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-Feb-2023	BBB+	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The rating reflects the competence of Bank of Ceylon (BOC) as the largest shareholder of Merchant Bank of Sri Lanka & Finance PLC (MBSL or the Company). As a fully state-owned bank and one of the systematically important banks of Sri Lanka, BOC brings stability to MBSL. The rating takes comfort from BOC, which has been provided in written form. MBSL has a capital augmentation plan to become compliant with capital requirements by March 2023, and this plan is backed by BOC. The Company earned a Net Interest Income (NII) of LKR 2.9bn as of CY21 with a Net Interest Margin (NIM) of ~52%. Its performance suffered in CY22 due to the dire economic condition in the country. It incurred a loss of LKR 421mn in the 3rd quarter and it was caused by the drop in core spread, which resulted in the NIM dropping to ~31%. The ratings reflect the small relative position the Company holds and its ability to sustain and improve its performance in the long run. The Company does not comply with the Tier II capital requirement of the regulator and therefore has regulatory restrictions imposed. The Capital Adequacy Ratio (CAR) as at CY22 and 9MCY22 is recorded at ~12.2% and ~11.2% respectively. MBSL issued an unsecured subordinated redeemable debenture to comply with the Tier II capital requirement, however since the instrument was not fully subscribed, the Tier II capital requirement remains non-compliant. The Company records gross and net Non-Performing Loans (NPL) of ~15.92% and ~6.01% as of CY21, which increased to ~18.51% and ~9.32% at 9MCY22 respectively.

The rating is dependent on the Company's ability to improve its Tier II capital to adhere to the statutory requirements. Improving its credit risk in the current macroeconomic conditions would be vital for the improvement of its performance. The rating will rely on the continuous support from BOC and the Company's proficiency in building a diversified portfolio while preserving its asset quality.

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(Jun-22)
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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 BOC and it directly owns ~76.56% of the Company. BOC Property Development & Management (Pvt) Ltd (“PDM”) owns ~7.94% while Ceybank Unit Trust (“CEYB”) 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 25% of the industry loans and advances, which amounts to LKR 2.6tn, and 23% of the industry deposits, which amounts to LKR 2.9tn. 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 of LKR 37.6bn during CY21, with an asset base of LKR 3.8tn. It also has investments worth LKR 1.1tn. The Company earned a dividend income of LKR 394mn 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 nine non-executive directors, out of which six are non-independent directors and the rest are independent. 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 a wealth of experience in many fields to guide the Company.

Board Effectiveness The Company has formed six board sub-committees, namely, i) Related Party Transactions Review Committee (“RPTRC”), ii) Integrated Risk Management Committee (“IRMC”), iii) Nominations and Corporate Governance Committee (“NCGC”), iv) Human Resources and Remuneration Committee (“HRRC”), v) Board Audit Committee (“BAC”), vi) Information and Communication Technology Committee (“ICTC”).

Financial Transparency The external auditors of the company, the National Audit Office, issued an unqualified audit opinion pertaining to the annual financial statements for CY21. 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 36 LFCs in Sri Lanka, out of which, 29 are listed in the CSE. The profit after tax for the six months ending September 2022 saw a decline of 11%. The loan loss provisions declined by ~LKR 6bn in the six months to September compared to the previous financial year, which aided the sector earn profits. The total asset base of the LFC sector stood at LKR 1.5tn as of 4QFY21, which represents 5.6% of Sri Lanka’s financial system. The gross and net NPLs deteriorated to ~16.76% and ~11.73% by September 2022.

Relative Position MBSL remains a small player in the industry. The Company’s relative position has in fact shrunk in many capacities, such as loans and advances, investments, assets and deposits, while the equity increased relative to the total industry.

