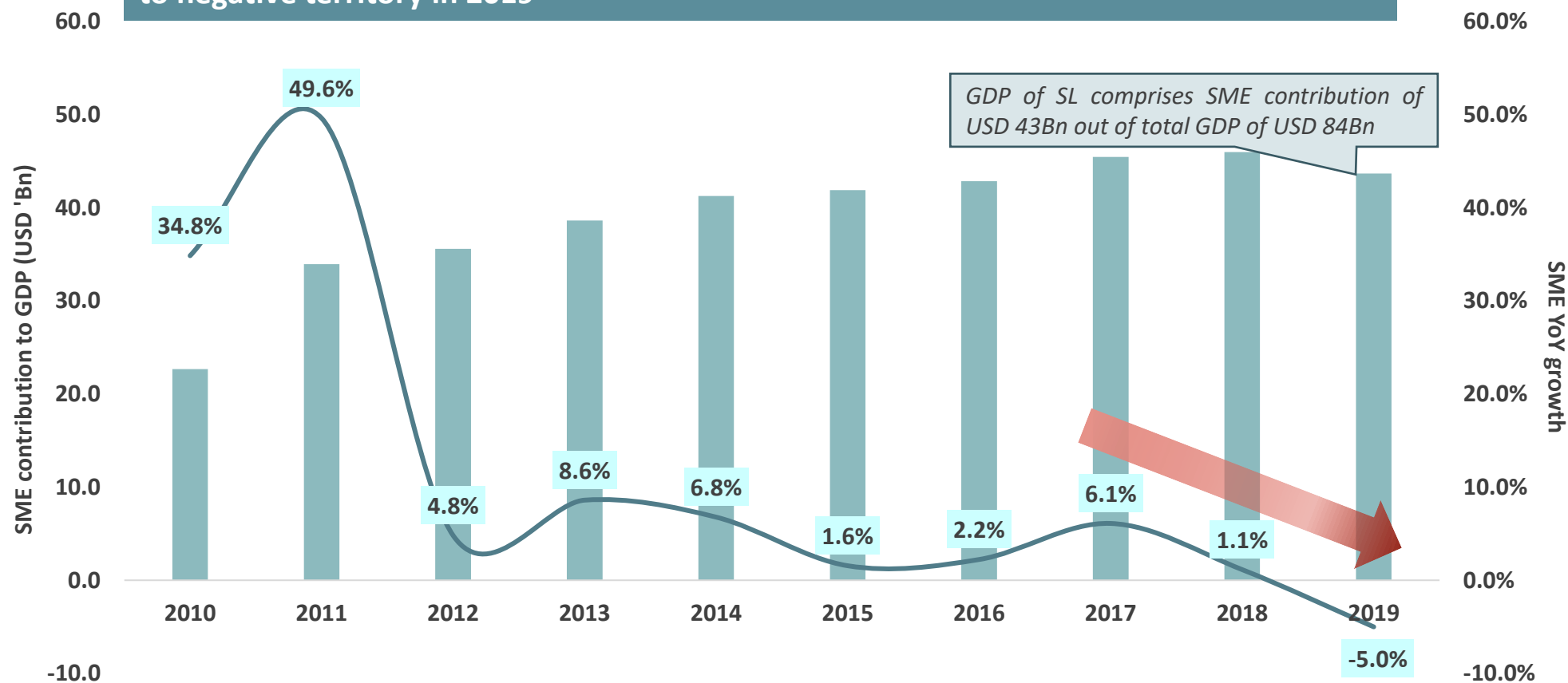
NBFI SECTOR PROFITABILITY PLUNGES TO A 5-YR LOW...



Source: CBSL

...as the targeted SME clientele struggle...

SME contribution to GDP has been deteriorating in line with economic freefall, swinging to negative territory in 2019



Source: CBSL, Industry.gov

...amidst the crippling Tortoise economy...

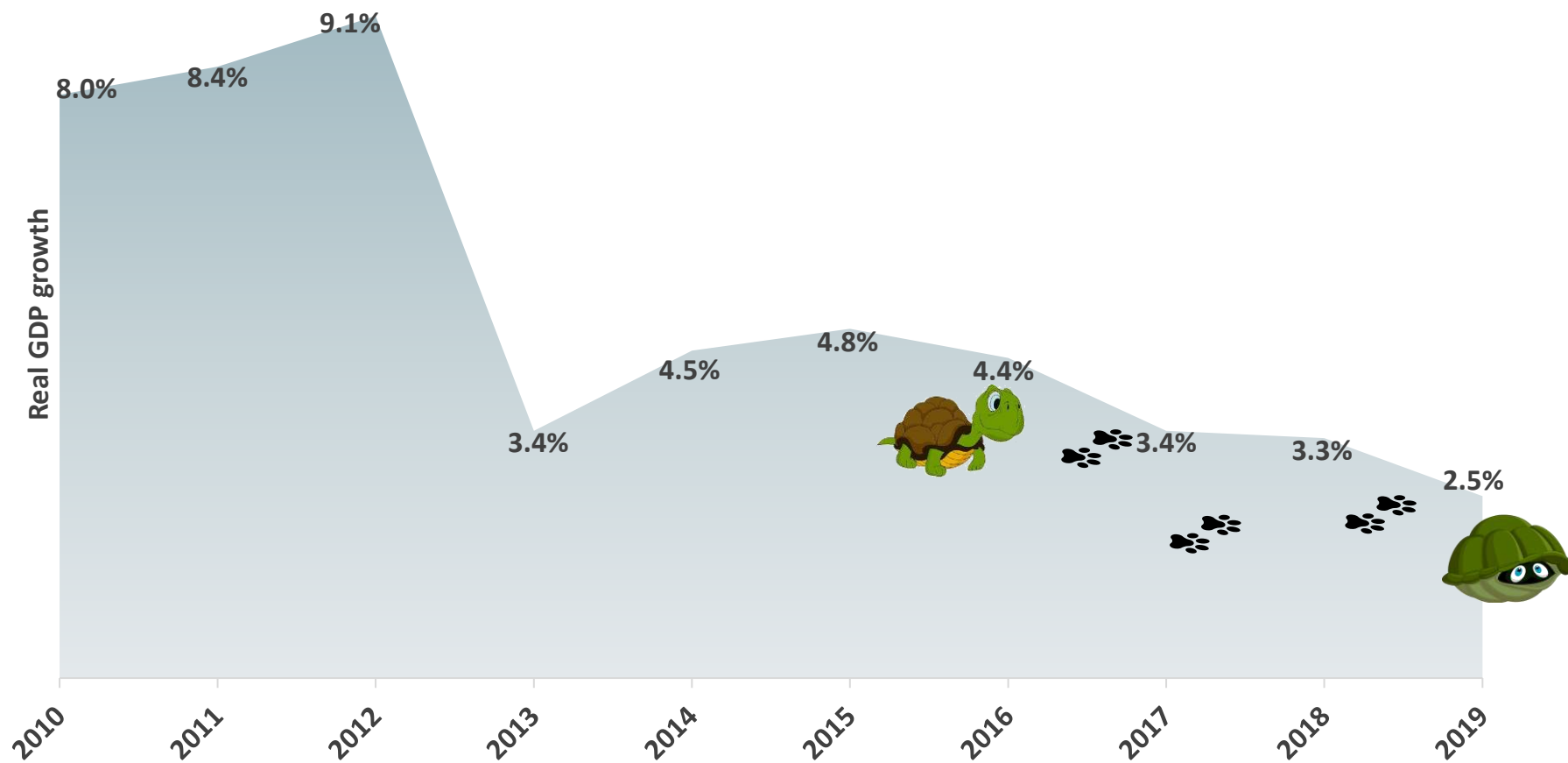
Sluggish fiscal conditions drive economic growth into a shell

SME accounts for 75% enterprises

45% of employment

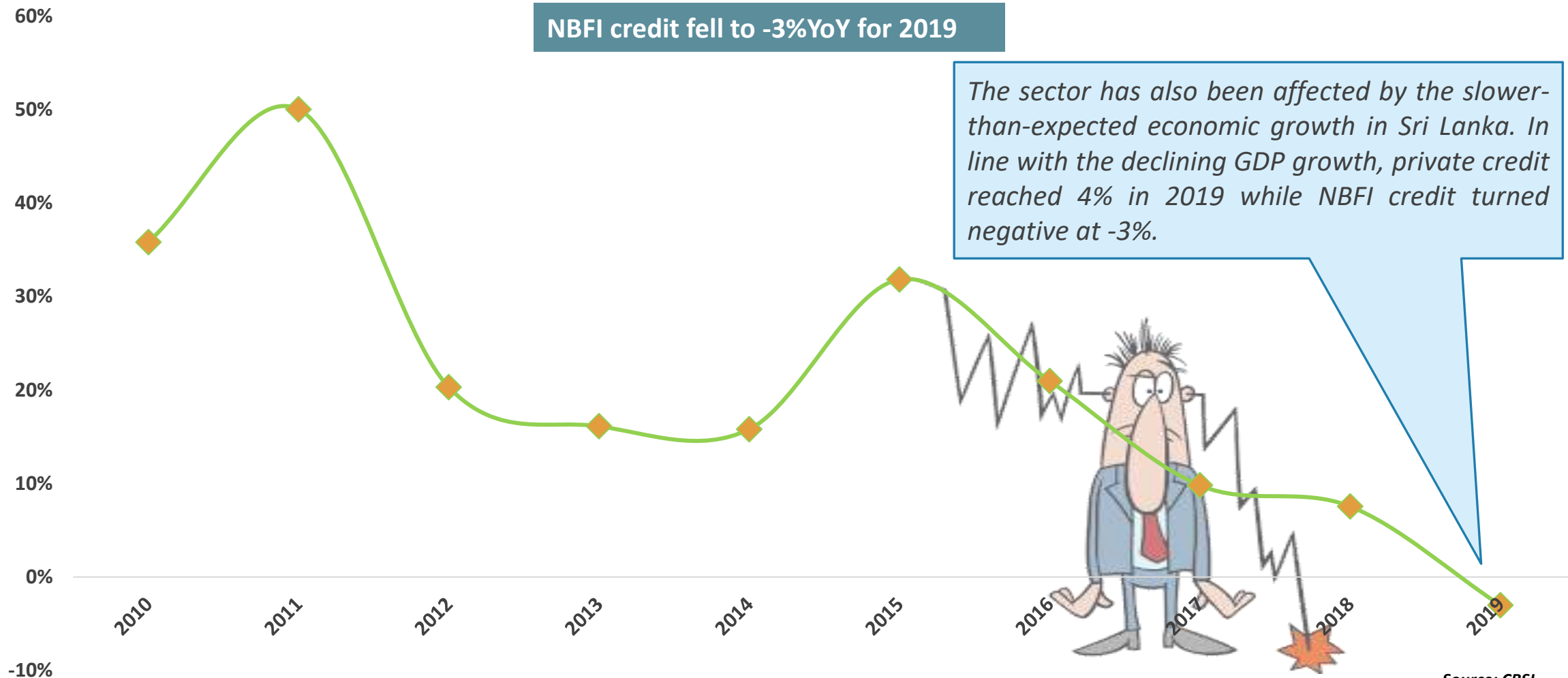
Contributes 52% of GDP

"Backbone" of the economy



Source: CBSL, Industry.gov

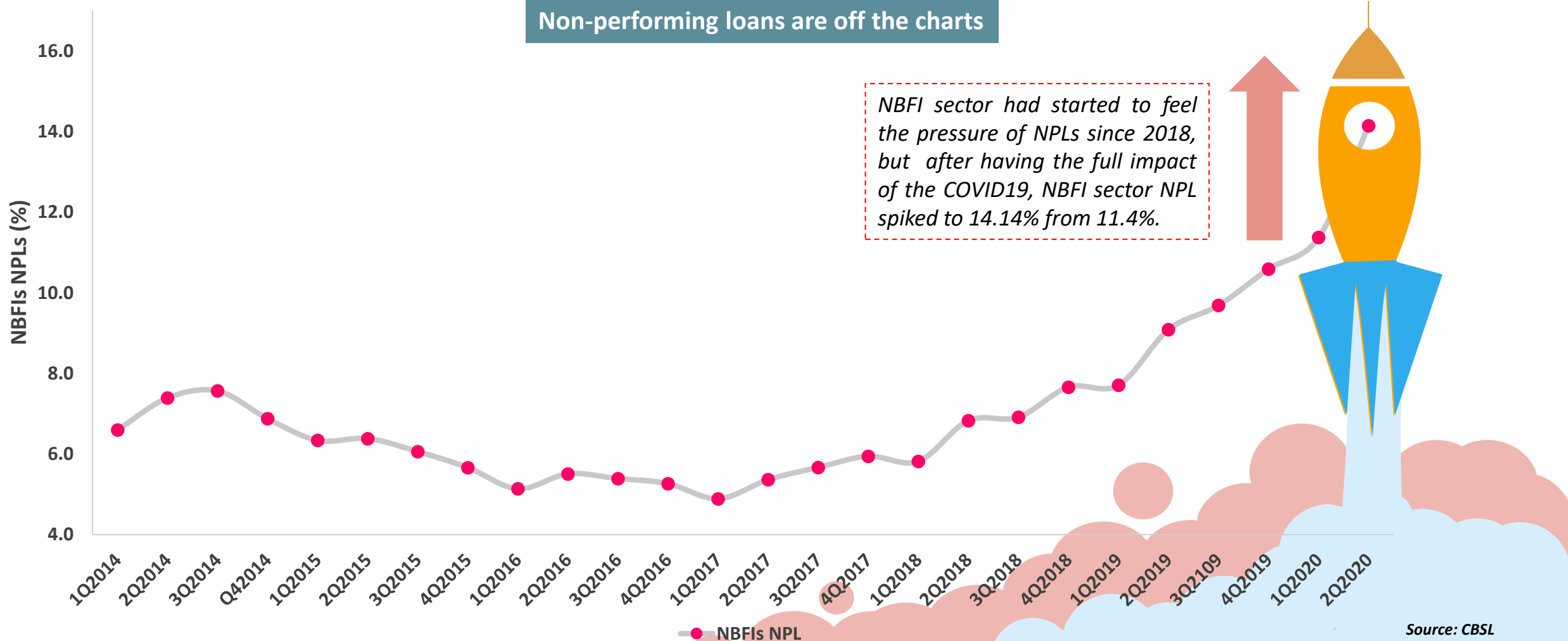
...spinning NBFI credit growth to **negative**...



