Lanka Rating Agency

Rating Report

Merchant Bank of Sri Lanka & Finance PLC

Report Contents

Rating History

Dissemination Date	Long Term Rating	Outlook	Action	Rating Watch
01-Aug-2024	BBB+	Stable	Maintain	-
01-Feb-2023	BBB+	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The rating reflects the robust ownership of Merchant Bank of Sri Lanka & Finance PLC ("MBSL" or "the Company") and demonstrated track record of sponsors to provide support. The Bank of Ceylon (BOC) is the largest shareholder of the Company and has provided written affirmation to support MBSL. As a fully state-owned bank and one of the systematically important banks of Sri Lanka, BOC brings stability and financial strength. MBSL is a relatively small player in the leasing industry, accounting for (~2%) of the assets in CY23, and (~3)% of deposits of the sector. The Company's gross non-performing loans (3MCY24: ~21.7%) remain above the industry average, showing stressed advances portfolio as its borrowers comprise relatively high risk segment. The recent focus on recoveries and improving macroeconomic conditions are expected to have a positive impact and reduce NPLs. The Company improved its performance in CY23 and posted PAT of LKR ~21 million (CY22: loss of ~496 million) on the back of substantial gain on investments and better spread. However, sustaining these performance trends is critical, going forward. MBSL was non-complaint in regulatory Capital Adequacy Ratio ("CAR") requirement in CY22, resulting in certain restrictions on its activities by the regulator. The CAR has improved to ~16.75% in CY23 and those restrictions are now removed. MBSL intends to focus on gold loans and prudent lending in the short-term as the economic activities pick up in the country.

The rating is contingent upon continued capacity and willingness of BOC to provide support. Any substantial reduction in BOC's shareholding or other restrictions imposed on the bank that would result in diminishing support prospects, would negatively impact the rating. Meanwhile, sustenance of current performance trends, complying with regulatory capital requirements and improvement in asset quality is critical.

Disclosure	
Name of Rated Entity	Merchant Bank of Sri Lanka & 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	Imran Iqbal | imran@lra.com.lk | +94 114 500099

Profile

Structure Merchant Bank of Sri Lanka & Finance PLC ("MBSL" or "the Company") is a registered Finance Leasing Company under the provisions of the Finance Leasing Act No. 56 of 2000 and a Finance Company licensed by the Monetary Board of Central Bank of Sri Lanka under the Finance Business Act No. 42 of 2011.

Background In 1980, the Company operated as a management consultancy division of the Bank of Ceylon ("BOC" or "the Bank"). In 1982, it was incorporated as a limited liability company. MBSL was listed on the Colombo Stock Exchange ("CSE") in 1991. The Company merged with two other companies in the BOC group in 2015.

Operations The principal business activities of the Company are leasing and hire purchase, corporate and retail credit, corporate advisory, capital market advisory, capital market activities, lending, deposit mobilization, and the provision of financial services.

Ownership

Ownership Structure The largest shareholder of the Company is Bank of Ceylon ("BOC") which is the country's top commercial Bank solely owned by the Government of Sri Lanka. It directly owns (~76.56%) of the Company. BOC Property Development & Management (Pvt) Ltd owns (~7.94%), Bank of Ceylon A/C Ceybank Unit Trust owns (~2.25%). BOC as a group owns (~86.75%) of MBSL.

Stability MBSL is the largest subsidiary of BOC and the bank has continuously supported the Company and plans to keep its shareholding intact which provided stability to the shareholding of the Company.

Business Acumen BOC owns a 22% share of the industry loans and advances, which amounts to LKR 4.4tn in December, 2023 and 22% of the industry deposits, which amounts to LKR 3.9tn in the same year. The Company also holds ownership in multiple subsidiaries and associates and it offers personal and corporate banking, primary dealing, investment banking, and money remittance among other financial services. Over the years BOC has demonstrated that its skills have also helped in better performance of MBSL.

