Lanka Rating Agency

Rating Report

SMB Finance PLC

Report Contents

Rating History

Dissemination Date	Long Term Rating	Outlook	Action	Rating Watch
19-Mar-2024	BB	Stable	Initial	-

Rating Rationale and Key Rating Drivers

SMB Finance PLC ("SMBF" or "the Company") operates as a public listed Licensed Finance Company (LFC) with primary focus on leasing, term loans and gold loans. Prior to Dec'22, SMBF was a specialized leasing company (known as "SMB Leasing PLC") dealing in the core business of leasing. SMBF obtained its finance business license in December, 2022. The Company has undergone several changes in its ownership structure since its inception. Mr. Wijaratne, a veteran businessman with investments in industries such as entertainment, cargo terminal and real estate, is the single largest shareholder (~64%) of SMBF since 2021. The rating takes account of SMBF's recent placement in the LFCs sector, which is reflected by very small share of ~0.3% in the sector's asset base and ~0.2% in the sector's loan portfolio. In terms of lending portfolio, SMBF's outstanding loans are a mix of its fresh disbursements as well as the legacy loans carried forward from its loan portfolio of Seylan Merchant Bank until 2010. A restricting factor for the rating is the considerably higher Non-Performing Loans (NPLs) of SMBF stemming not only from the legacy portfolio but also from the fresh book. SMBF's Gross NPLs rose to ~36% in CY23 (~24% in CY22) significantly above the average Industry NPLs of ~20% in 6MFY24. Furthermore, NPLs from the fresh loan portfolio also stood at a very high level of ~38% as at CY23 and the NPLs from old portfolio were ~97%. SMBF's overall portfolio declined by ~11% recording at LKR~2.2bn in CY23. On the other side, SMBF's NPLs remain well covered with ~86% provision coverage in CY23 (~106% in CY22), which bodes well for the Company. SMBF has a strong capital structure, following the injection of capital through the rights issue of LKR~2.1bn in CY21 to meet the core capital requirements of LFCs as set out by the CBSL. SMBF's external funding majorly comprises of bank borrowings, i.e., LKR~1.5bn (CY23) and a nominal portion of public deposits (LKR~42mn as at CY23). Meanwhile, SMBF's asset base includes a significant portion of liquid assets, i.e., placements with banks (LKR~2.5bn as at CY23) along with its lending portfolio. The liquidity profile of SMBF, therefore, remains sound as a large portion of its investments are backed by its internal capital. While liquidity and capital profile remain promising, the rating takes into account relatively small size of SMBF's lending portfolio, coupled with a rising credit risk and the LFC's yet to be implemented growth plans and franchise value. The rating also factors in the inadequacy of a formal risk management framework to ensure adequate controls and operational procedures in place.

The rating is dependent on SMBF's ability to turnaround its deteriorating asset health and ensure a sustainable business growth model. Any further dip in the credit quality or weakened growth prospects will have a negative impact on the rating. Meanwhile establishing sound risk management framework, advanced technological framework and strong operational practices remains critical.

Disclosure	
Name of Rated Entity	SMB Finance PLC
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Non-Banking Finance Companies Rating(Jun-22)
Related Research	Sector Study | Leasing & Finance Companies(Aug-23)
Rating Analysts	Savindri Hansamala Kuruppu | savindri@lra.com.lk | +92-42-35869504

Profile

Structure SMB Finance PLC ("SMBF" or "the LFC") was established in 1992 and listed in the Colombo Stock Exchange ("CSE") in 1993. The LFC was re-registered under the Companies Act No. 07 of 2007 and is authorized to carry out finance leasing under the Finance Leasing Act No. 56 of 2000. The LFC obtained the finance business license under the Finance Business Act No. 42 of 2011 w.e.f. December 1, 2022.

Background The LFC was Seylan Merchant Bank PLC up until 2010 when Seylan Bank divested its majority shareholding during the Ceylinco Group crisis subsequently becoming SMB Leasing PLC. In December 2022, it became a Licensed Finance Company and was renamed as SMB Finance PLC. The LFC has a subsidiary, SMB Money Brokers (Pvt) Ltd which is fully provided for and an associate named Kenanga Investment Corporation Ltd.

Operations The principal activities of the LFC include granting finance leases, mortgage loans, gold loans and accepting deposits.

Ownership

Ownership Structure The largest shareholder of the LFC is Mr. H R S Wijeratne, who is also the Chairman of the Board.

Stability There have been several changes in the ownership of SMBF over the years. Going forward, the ownership structure is expected to remain stable in the medium to long term.