Source: CBSL

...NPLs too skyrocket destabilizing the sector...

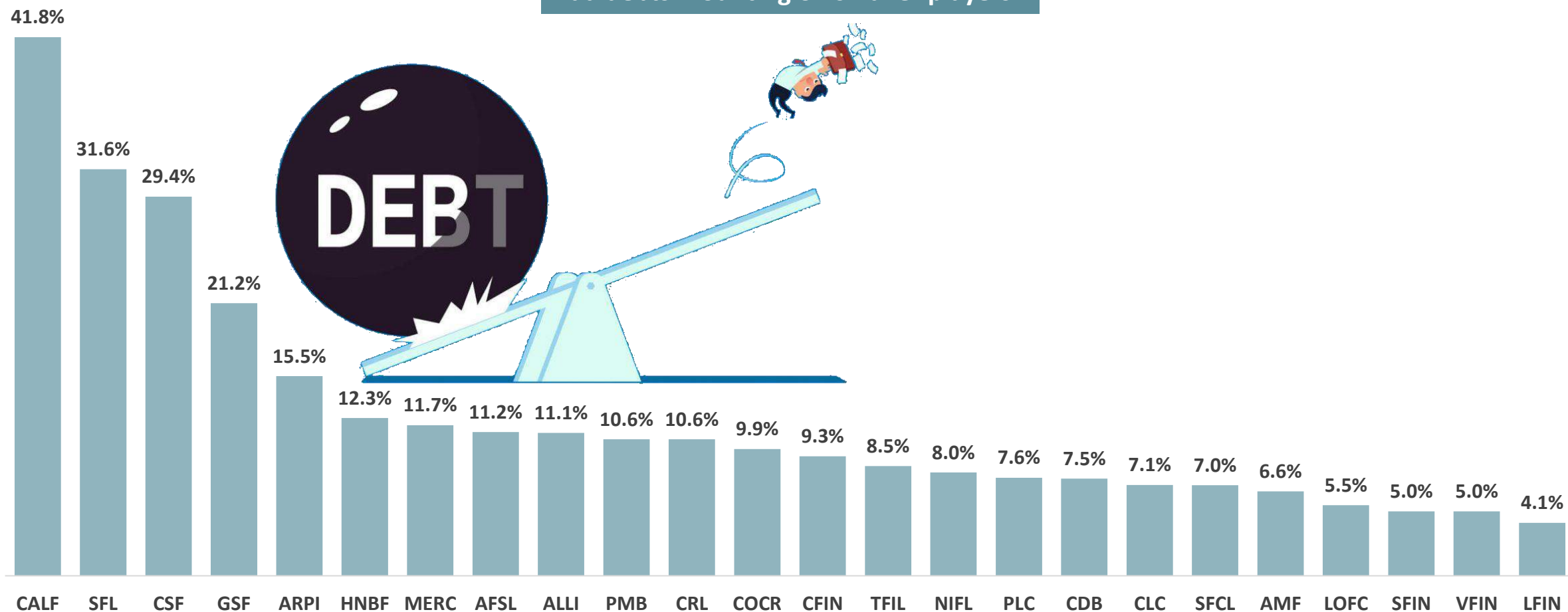
Non-performing loans are off the charts



Source: CBSL

...with smaller NBFIs facing the biggest hit...

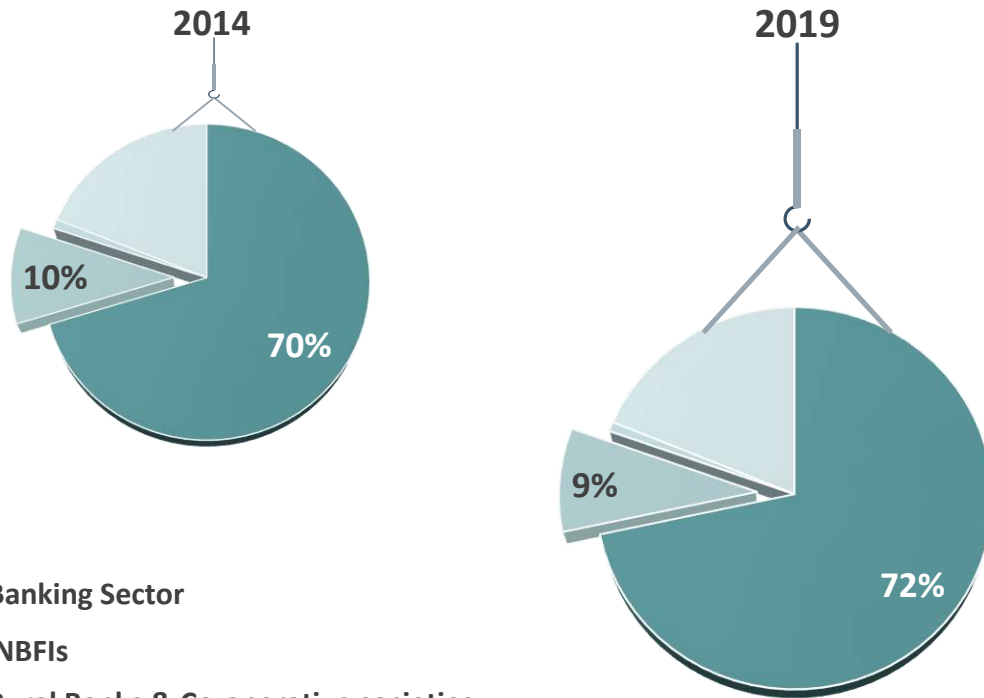
Bad debts mounting on smaller players



Source: Company Reports

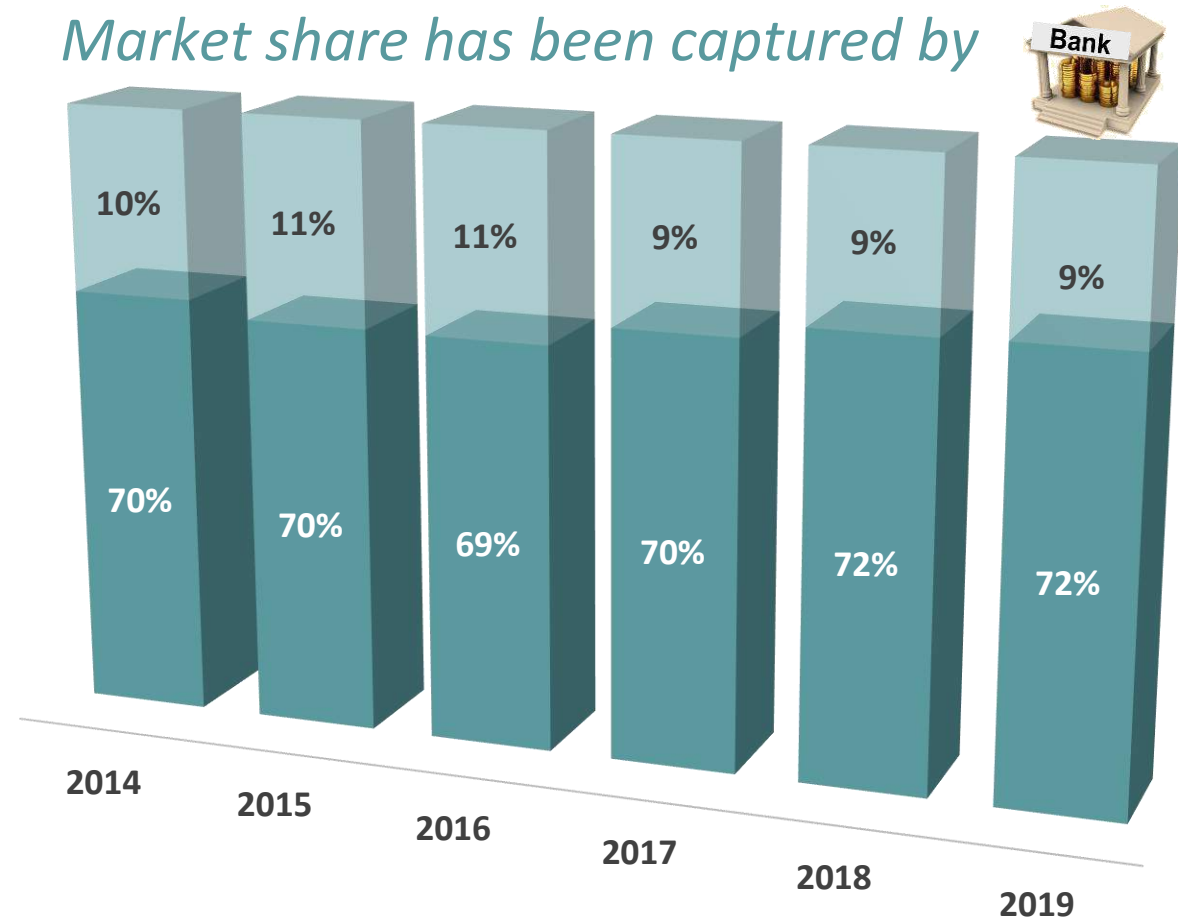
...thus, market share of NBFIs staggers at 9% for the last 3 years, but dipped over 6-Yr Period

Market share of NBFIs in terms of assets



- Banking Sector
- NBFIs
- Rural Banks & Co-operative societies
- Contractual Savings Institutions

Market share has been captured by



■ Banking Sector ■ NBFIs

Source: CBSL

CBSL steps in strengthening capital requirements adding to the woes...



Increasing the core capital requirement of LFCs

- LKR 2.0Bn by 01.01.2020
- LKR 2.5Bn by 01.01.2021

Increasing the Tier 1 and Total capital requirement for NBFIs
Please refer [slide 16](#)

Find below table on directions on LTV for vehicles when granting Leasing facilities

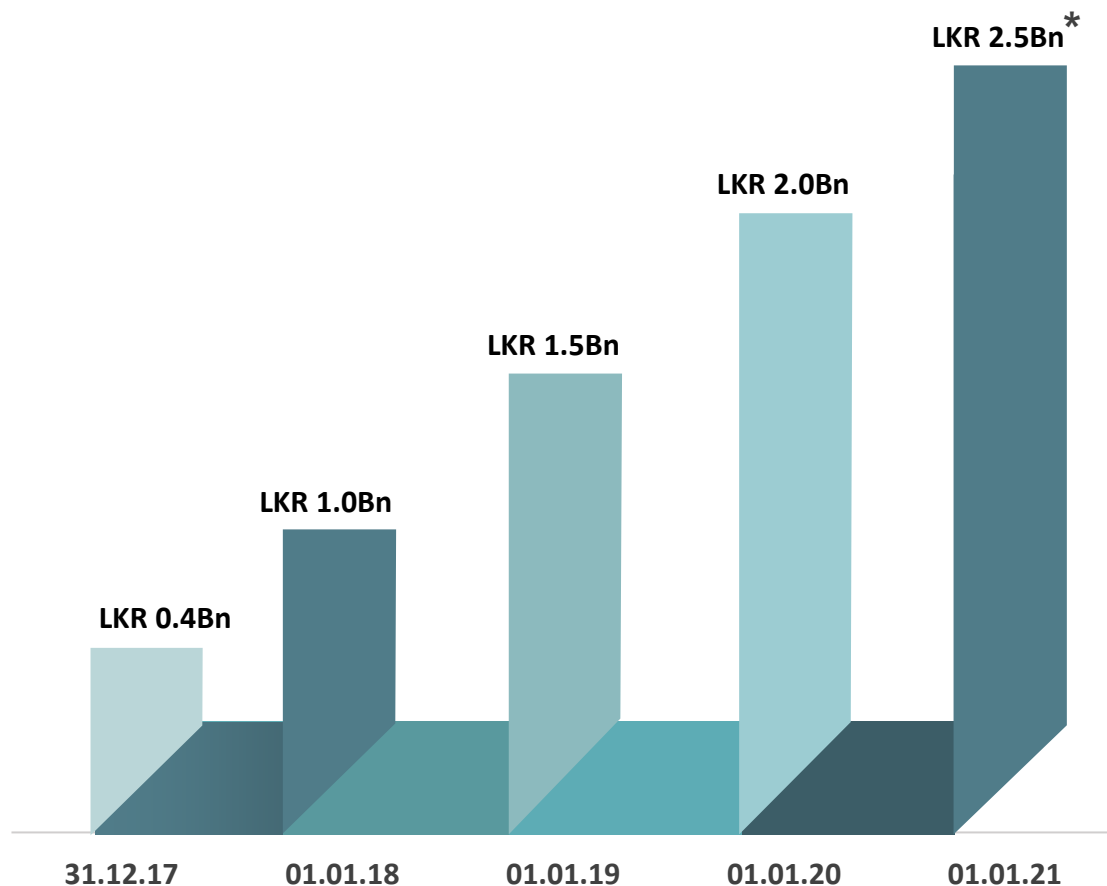
Vehicle Category [Unregistered]	Electric Vehicle	Other
Commercial Vehicles/ Light Trucks	90%	90%
Motor cars, SUV and Vans	90%	50%
Three wheelers	90%	25%
Any other vehicle	90%	70%
Hybrid Motor Cars, Vans and SUV	50%	
Registered Vehicles	70%	

Source: CBSL

...with annual targets to elevate capital...