Financial Strength BOC earned a Profit before Tax of LKR 40bn during CY23, with an asset base of LKR 4.1tn. Investments in subsidiaries & associates worth LKR 10.69bn. The Company earned a dividend income of LKR 372mn from subsidiaries and associates. The Bank has supported MBSL and also provided a written commitment to keep supporting the Company if the need arises.

Governance

Board Structure The board consists of eight non-executive directors, out of which five are non-independent directors and three are independent directors. All the non-independent directors of the Company represent BOC.

Members' Profile The board members have experience in law, finance, banking and treasury. They possess the experience in the requisite fields to guide the Company.

Board Effectiveness The Company Board meeting is held at least once every month. For evaluation of critical activities of the Bank Company Secretary convene a meeting on an annual basis. The company secretary maintains minutes of the Board meetings with all submissions to the Board and/or voice recordings/video recordings for a minimum period of 6 years.

Financial Transparency The external auditors of the company, the National Audit Office, issued an unqualified audit opinion pertaining to the annual financial statements for CY23.The internal audit department performs one audit per branch for all 48 branches. The departmental audits will be based on their perceived risk.

Management

Organizational Structure MBSL has an organizational structure which is headed by the Board of Directors. The Chief Executive Officer ("CEO") is the reporting line for 11 divisions. Compliance and risk departments report directly to the IRMC, while the internal audit department reports to the BAC.

Management Team The corporate management has decades of experience in their respective fields. The CEO has over 31 years of experience in leasing and banking. He has gained experience in retail banking, consumer and lease financing, real estate, product development and risk management.

Effectiveness The Company has formed 14 management committees, and these committees help the Company to run smoothly.

MIS The Company has four main software application systems. It is also planning to move into internet banking, mobile banking and paper-less environment. The disaster recovery site is situated at its office premises, while the live environment is situated at SLT Pitipana data center.

Risk Management Framework The risk management policy has laid out the functions to be carried out by the committees and the divisions and it follows the three lines of defense. The risk management function is centralized, however, the risk management functions maintain a channel of communication.

Business Risk

Industry Dynamics At present, there are 34 LFCs in Sri Lanka, out of which, 28 are listed in the Colombo Stock Exchange. During the nine months ending December 2023, the profit after tax (PAT) of the LFCs sector increased by 89.2 percent to Rs.34.8 bn, compared to Rs. 18.5 bn recorded in the corresponding period of the previous year. This substantial increase in profitability was primarily driven by interest income, coupled with reduced impairment charges for loan losses. However, reducing new impairment charges while stage 3 loans are increasing may not be sustainable.

Relative Position MBSL remains a small player in the industry. MBSL accounts for 2% of the assets in FY23, and 3% of deposits in the LFC and specialized leasing companies' sector. Apart from the above-mentioned, MBSL net loan and advancement accounts for 2% in FY23 in LFC and specialized leasing companies sector.

Revenues The gross interest income of the company stood at 6.5bn in FY 23 which is 1.7% increase compared to FY 22. The gross interest income stood at 1.5bn in 3MFY24 whereas it was 1.6bn in 3MFY23 a decrease of 4.6% in 3MFY24.

Performance The PAT of the company increased by 104% in FY23 to 20mn, compared to a 495mn loss in FY22.This increase in PAT is due to a 532% increase in net gain on financial instruments going up to 559mn from a net loss of 132mn.

Sustainability According to the forecasted results, the company expects growth in leases, loans, and advances of 51% in CY24, 29% in CY25, and 19% in CY26. This growth is considered after taking into account the improvement in the tourism industry, the restriction on the importation of vehicles has increased the prices of second-hand vehicles and transportation, services, including SME working capital support.

Financial Risk

Credit Risk The company gross non-performing loans has increased over the period from 21% in CY22 to 24% in 3MCY24.This is a marginal increase of 13%.

Market Risk The company's investment portfolio consists of investments in fixed deposits, Government securities, Investment Quoted – Quoted, and unquoted and investments property.

Liquidity And Funding The concentration of the top 20 deposits has decreased from 23% in CY21 to 10.40% in CY23.