Business Acumen Mr. Wijeratne, is a businessman and an accountant by profession, who has international investments in different industries such as real estate, cargo, energy, and entertainment. He is the Chairman of Rank Holdings through which he manages his many investments. But he has no previous experience in the finance sector.

Financial Strength Mr. Wijeratne had first invested in the LFC in 2011 and he has got the major shareholding of 64% in the rights issue in 2021. He has not given any financial guarantees to the LFC.

Governance

Board Structure The Board consists of six directors, out of which four are Independent, Non-Executive Directors. Since the Chairman is a Non-Independent, Non-Executive Director, Mr. Wadood has been appointed as a Senior Director. The Chief Executive officer ("CEO") is an Executive Director. Mr. Anura Chandrasiri (ID/NED) has resigned from the Board w.e.f. August 28, 2023.

Members' Profile The Chairman is Mr. Ravi Wijeratne and the other directors are well experienced in diverse industries.

Board Effectiveness The Board have formed and operates through seven board sub-committees.

Financial Transparency The External Auditors of the LFC, KPMG issued an unqualified audit opinion for the year CY22.

Management

Organizational Structure The LFC has a well-defined organizational structure with 12 divisions where 10 divisions directly report to the CEO.

Management Team The management team is steered by the CEO, Mr. Supul Wijesinghe who is a Chartered Accountant by profession with relevant qualifications and experience. The Corporate management team possesses professional and academic qualifications related to their respective functions.

Effectiveness The LFC has formed four management committees and these committees assist the LFC to effectively carry out its operations.

MIS The LFC is in the process of migrating from the legacy software and hardware to new integrated system, a new cloud-based backup system and disaster recovery options. Having a comprehensive Enterprise Resource Planning system is crucial for the decision making.

Risk Management Framework The LFC is in the process of formulating a risk management policy, which is currently not in place as each department prepares their own risk registers after identifying the key risks which are then presented in the IRMC.

Business Risk

Industry Dynamics At present, there are 34 LFCs in Sri Lanka, out of which, 27 are listed on the CSE. The profitability of the sector dropped by ~47% in FY23 to LKR~31bn (6MFY24: LKR~16bn, 6MFY23: LKR~13bn). In comparison to FY22, the interest income has increased by ~46% to LKR~307bn in FY23 (6MFY24: LKR~169bn), while the interest expenses show a major increase of ~134% as at FY23 to LKR~192bn (6MFY24: LKR~55bn). The loan loss provisions increased by ~118% to LKR~14bn in FY23 (6MFY24: LKR~6bn). The total asset base of the LFC sector was recorded at LKR~1.64tn as at 6MFY24. The gross and net NPL ratio clocked in at ~19.99% and ~14.06% respectively as at 6MFY24.

Relative Position SMBF has a small presence in the LFC sector in Sri Lanka as per its asset base (9MCY23: ~0.33% share). The loans and advances are only ~0.16% of the industry loans in 9MCY23. The share of equity base also decreased to ~0.88% in 9MCY23 from ~0.92% in CY22 (CY21: ~1.07%).

Revenues The LFC increased its Net Interest Income by ~212% to LKR~483mn during CY23. During the year, the interest income rose to LKR~792mn in CY23 from LKR~289mn in CY22, which is a growth of ~174%. This is due to ~145% improvement in gold loan advances income to LKR~133mn and reclassification of interest on investments, mainly interest from placements with banks, from other income to interest income. Impact of the falling interest will affect the revenues as 53% of the revenue is from investment income. The interest cost has gone up considerably mainly due to ~134% increase in bank borrowing cost to LKR~300mn in CY23 from LKR~128mn in CY22.

Performance SMBF earned a profit after tax (PAT) of LKR~53mn and LKR~80mn in CY21 and CY22 respectively after making losses in CY20. PAT has increased by 77% to LKR 141Mn in CY23. The core spread for CY23 and CY22 were recorded at ~12.1% and ~10.6% respectively. In CY23, the gold loan portfolio increased by 1% to LKR~422mn, while the loans and advances portfolio decreased by ~10% to LKR~1bn and leases by ~18% to LKR~761mn. During CY23, the LFC's ROE stood at ~4.1% and ROA was recorded at ~2.7%.

Sustainability The LFC's strategy is to focus on high-net-worth individuals, with a value proposition of high confidentiality. The leases will be focused on high-end vehicles rather than commercial vehicles. Introducing savings account to minors is also in the pipeline. They have a greater potential to grow with the high equity base and potential to attract public deposits. SMBF had a branch network of five branches as at CY23 and they have plans to open 20 more branches by CY25. Establishing sound risk management framework, advanced technological framework and strong operational practices remains critical for the sustainability of the LFC.