Revenues The Company increased its gross interest income and net interest income by ~12% and ~101% to LKR 5.5bn LKR 2.9bn respectively in CY21. It has increased its net interest income to LKR 1.4bn by 9MCY22, which is a ~19% increase since the last quarter. The highest NIM is earned for capital markets and corporate advisory-related products as at 9MCY22. The Company increased the NIM from ~6% in CY21 to ~54% in the nine months for CY22.

Performance The Company experienced a loss of LKR 1.1bn in CY20, as compared to a profit of LKR 529mn in CY21. However, as of 1HCY22, MBSL has recorded a loss of LKR 384mn due to its core spread dropping in 9MCY22, compared to CY21. This loss has increased by approximately 10% to LKR 421mn as of 9MCY22.

Sustainability Due to the current economic condition of the country, MBSL is looking into managing its current portfolio. The Company will focus on merchant banking in the future as well since MBSL can tap into a large market and earn a high fee income. It currently has no plans of increasing its branch network, but rather convert its seven mini branches to fully-fledged branches instead.

Financial Risk

Credit Risk The gross NPLs remains in the double digits since CY19 and the Company recorded ~18.51% (1HCY22: ~19.95%) in 9MCY22. Although the gross and net NPL reduced in 9MCY22, compared to 1HCY22, the gross NPL remains above the industry level. The Company has a large exposure to leasing, loans and pawning. The exposure to leasing and loans has reduced over the years, while the exposure to pawning shows a steady increase. High NPLs are recorded for hire purchases, bill discounting, cheque discounting, and loans.

Market Risk Government securities comprise ~68% (CY20: ~63%) of the investments as of CY21. MBSL also has investments in associates and subsidiaries amounting to LKR 452mn (CY20: LKR 469mn) in CY21. However, the fair value of the investment in subsidiaries was reduced during CY20 and CY21 as a result of the impairment.

Liquidity And Funding The Company has a higher dependency on customer deposits, compared to bank borrowings. Around ~77% of the funding is formed by customer deposits, which amounts to LKR 22.3bn. MBSL has regulatory restrictions imposed by CBSL due to non-compliance with Tier II capital requirements. As per the maturity match, a higher onus is on short-term liabilities.

Capitalization The Capital Adequacy Ratio (“CAR”) stood at ~12.22% and ~5.92% as at CY21 and CY20 respectively. The Company issued unsecured subordinated redeemable debenture to comply with the regulatory minimum for Tier II capital. However, due to the under-subscription, MBSL has not adhered to the statutory requirement.

LRA

Lanka Rating Agency

LKR mln

Merchant Bank of Sri Lanka & Finance PLC	Sep-22	Dec-21	Dec-20	Dec-19
Listed Public Limited	9M	12M	12M	12M
A BALANCE SHEET				
1 Total Finance-net	25,715	26,310	24,814	27,342
2 Investments	5,129	3,067	3,155	3,502
3 Other Earning Assets	553	1,267	890	2,676
4 Non-Earning Assets	912	1,759	1,574	1,568
5 Non-Performing Finances-net	2,958	1,875	1,974	1,888
Total Assets	35,266	34,277	32,406	36,975
6 Funding	30,168	28,766	29,731	32,971
7 Other Liabilities	1,293	1,342	1,208	1,396
Total Liabilities	31,461	30,109	30,938	34,367
Equity	3,805	4,169	1,468	2,608
B INCOME STATEMENT				
1 Mark Up Earned	4,661	5,526	4,951	6,533
2 Mark Up Expensed	(3,217)	(2,676)	(3,533)	(4,331)
3 Non Mark Up Income	74	407	215	280
Total Income	1,519	3,257	1,633	2,482
4 Non-Mark Up Expenses	(1,691)	(2,059)	(1,955)	(2,122)
5 Provisions/Write offs/Reversals	(204)	(90)	(1,021)	(14)
Pre-Tax Profit	(375)	1,107	(1,343)	346
6 Taxes	(46)	(578)	235	(243)
Profit After Tax	(421)	529	(1,108)	103
C RATIO ANALYSIS				
1 PERFORMANCE				
a Non-Mark Up Expenses / Total Income	111.3%	63.2%	119.7%	85.5%
b ROE	-14.1%	18.8%	-54.4%	3.9%
2 CREDIT RISK				
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	105.9%	110.1%	101.6%	97.3%
b Accumulated Provisions / Non-Performing Advances	52.5%	65.0%	63.4%	60.2%
3 FUNDING & LIQUIDITY				
a Liquid Assets / Funding	17.2%	13.1%	11.0%	15.1%
b Borrowings from Banks and Other Financial Institutes / Funding	14.6%	22.6%	26.9%	31.0%
4 MARKET RISK				
a Investments / Equity	134.8%	73.6%	215.0%	134.3%
b (Equity Investments + Related Party) / Equity	15.0%	17.2%	49.0%	46.8%
5 CAPITALIZATION				
a Equity / Total Assets (D+E+F)	10.8%	12.2%	4.5%	7.1%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	-13.5%	36.0%	-42.5%	3.9%