However, 1 Yr extension granted post Covid-19 outbreak

Core Capital requirements



For LFCs with assets less than LKR 100.0Bn

	Tier 1	Total Capital
01.07.2018	6.00	10.00
01.07.2019	6.50	10.50
01.07.2020*	7.00	11.00
01.07.2021*	8.50	12.50

For LFCs with assets above than LKR 100.0Bn

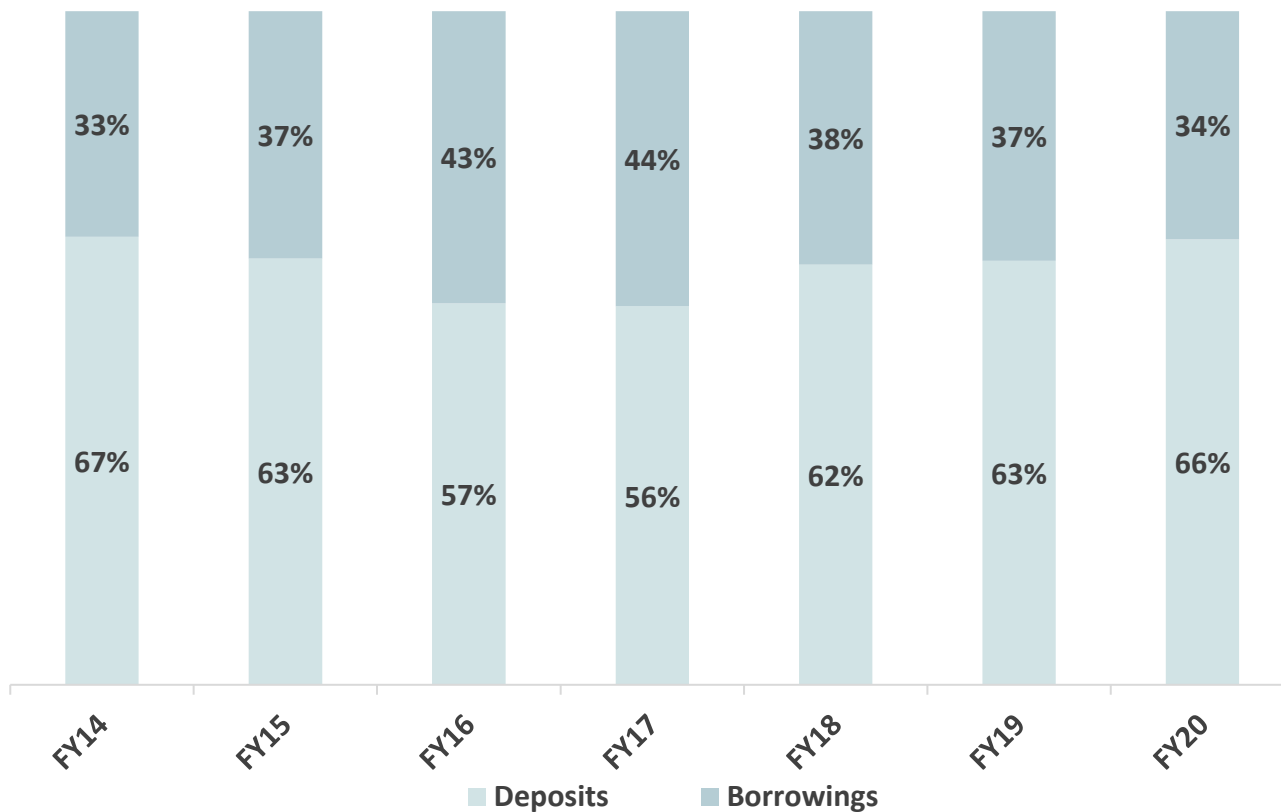
	Tier 1	Total Capital
01.07.2018	6.00	10.00
01.07.2019	7.00	11.00
01.07.2020*	8.00	12.00
01.07.2021*	10.00	14.00

* Extension granted

Source: CBSL

...however, NBFI sector funding via borrowings has reduced as liquidity increases...

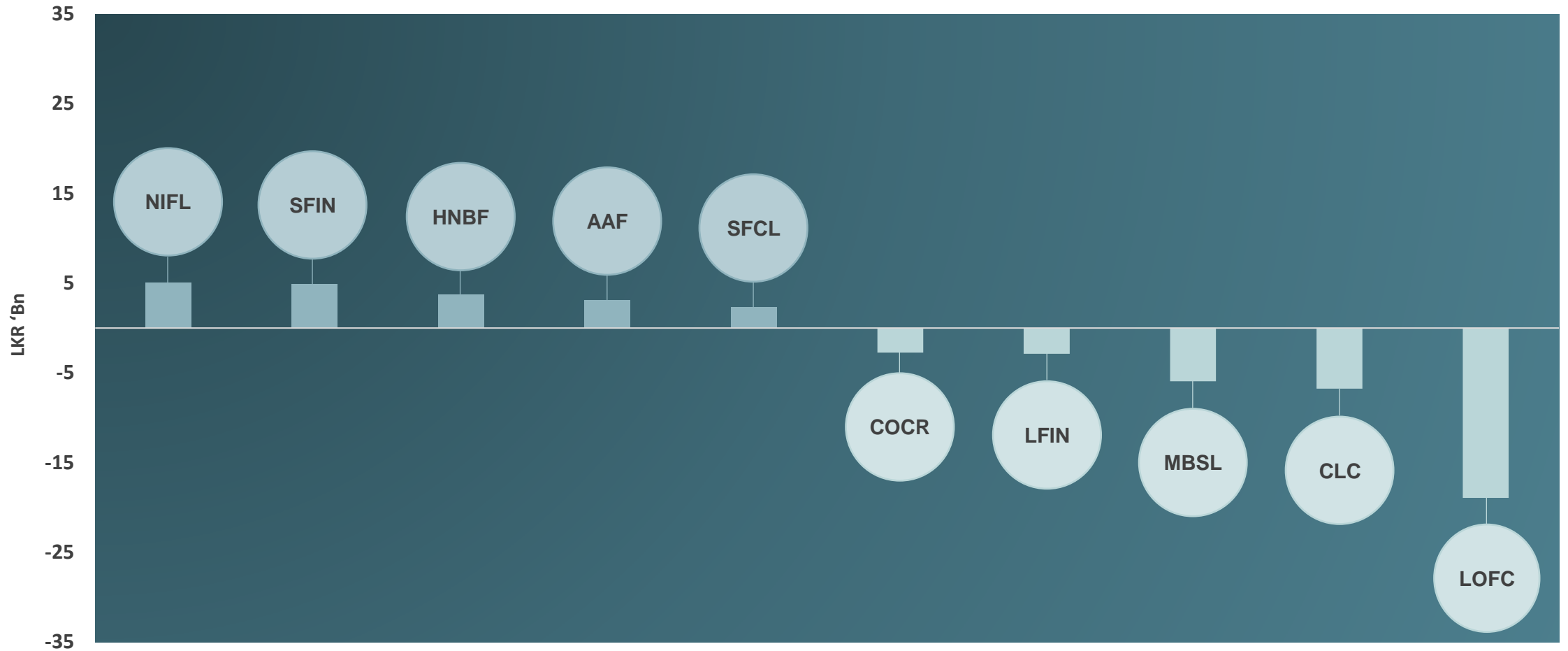
NBFI Sector borrowings plunge to 34% from 44% in FY17 amidst the surge in liquidity in the system and lack of credit growth



- Due to lackluster growth in the sector, NBFIs were seen settling the bank borrowings while heavily depending on deposits for fund mobilization.
- Funding profiles of Sri Lanka's finance companies have been largely characterized by limited diversity, with deposits dominating the funding profile by 66% as of FY20.
- A highly concentrated and pricing-sensitive deposit base is susceptible to market events and less reliable in situations of market distress.
- Higher deposit dependence coupled with limited access to funding lines could create liquidity stress for finance companies, as depositors will tend to shift to safer asset classes during crisis periods.

Source: CBSL, Company Reports

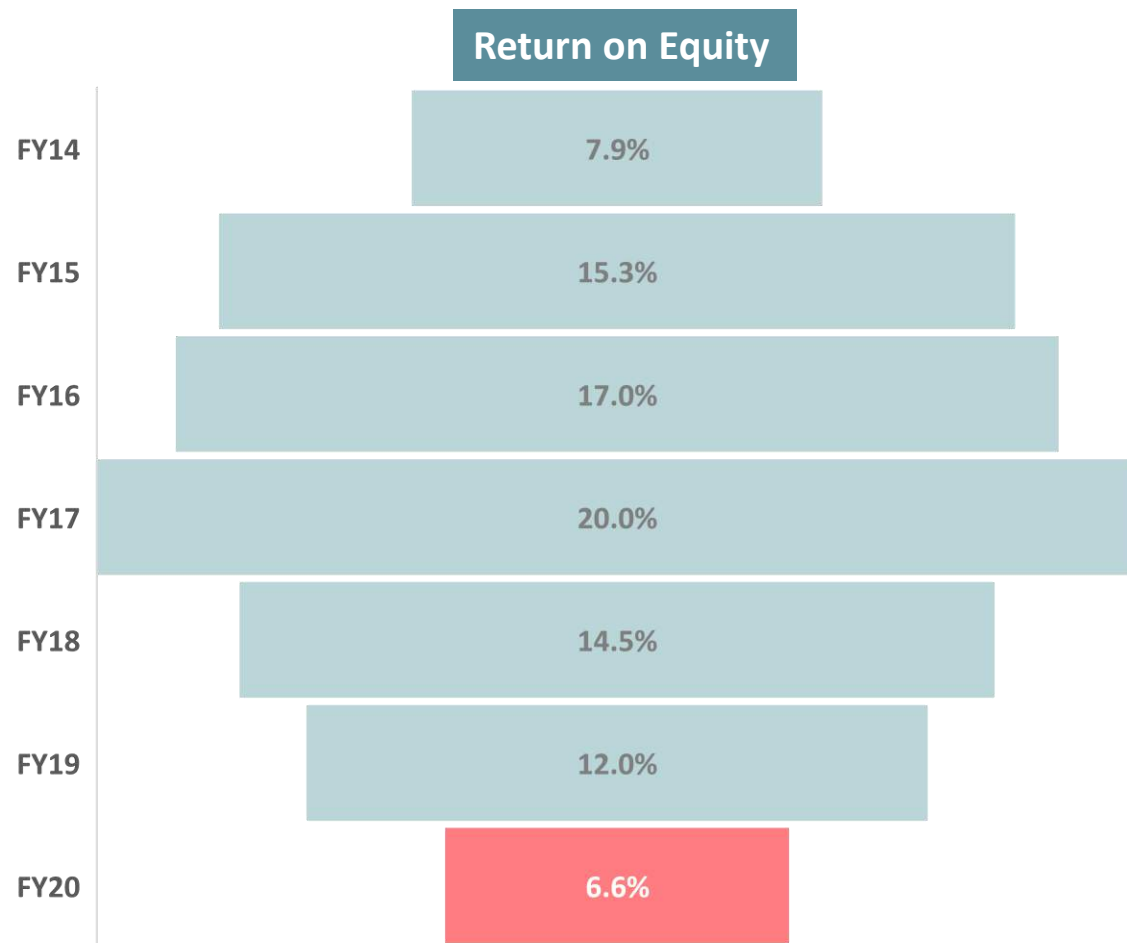
Debt settlement for the period FY18-FY20