Financial Risk

Credit Risk The Non-Performing Loans (NPL) of SMBF have been considerably higher in comparison to the industry average. The Gross NPLs of SMBF were recorded ~25% in CY22 which increased further to ~36% in CY23. Nevertheless, ~86% of the lending portfolio is provided for. The top 20 borrowers' concentration stood at ~67% in CY23, posing a high concentration risk.

Market Risk SMBF has reduced its risk by investing in various assets, such as fixed deposits with the banks amounting to LKR~2.5bn, and quoted/unquoted shares of LKR~104mn in CY23. The interest cost for bank borrowings was recorded at LKR~300mn in CY23 and LKR~128mn in CY22. Some loans were borrowed against the fixed deposits for which the incremental cost was recorded around ~1%.

Liquidity And Funding The interest-bearing borrowings amounted to ~93% of the total funding as at CY22 reducing slightly in CY23 to ~90% to LKR:~1,505mn. The remaining 10% is from promissory notes, a time deposit and savings deposits acquired from Swarnamahal Financial Services PLC. The top 20 time and savings accounts for ~95% of the total deposits as at 9MCY23. The maturity mismatch indicates good liquidity but it shows that the Company has not effectively utilized its assets in the less than one year bracket. This is mainly due to lack of deposits and loan portfolio as well as bank deposits being mainly short-term in nature.

Capitalization The Core Capital Adequacy Ratio ("CAR") was maintained at ~103.6% and ~81.1% as at CY23 and CY22, while the regulatory requirement is 8.5%. SMBF records a core capital of LKR~2.8bn and LKR~3.1bn during CY23 and CY22 respectively, while the required minimum was LKR~2.5bn. The LFC had carried out a rights issue in CY21 and raised LKR~2.1bn to satisfy the core capital requirement. The total CAR stood at ~101.9% as at CY23 which is above the requirement of 12.5%. With the expected growth in the lending portfolio, the ratios are expected to dilute.

Lanka Rating Agency

LKR mln

SMB Finance PLC Listed Public Limited	Dec-23 12M	Dec-22 12M	Dec-21 12M	Dec-20 12M
A BALANCE SHEET				
1 Total Finance-net	1,502	1,893	995	997
2 Investments	769	533	279	211
3 Other Earning Assets	2,481	2,364	2,393	206
4 Non-Earning Assets	608	435	208	335
5 Non-Performing Finances-net	(30)	(38)	120	74
Total Assets	5,329	5,187	3,996	1,823
6 Funding	1,700	1,710	664	738
7 Other Liabilities	132	121	80	48
Total Liabilities	1,833	1,831	744	786
Equity	3,497	3,356	3,252	1,037
B INCOME STATEMENT				
1 Mark Up Earned	792	484	230	166
2 Mark Up Expensed	(309)	(135)	(52)	(60)
3 Non Mark Up Income	35	71	66	17
Total Income	518	420	244	123
4 Non-Mark Up Expenses	(212)	(146)	(120)	(111)
5 Provisions/Write offs/Reversals	(105)	(179)	(57)	(79)
Pre-Tax Profit	200	95	67	(67)
6 Taxes on Financial Services	(44)	(19)	(11)	(3)
Profit Before Income Taxes	156	76	56	(70)
7 Income Taxes	(15)	3	(2)	-
Profit After Tax	141	80	53	(70)
C RATIO ANALYSIS				
1 PERFORMANCE				
a Non-Mark Up Expenses / Total Income	41.0%	34.7%	49.3%	90.7%
b ROE	4.1%	2.4%	2.5%	-6.8%
2 CREDIT RISK				
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	116.3%	145.8%	238.1%	199.8%
b Accumulated Provisions / Non-Performing Advances	106.3%	106.3%	79.4%	84.5%
3 FUNDING & LIQUIDITY				
a Liquid Assets / Funding	162.5%	147.6%	388.3%	67.6%
b Borrowings from Banks and Other Financial Institutes / Funding	88.5%	91.7%	79.2%	81.2%
4 MARKET RISK				
a Investments / Equity	22.0%	15.9%	8.6%	20.4%
b (Equity Investments + Related Party) / Equity	4.2%	4.4%	4.2%	11.1%
5 CAPITALIZATION				
a Equity / Total Assets (D+E+F)	65.6%	64.7%	81.4%	56.9%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	4.2%	2.4%	5.2%	-6.8%