Capitalization The Capital Adequacy Ratio ("CAR") stood at (~16.75%) and (~12.01%) as at CY23 and CY22 respectively. The required rate as of CY23 and CY22 is at 12.5%.

Lanka Rating Agency

Lkr mln

Merchant Bank of Sri Lanka & Finance PLC	Mar-24	Dec-23	Dec-22	Dec-21	Dec-20
Listed Public Limited	3M	12M	12M	12M	12M
A BALANCE SHEET					
1 Total Finance-net	17,402	17,135	22,004	26,310	24,814
2 Investments	13,730	12,491	5,151	3,067	3,155
3 Other Earning Assets	294	1,027	637	1,267	890
4 Non-Earning Assets	1,156	1,127	1,020	1,759	1,574
5 Non-Performing Finances-net	2,221	1,920	2,419	1,875	1,974
Total Assets	34,804	33,699	31,232	34,277	32,406
6 Funding	29,568	28,785	26,520	28,766	29,731
7 Other Liabilities	1,522	1,243	1,017	1,342	1,208
Total Liabilities	31,090	30,028	27,536	30,109	30,938
Equity	3,714	3,671	3,696	4,169	1,468
B INCOME STATEMENT					
1 Mark Up Earned	1,549	6,559	6,451	5,526	4,951
2 Mark Up Expensed	(1,103)	(4,919)	(4,696)	(2,676)	(3,533)
3 Non Mark Up Income	448	902	72	407	215
Total Income	895	2,543	1,828	3,257	1,633
4 Non-Mark Up Expenses	(622)	(2,302)	(2,259)	(2,059)	(1,955)
5 Provisions/Write offs/Reversals	(48)	120	(97)	(90)	(1,021)
Pre-Tax Profit	225	361	(529)	1,107	(1,343)
6 Taxes	(181)	(340)	33	(578)	235
Profit After Tax	43	21	(496)	529	(1,108)
C RATIO ANALYSIS					
1 PERFORMANCE					
a Non-Mark Up Expenses / Total Income	69.5%	90.5%	123.6%	63.2%	119.7%
b ROE	4.7%	0.6%	-12.6%	12.7%	-75.5%
2 CREDIT RISK					
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	75.2%	75.4%	102.4%	110.1%	101.6%
b Accumulated Provisions / Non-Performing Advances	54.0%	58.1%	53.1%	65.0%	63.4%
3 FUNDING & LIQUIDITY					
a Liquid Assets / Funding	46.7%	45.9%	20.6%	13.1%	11.0%
b Borrowings from Banks and Other Financial Institutes / Funding	11.1%	11.6%	11.3%	22.6%	26.9%
4 MARKET RISK					
a Investments / Equity	369.7%	340.3%	139.4%	73.6%	215.0%
b (Equity Investments + Related Party) / Equity	22.4%	21.9%	17.4%	17.2%	49.0%
5 CAPITALIZATION					
a Equity / Total Assets (D+E+F)	10.7%	10.9%	11.8%	12.2%	4.5%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	4.7%	0.6%	-11.9%	12.7%	-75.5%

Credit Rating

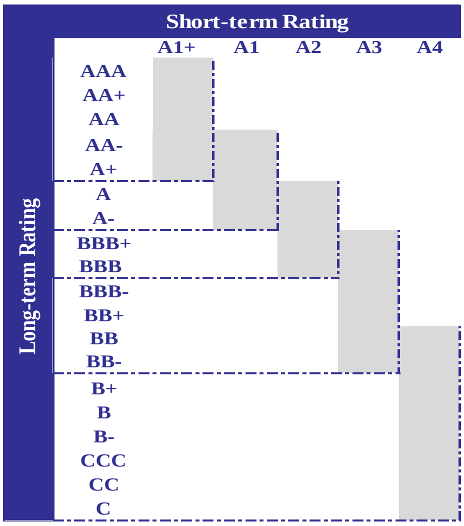
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

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