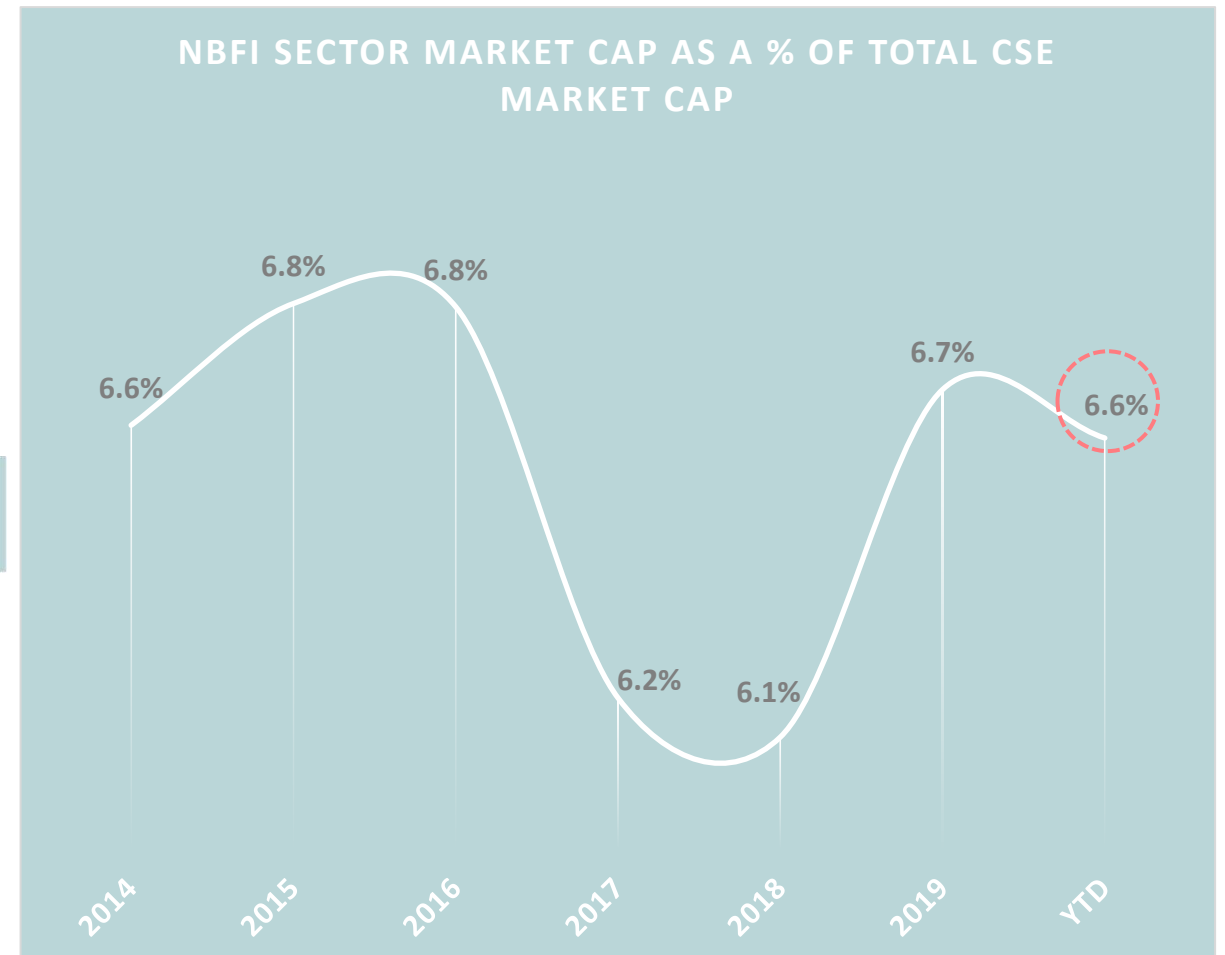
Source: Company Reports, First Capital Research

...comparatively, larger players have settled their debt at a much rapid pace

Amidst the struggle, Sector ROEs plunged at an accelerated pace, eroding sector Market Cap...



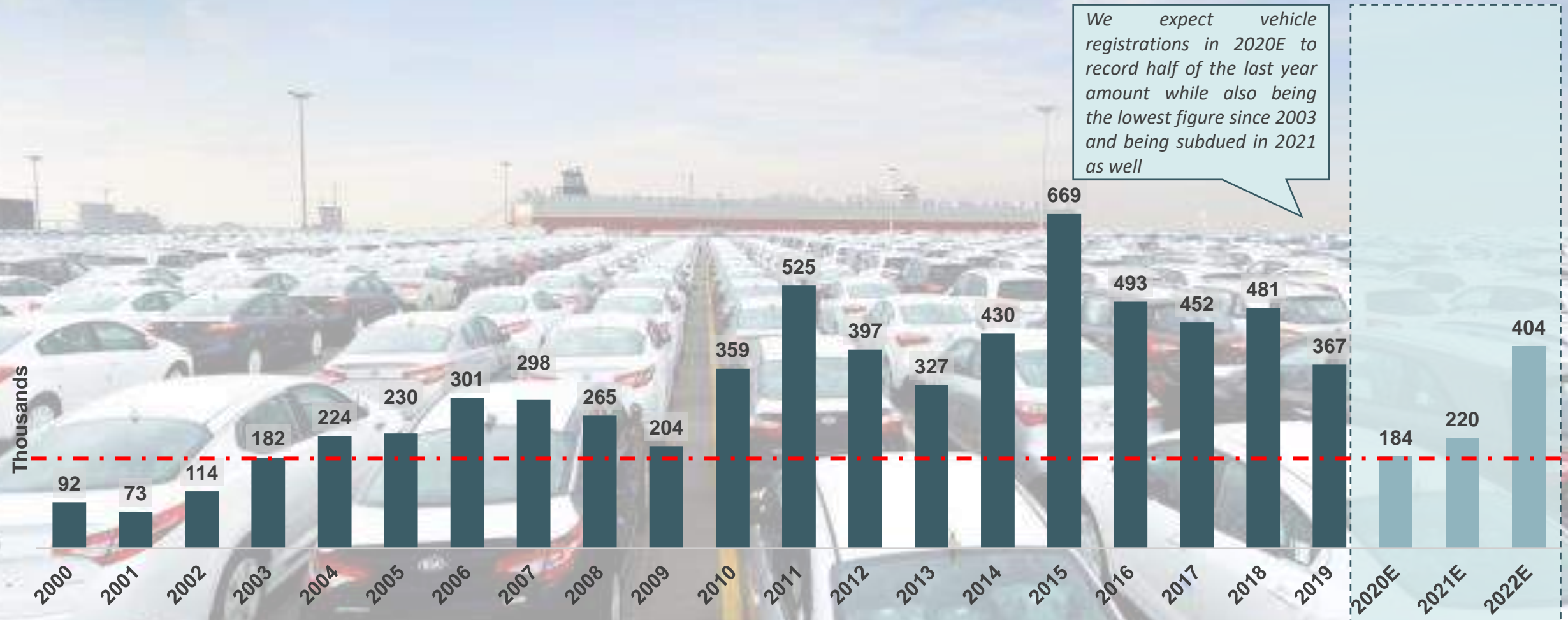
Source: CBSL



Source: CBSL, CSE, First Capital Research

2. Credit growth to struggle post COVID-19 with further hits to NPLs

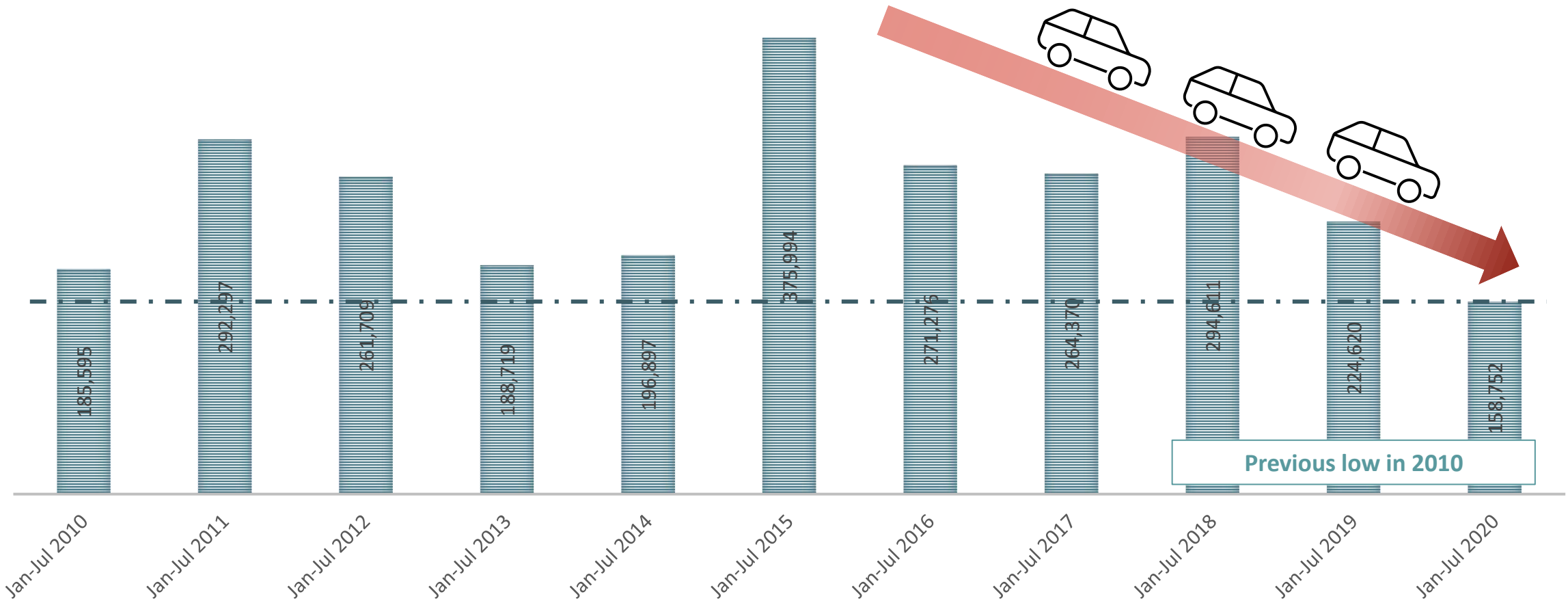
With restriction on vehicle imports, registrations may halve to a 17-Yr low in 2020E.....



Source: CEICDATA, First Capital Research

...New Vehicle registrations have already fallen to a decade low in 1H2020...

New registration of vehicle units witnessed a significant decline in Jan-Jul 20



Previous low in 2010

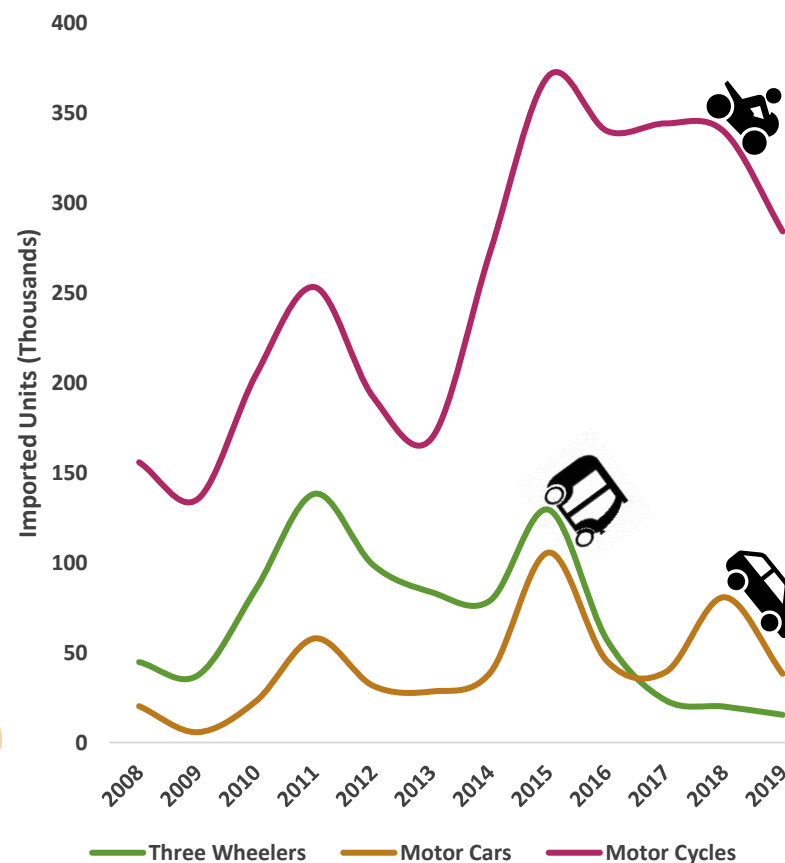
Source: CEICDATA, First Capital Research

...However, import of three wheelers and motorcycles have suffered a dipping trend since 2015 even before the import ban amidst the previous tax hikes and LTV regulations

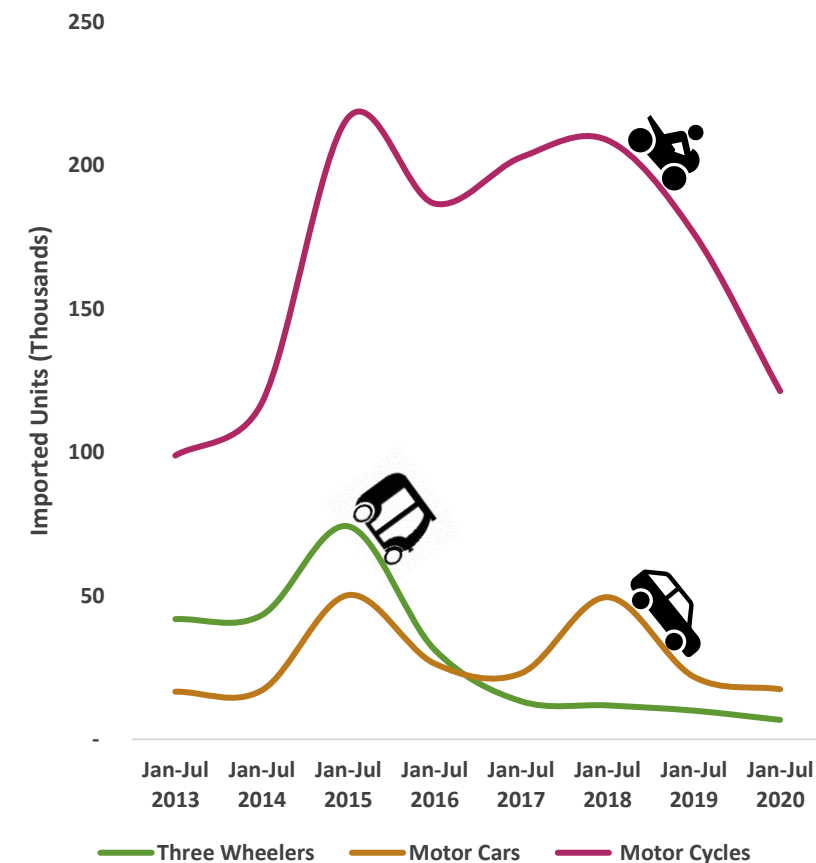
Out of the total vehicle population more than 50% comprises of Motorcycles which witnessed a decline in imports since 2015.