Credit Rating

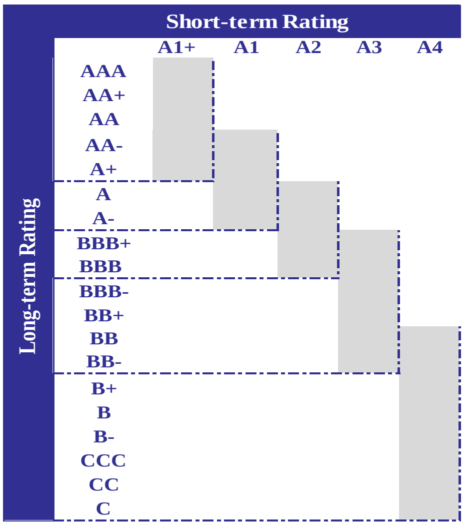
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating

Regulatory and Supplementary Disclosure

(Rules applicable to Credit Rating Agencies, No. 19 of 2021 - issued on 15th March 2022)

Rating Team Statements

(1) Credit Rating Agency means a body corporate engaged in the business of assessing and evaluating the credit- worthiness of any issuer or a specific issue of securities. https://www.sec.gov.lk/credit-rating-agency/

Conflict of Interest

(2) i. LRA will disclose to the Commission all other business activities it is engaged in at the time of applying for its licence and inform the Commission in writing prior to engaging in any other business activity after obtaining a licence from the Commission. (Section 34 – Rules applicable to Credit Rating Agencies)

(2) ii.LRA will not engage in any other business which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained. (Section 35 – Rules applicable to Credit Rating Agencies)

(2) iii.In the conduct of any such other business activity, the LRA will ensure that proper processes are in place to have a clear demarcation of the different functions pertaining to such businesses. (Section 36 – Rules applicable to Credit Rating Agencies)

Restrictions

(3) (i) LRA will not be outsource any part of its work, which has a direct bearing on the function of rating. (Section 24 – Rules applicable to Credit Rating Agencies)

(3) (ii) LRA will enter into a written agreement with the party to whom any work is outsourced. Such agreement contains an undertaking from the party to whom any work is outsourced that they shall comply with the laws, rules, and directives that the LRA is bound to follow. (Section 25 – Rules applicable to Credit Rating Agencies)

(4) The LRA will not appoint any individual as a member of the rating committee who:
(a) has a business development function of the Credit Rating Agency; or
(b) who initiates or participates in discussions regarding fees or payments with any Client of the LRA. (Section 28 – Rules applicable to Credit Rating Agencies)

Conduct of Business

(5) Prior to the commencement of a rating or during such process the LRA will not promise, assure or guarantee to a Client that a particular rating will be assigned. (Section 39 – Rules applicable to Credit Rating Agencies)

(6) LRA performs a rigorous and formal periodic review of all its methodologies. Such methodologies will be made available to the Commission for perusal, upon request. (Section 41 – Rules applicable to Credit Rating Agencies)

Independence & Conflict of interest

(7) LRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on LRA´s opinions or other analytical processes. In all instances, LRA is committed to preserving the objectivity, integrity, and independence of its ratings.

(8) LRA will not engage in any other business which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained. (Section 35 – Rules applicable to Credit Rating Agencies)

(9) LRA will structure its rating teams and processes to promote continuity, consistency and avoid bias in the rating process. (Section 47 – Rules applicable to Credit Rating Agencies)

Monitoring and review

(10) For purposes of transparency the LRA will publish sufficient information about an entity/security rated, frequency of default and whether a rating grade assigned has changed over time. The definitions and computation methods for the default rates stated in the default studies shall also be disclosed. (Section 44 – Rules applicable to Credit Rating Agencies)

LRA maintain the following records pertaining to Clients:
(a) all internal records to support its credit rating opinions;
(b) all particulars relating to Clients at its office which shall include the name and registered address and contact numbers of such Client, names and addresses of their directors as at the date of rating, its issued share capital and the nature of business; and
(c) a written record of all complaints received from Clients and action taken thereon by the LRA. (Section 48 – Rules applicable to Credit Rating Agencies)

(11) LRA maintains confidentiality of all non-public information entrusted to it by Clients at all times including such Client’s identity and transactions carried out for such Client unless and to the extent such disclosure is required by law, or unless authorised by the Client to disclose such information. (Section 50 – Rules applicable to Credit Rating Agencies)

(12) LRA does not destroy, conceal or alter any records, property or books relating to the business of the Credit Rating Agency which are in its possession or under its control with the intention of defeating, preventing, delaying or obstructing the carrying out of any examination (Section 53 – Rules applicable to Credit Rating Agencies)

Probability of Default

(13) LRA’s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e., probability).

Proprietary Information