Further, nearly 17% of vehicles accounts for three-wheelers which are experiencing a similar trend followed by cars which account over 10% of the market.

Imported vehicle units by year



Imported vehicle units by period



Source: CBSL, First Capital Research

Govt. to ban vehicle imports for at least a year to survive a possible forex crisis...



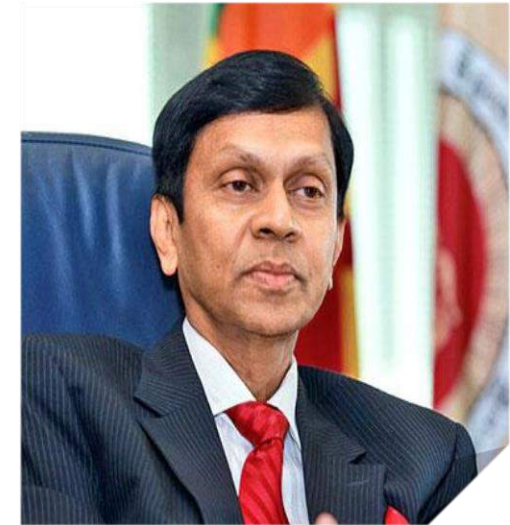
"Sufficient vehicle stock for next 2 years"

Secretary to the President:
P.B Jayasundara
Source: Newswire
(25.08.2020)



"Sri Lanka to ban vehicle imports for a year"

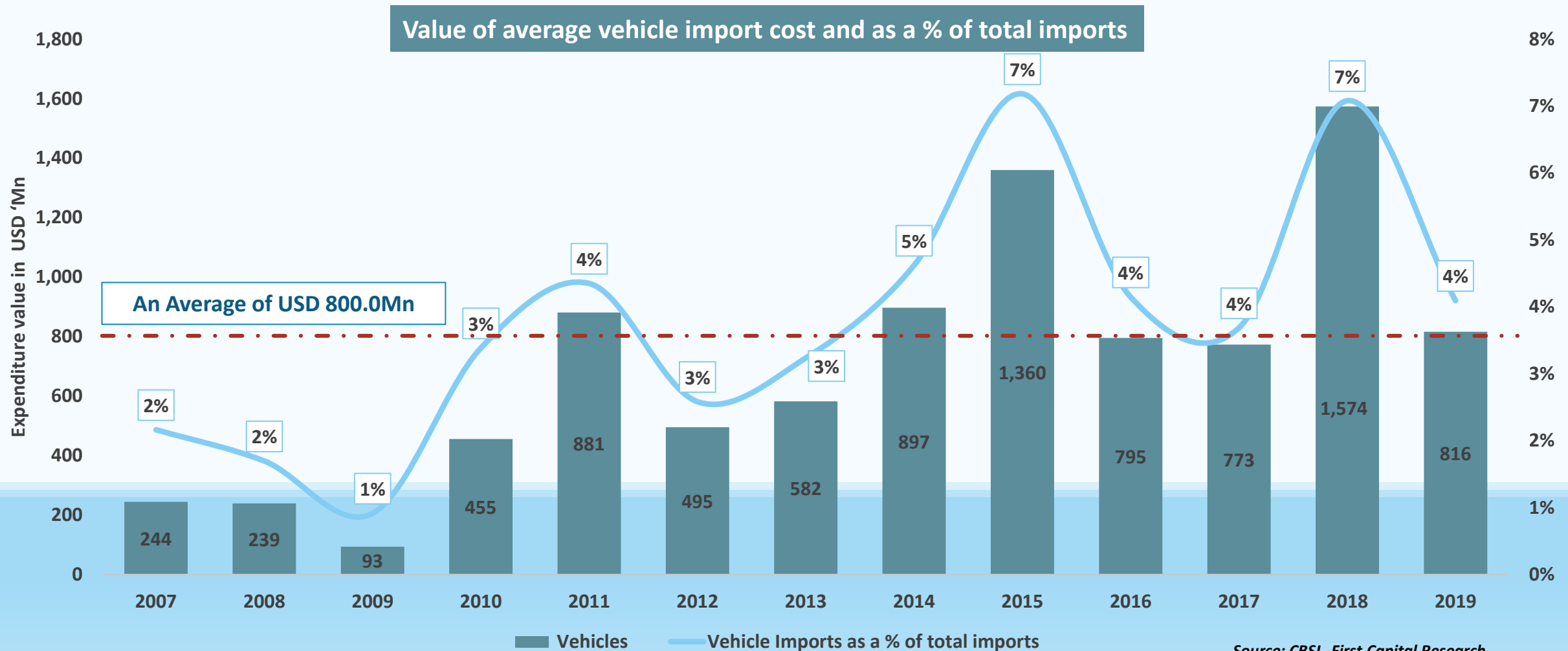
Cabinet spokesman:
Keheliya Rambukwella
Source: Newsfirst
(03.09.2020)



"When steady inflow comes in restrictions will be eased, but until that our hands are tied"

State Minister:
Ajith Nivard Cabraal
Source: Ada Derana
(04.09.2020)

...as avg vehicle imports constitute nearly USD 800Mn
or 4% of total imports for previous 13 years



Source: CBSL, First Capital Research

Registered vehicle prices have shot up while unregistered vehicles are scarce due to import restrictions, resulting in lesser transactions and lower affordability...

**Suzuki Wagon R
(2019)**



**Toyota Passo
(2018)**



**Toyota Vitz
(2019)**



**Toyota Premio
(2019)**



**Honda Vezel
(2019)**



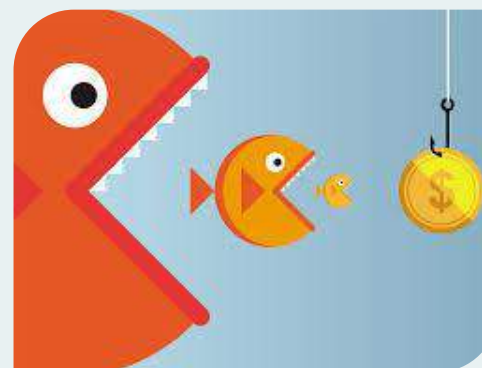
Before Price	LKR 2.85Mn	LKR 3.25Mn	LKR 3.85Mn	LKR 8.00Mn	LKR 6.62Mn
	+35%	+42%	+30%	+19%	+36%
Current Price	LKR 3.85Mn	LKR 4.60Mn	LKR 5.00Mn	LKR 9.50Mn	LKR 9.00Mn

Source: Market Research

...as a result, competition is intensifying in the Leasing segment in NBFIs sector due to attractive rates by Banks

Name of the Finance Company	5 Yr
LOLC Finance PLC	16.00%
People's Leasing and Finance PLC	10.50%
LB Finance PLC	11.00%
Central Finance Company PLC	11.50%
Citizens Development Business Finance PLC	12.00%
Commercial Leasing and Finance PLC	16.00%

Name of the Bank	5 Yr
Commercial Bank of Ceylon PLC	9.50%
Hatton National Bank PLC	10.00%
Sampath Bank PLC	10.00%
National Development Bank PLC	9.50%
Nations Trust Bank PLC	9.50%
Seylan Bank PLC	11.00%

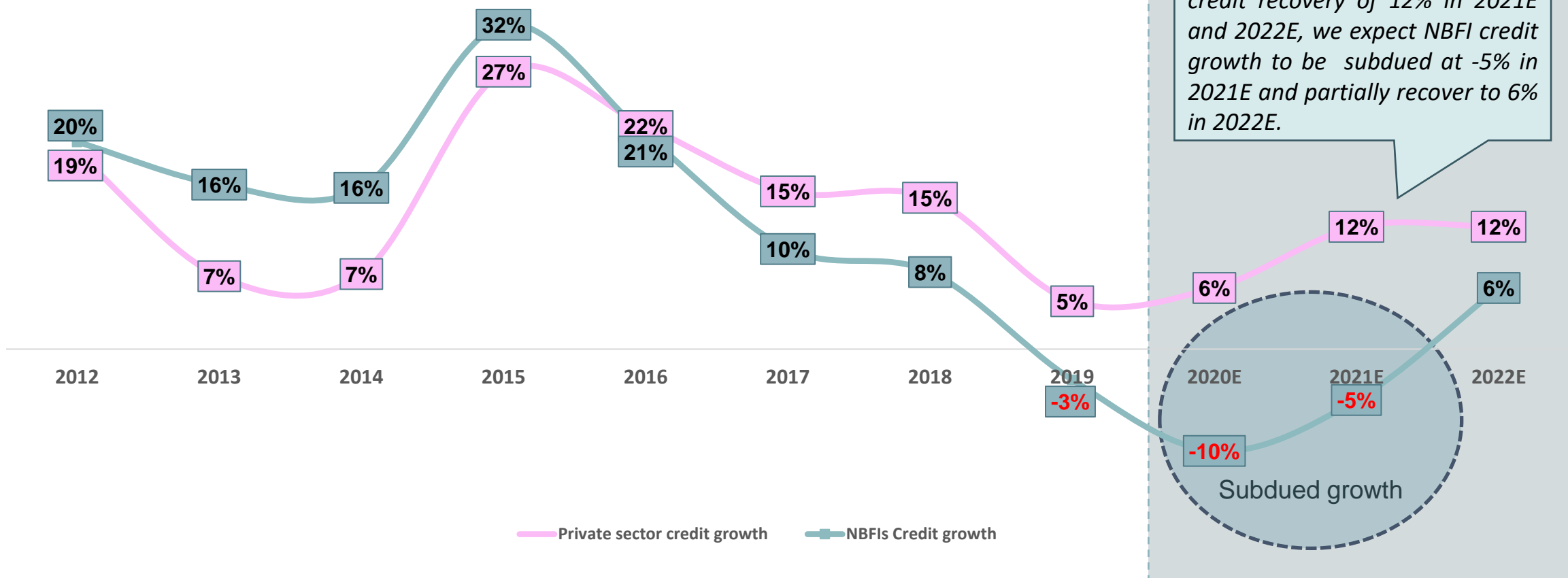


**As at 15th September 2020*

Source: Market Research, First Capital Research

Thereby, NBFIs credit growth portion may remain subdued despite the expected recovery in private sector credit growth...

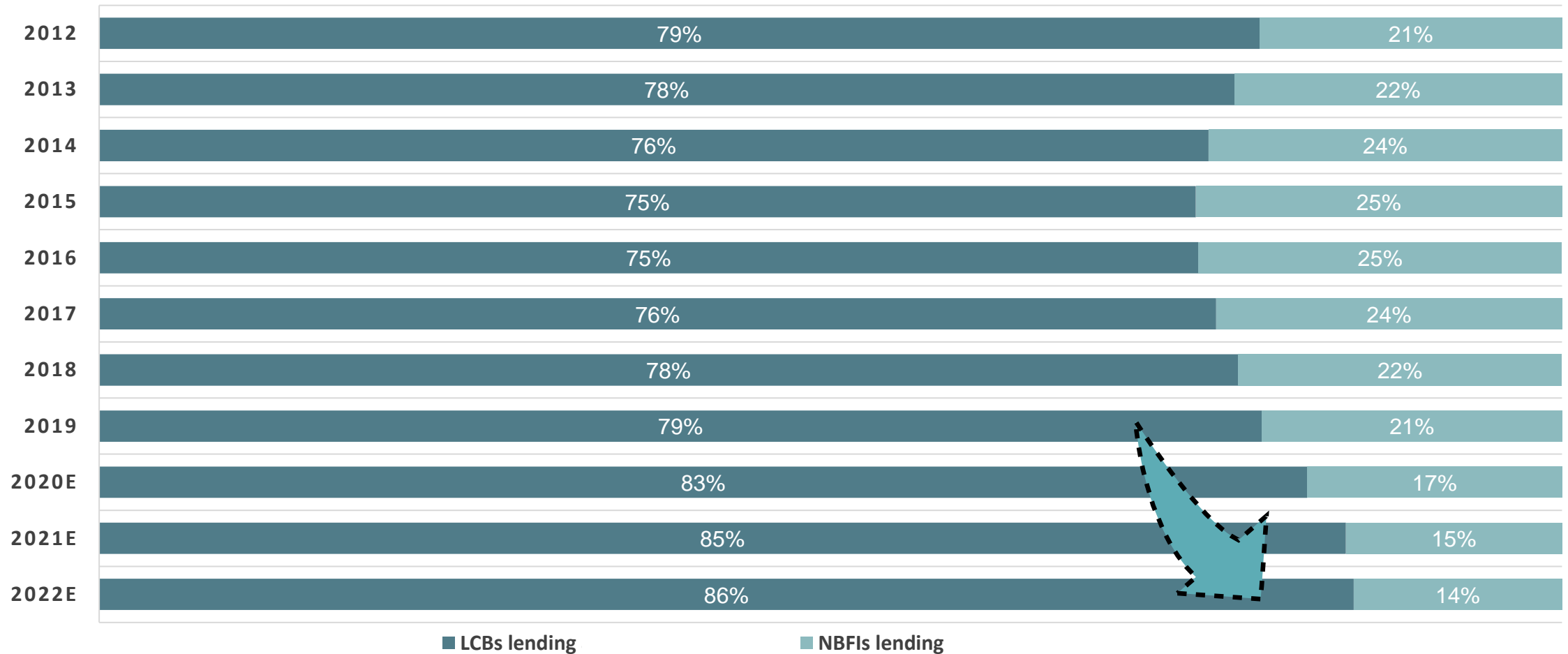
NBFI credit growth significantly under-performs total private sector credit growth



Source: CBSL, First Capital Research

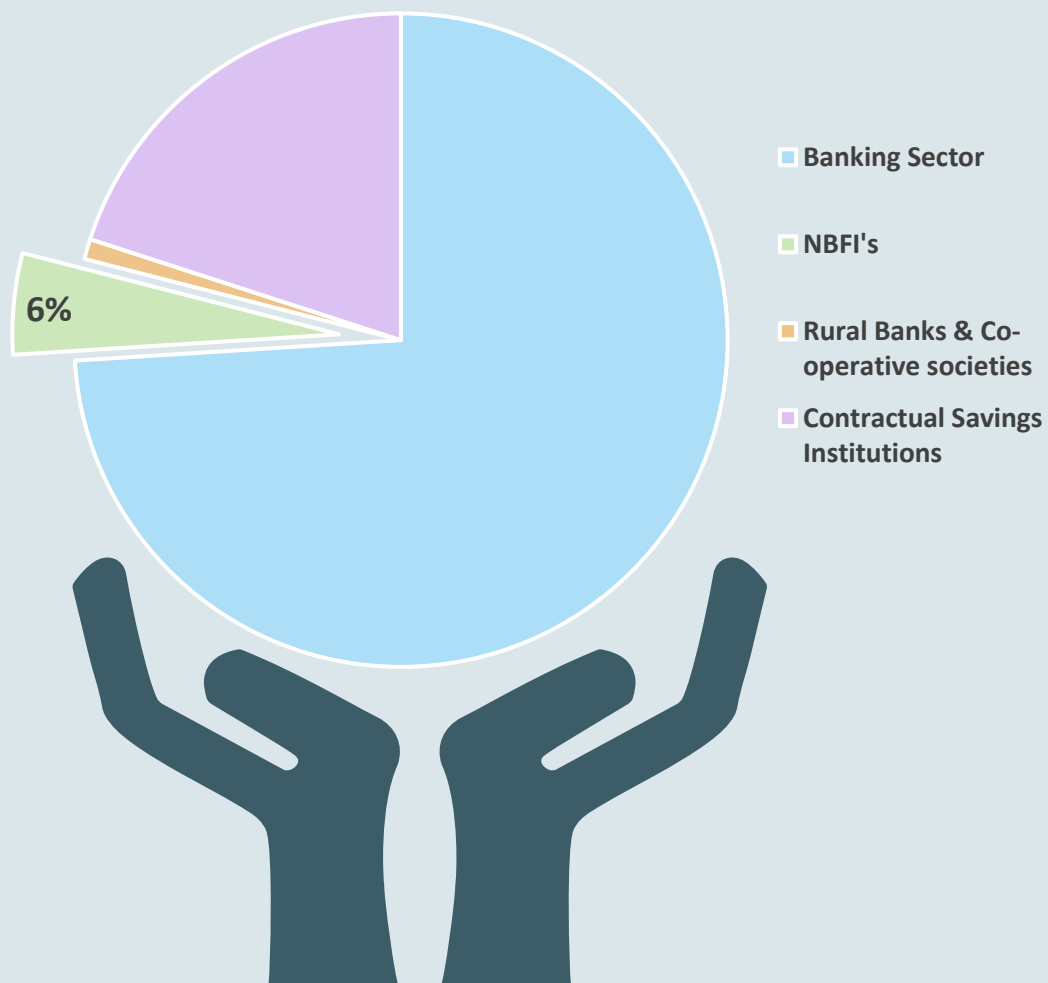
...resulting in total private credit being captured by LCBs...

NBFI Lending market to erode by 1/3 to 14% by FY22E



Source: CBSL, First Capital Research

...ultimately impacting NBFI market share to potentially reduce to 6%



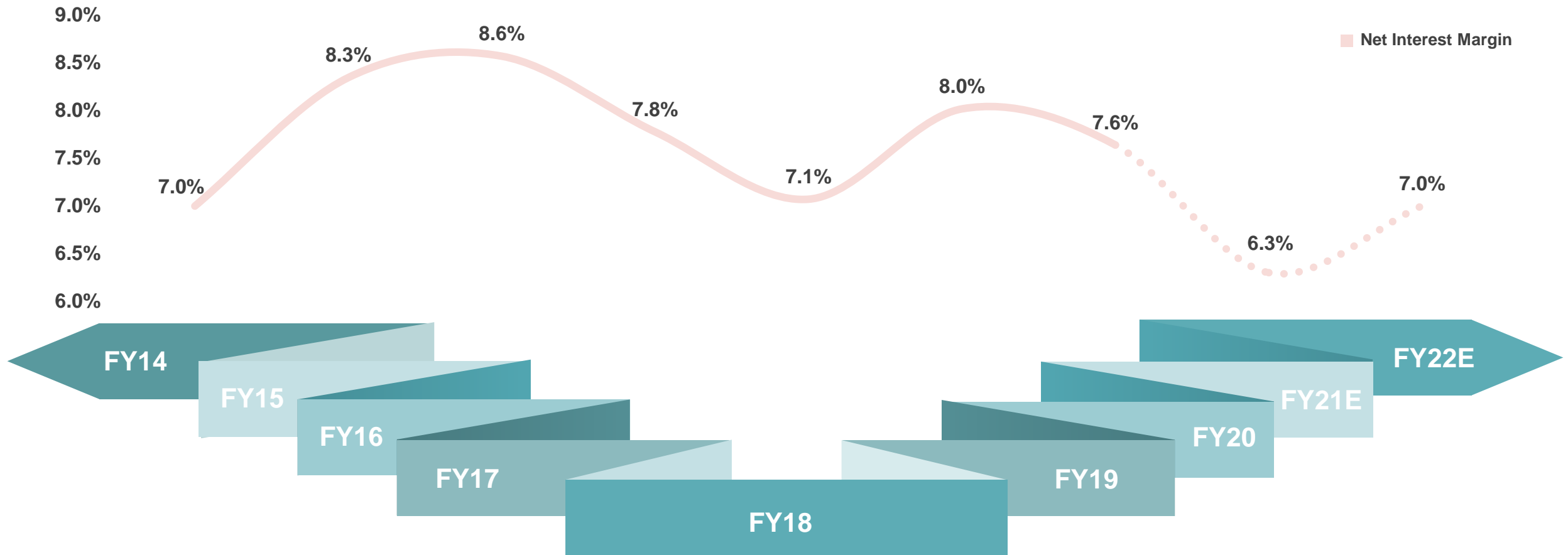
...We expect, NBFI market share to reduce to 6% by 2022E



Source: CBSL, First Capital Research

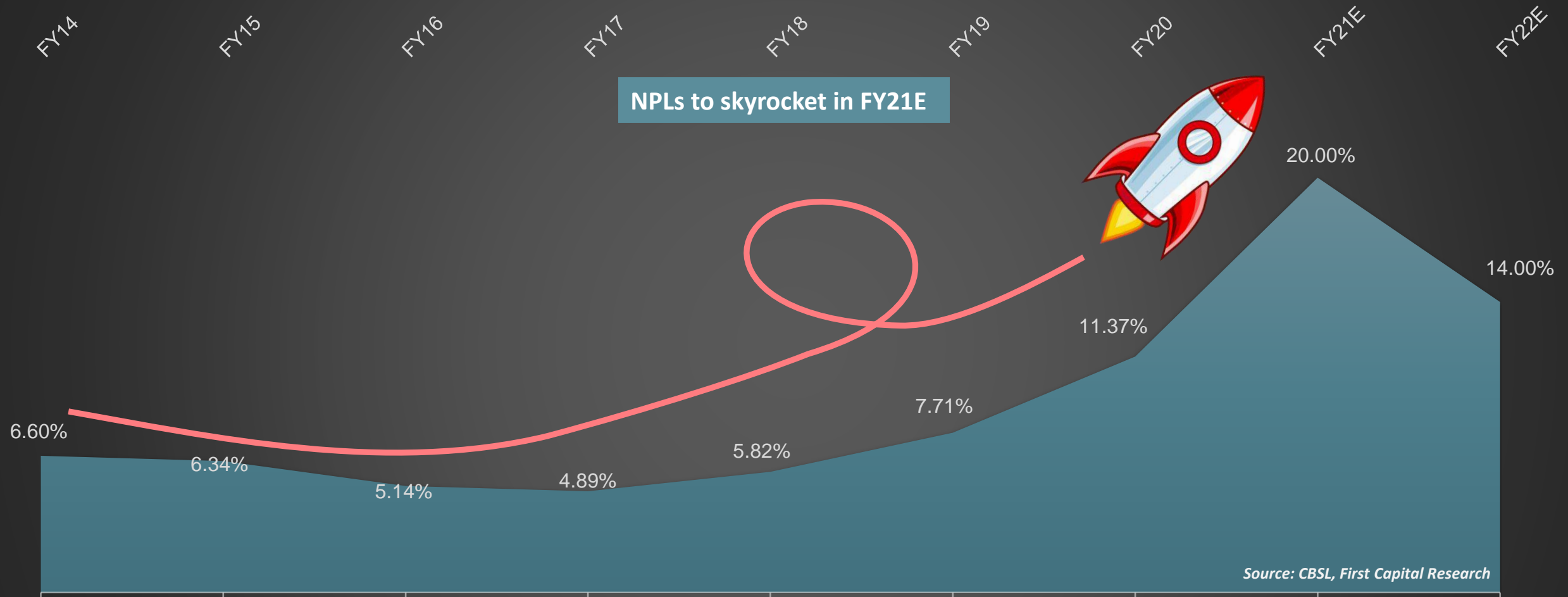
Sector wise NIMs and spread may further narrow to 6.3% in FY21E, lowest in the recent past...

NIMs to erode in FY21E, and to recover gradually

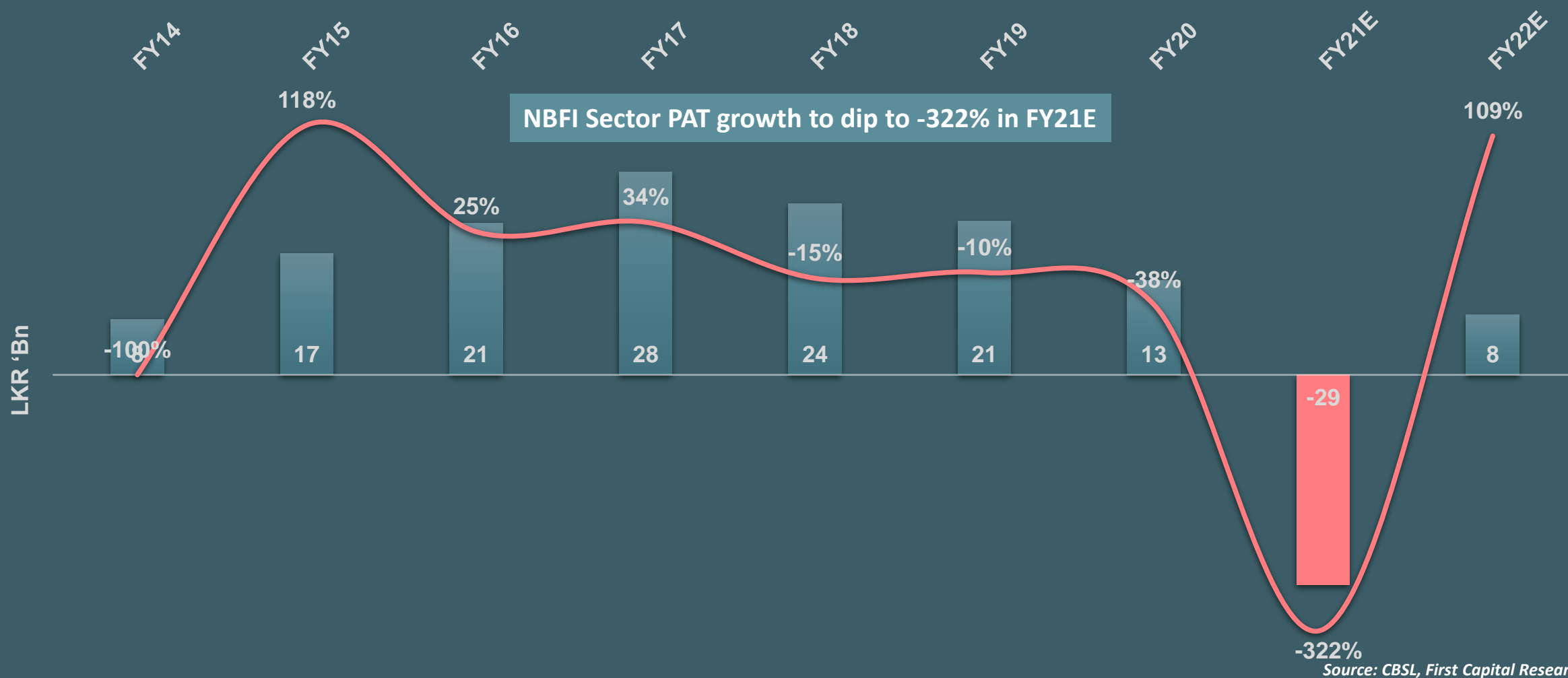


Source: CBSL, First Capital Research

...while post moratorium, NPLs may reach an astronomical high of 20% at its peak

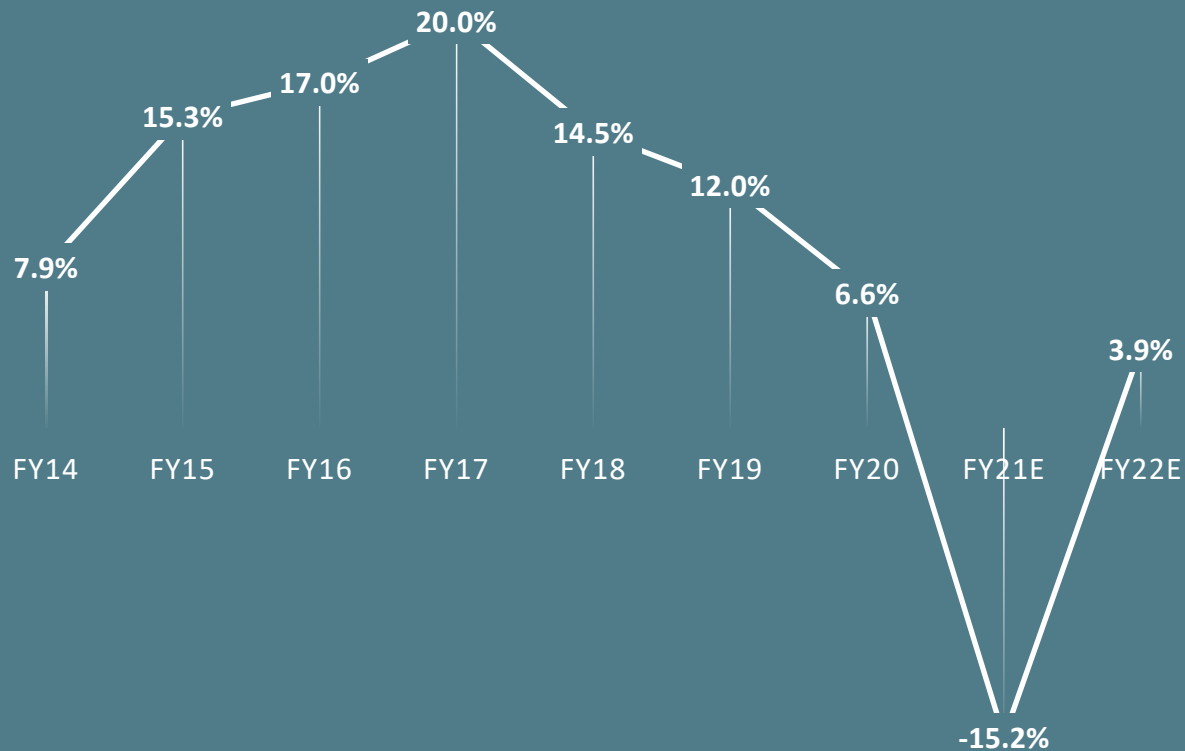


NBFI sector may record a substantial “LOSS” in FY21E, weakest performance in the current “DECADE”...



...and with it, sector ROE is expected to decline to **-15%** for FY21E

ROEs to record negative since recent past



ROEs have been declining since FY17

ROE to record a negative return in FY21E

A negative ROE recorded after 10 years

Gradual recovery expected beyond FY21E

Source: CBSL, First Capital Research

3. NBFI Sector requires to raise LKR 20Bn capital by 2021E to stay alive

CBSL provides a short-term breathing space for NBFIs via temporary measures post COVID-19

Regulations on the liquid assets

Regulations on the core capital requirement (refer [slide 16](#))

Regulations on the minimum capital adequacy (refer [slide 16](#))

✓ Reduction of maintenance of liquid asset requirement for time deposits, savings deposits and borrowings.

✓ Timeline of 01.01.2020 extended until 31.12.2020 for the enhancement of capital up to LKR 2.0Bn.

✓ Timeline of 01.01.2021 extended until 31.12.2021 for the enhancement of capital up to LKR 2.5Bn.

✓ Capital requirements set for 01.07.2020 extended until 01.07.2021.

✓ Capital requirements set for 01.07.2021 extended until 01.07.2022 respectively.

Source: CBSL, First Capital Research

CBSL's new capital adequacy framework was effective from Jul 2018....

$$\text{Tier 1 Ratio} = \frac{\text{Tier 1 Capital}}{\text{Risk Weighted Assets}}$$

Core Capital
(Tier 1 capital)

This basically includes the share capital, share premium, retained earnings including current year profit.

+

Tier 2
(Supplementary
Capital)

Tier 2 capital is Supplementary Capital. Undisclosed reserves, subordinated term debts, hybrid financial products, and other items make up these funds.

=

Total Capital

Total Capital is calculated by adding its Tier 1 and Tier 2 Capital together.

$$\text{Total Capital Ratio} = \frac{\text{Tier 1 Capital} + \text{Tier 2 Capital}}{\text{Risk Weighted Assets}}$$

...with Tier 1 calculation involving multiple adjustments to stated capital

Tier 1 Capital

+	Stated capital
+	Non-cumulative, Non-redeemable Preference Shares
+	Reserve fund
+	Audited retained earnings/(losses)
–	Revaluation gains/surplus of investment property
+	General and other disclosed reserves
+	Current year profit/(loss)



Total Adjustments to Tier 1 Capital

–	Goodwill (net)
–	Other intangible assets (net)
	Other Comprehensive Income losses
–	Deferred tax assets (net)
–	Shortfall of the cumulative impairment to total provisions and interest in suspense
–	50% of investment in banking and financial subsidiary companies
–	50% of investment in other banking and financial institutions
–	Shortfall of capital in financial subsidiaries



Tier 1
Capital
after
adjustment

Source: CBSL

The Regulation assigns varied risk weights for Leasing, Gold and Un-collateralized lending

Leasing

100%

Any credit facility for purchase or utilization of vehicles when the ownership lies with the NBFIs.



Gold Loans

- ✓ 0% risk weight for LTV less than 70%
- ✓ 100% risk weight For LTV greater than 70%)

(Refer slide 40 for NBFIs with higher exposure to gold loans)



Un-collateralized

Ex:-Microfinance

- ✓ 125% risk weight



*Companies which have **higher exposure** to these mentioned **assets** will have to assign a **higher risk weightage** compared to other classes of assets thus creating **pressure** on the **capital ratios**.*

Source: CBSL, First Capital Market Research

High **Gold Loan** exposure above 10% is limited to 4 companies in the sector

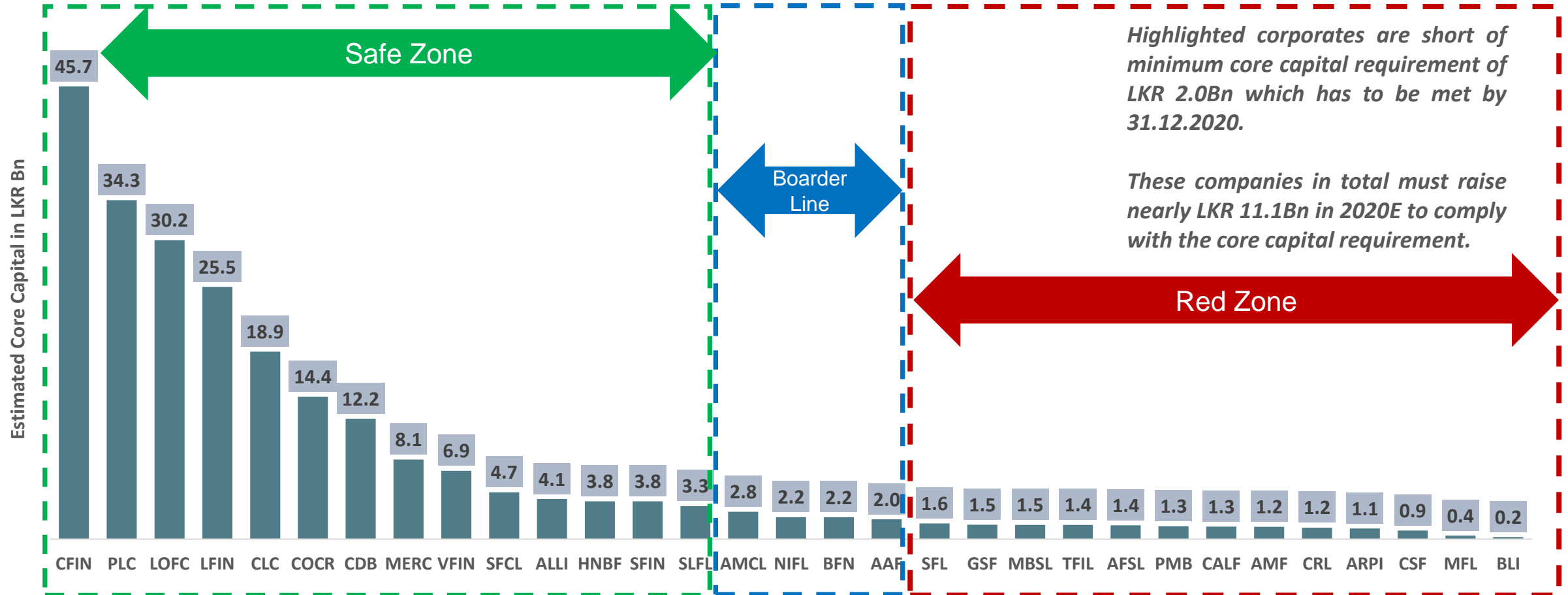
Company	Gold Loan (LKR Mn)	Loan Book (LKR Mn)	Gold Loan % out of total Portfolio
1. LB Finance PLC	31,018	119,420	26%
2. Asia Asset Finance PLC	2,838	12,640	22%
3. Softlogic Finance PLC	2,941	16,712	18%
4. Siyapatha Finance PLC	5,512	37,766	15%
5. Orient Finance PLC	1,110	12,339	9%
6. Commercial Credit and Finance PLC	6,060	70,379	9%
7. Alliance Finance Company PLC	2,100	26,245	8%
8. Vallibel Finance PLC	3,289	41,114	8%
9. Citizens Development Business Finance PLC	4,688	72,561	6%
10. Singer Finance (Lanka) PLC	1,265	20,158	6%
11. LOLC Finance PLC	6,107	133,954	5%
12. Senkadagala Finance PLC	1,160	27,247	4%
13. HNB Finance PLC	1,122	28,303	4%
14. Merchant Bank of Sri Lanka and Finance PLC	647	27,951	2%
15. Commercial Leasing and Finance PLC	603	54,139	1%
16. People's Leasing Finance PLC	896	154,135	1%



Source: Company Annual Reports & First Capital Research

NBFIs which may **fall short** of core capital LKR 2.0Bn by 31.12.2020

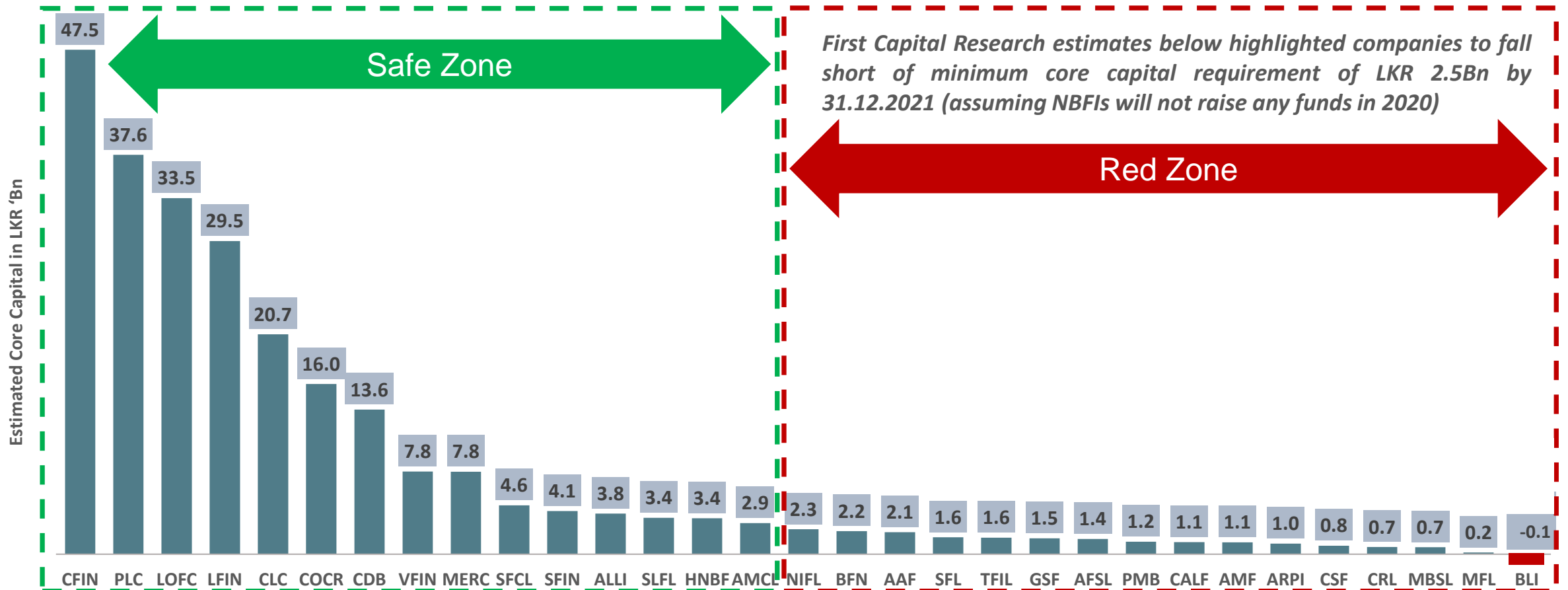
In total NBFFI industry has to raise nearly LKR 11.1Bn in 2020E to comply with the core capital requirement



Source: CBSL, Company Reports, First Capital Research Estimates

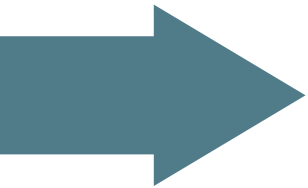
NBFIs which may **fall short** of core capital LKR 2.5Bn by 31.12.2021

In total NBFFI industry has to raise nearly LKR 20.0Bn by 2021E to comply with the core capital requirement



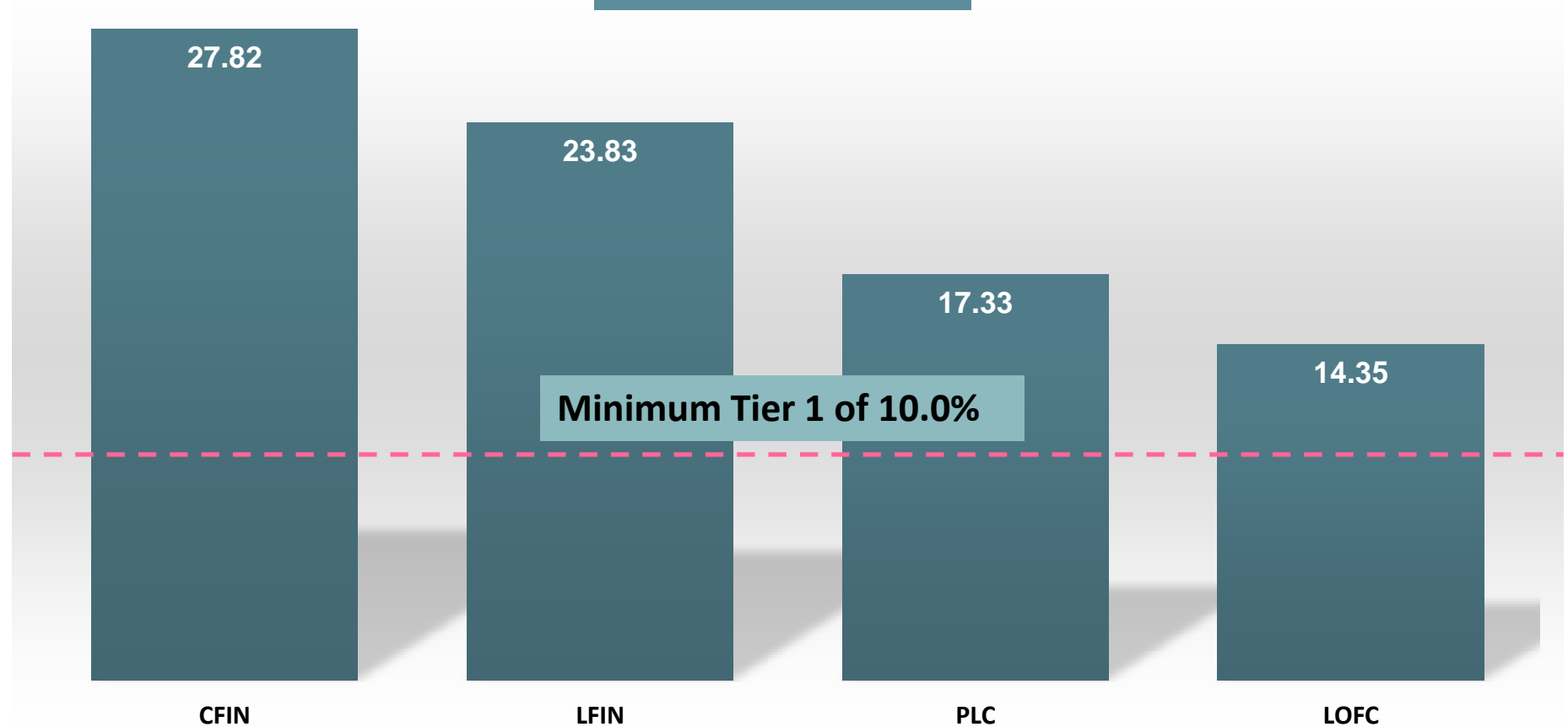
Source: CBSL, Company Reports, First Capital Research Estimates

Big cap Finance companies in the sector benefit amidst the comfortable capital levels



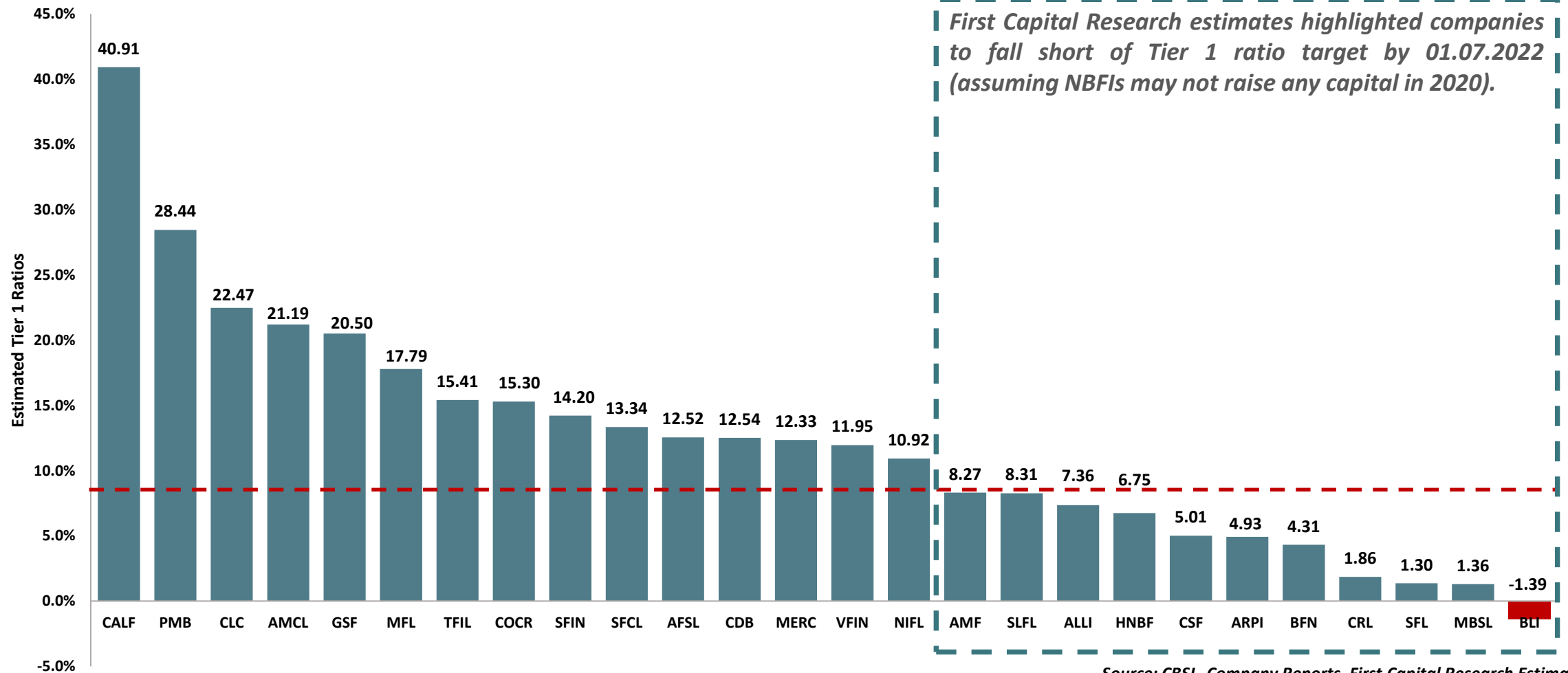
We expect big cap, CFIN, LFIN, PLC and LOFC to maintain Tier 1 capital ratios well above the minimum requirement and thus benefit over middle and smaller NBFIs.

Estimated Tier 1 Ratios



Source: CBSL, Company Reports, First Capital Research Estimates

Highlighted NBFIs will **fall short** to maintain 8.5% minimum Tier I by 01.07.2022



Source: CBSL, Company Reports, First Capital Research Estimates

TIME IS UP.....



In total NBFI industry has to raise nearly *LKR 11.1Bn* in 2020E to comply with the core capital requirement



In total NBFI industry has to raise nearly LKR 20.0Bn in 2021E to comply with the core capital requirement

Note- For companies that meet the minimum core capital and do not comply with the Tier 1 ratios, portfolios can be realigned to improve the capital ratios.

Source: CBSL, Company Reports, First Capital Research Estimates

Potential capital infusion strategies

Company Name	Name of the Parent	Amount to be raised (LKR Bn) by 31.12.2021	Parent company infusing capital	Possible Rights Issue	Need of a Strategic Investor	Possible Merger with another company
LOLC Development Finance PLC	LOLC Holdings PLC	0.2	✓	✓		
Orient Finance PLC	Janashakthi PLC	0.3	✓	✓		
Asia Asset Finance PLC	Muthoot Finance Ltd	0.4	✓	✓		
Sinhaputhra Finance PLC	N/A	0.9			✓	✓
Trade Finance and Investments PLC	Commercial Credit and Finance PLC	0.9				[Announced]
Prime Finance PLC	Prime Lands (Pvt) Ltd	1.0	✓	✓		
Abans Finance PLC	Abans PLC	1.1				[Announced]
People's Merchant Finance PLC	Sterling Capital Investments	1.3			✓	✓
Associated Motor Finance Company PLC	N/A	1.4			✓	[Announced]
Arpico Finance Company PLC	Associated Motor Finance Company PLC	1.5			✓	[Announced]
Merchant Bank of Sri Lanka and Finance PLC	Bank of Ceylon	1.7	✓	✓		
Nation Lanka Finance PLC	N/A	1.7			✓	✓
Softlogic Finance PLC	Softlogic Holding's PLC	1.8	✓	[Announced]		
Multi Finance PLC	Fairway Holdings Private Limited	2.3			✓	✓
Bimpuh Finance PLC	N/A	2.6			✓	✓

Source: CBSL, Company Reports, First Capital Research Estimates

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Thank You

"Successful Investment Is About Managing Risk..."