Scale – Credit Rating

Credit Rating

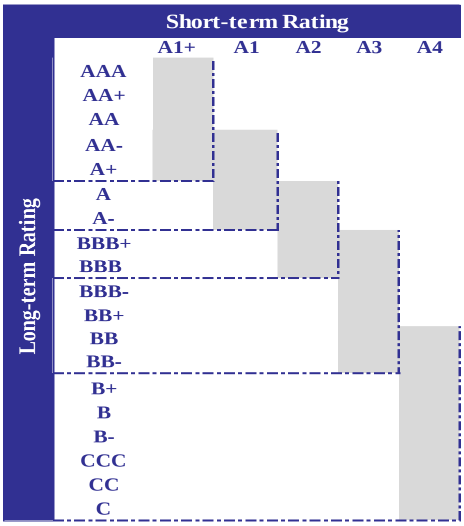
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

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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/index.php/credit-rating-agency/)

2) **Conflict of Interest**
i. LRA shall 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 33- Draft Rules Credit Rating Agency - 2021)

Restrictions
(3) LRA is not entitled to outsource any part of its work, which has a direct bearing on the act of rating. However, if any other function other than the core function of rating is to be outsourced, such fact shall be brought to the attention of the Client and be included in the Credit Rating Agreement entered into with the Client. (Section 22- Draft Rules Credit Rating Agency - 2021)
(4) LRA cannot appoint any individual as a member of the Rating Committee who has a business development function of the Credit Rating Agency, or who initiates or participates in discussions regarding fees or payments with any Client of Credit Rating Agency. (Section 26- Draft Rules Credit Rating Agency -2021)

Conduct of Business
(5) Prior to the commencement of a rating, LRA does not promise, assure or guarantee to a client that a particular rating will be assigned.
(6) LRA performs a rigorous and formal periodic review of all its methodologies. Such methodologies shall be made available to the Commission for perusal, upon request. (Section 39- Draft Rules Credit Rating Agency -2021)

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 does not engage in any other business activity which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained (Section 33- Draft Rules Credit Rating Agency -2021)
(9) LRA structures its rating teams and processes to promote continuity, consistency and avoid bias in the rating process. (Section 45 - Draft Rules Credit Rating Agency -2021)

Monitoring and review
(10) For purposes of transparency, LRA publishes 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 are also be disclosed. (Section 42- Draft Rules Credit Rating Agency -2021) LRA monitors below factors specifically, (a) all internal records to support our credit rating opinions; (b) all particulars relating to Clients at our office which shall include the name and registered address and contact numbers of such Client's, names and addresses of their Directors as at the date of rating, its issued share capital and the nature of business; and (c) a comprehensive written record of all complaints received from Clients and action taken thereon by LRA.
(11) LRA ensures confidentiality of all information at all times relating to Clients including such Client's identity and transactions carried out for such Client unless and to the extent such disclosure is required by law. (Section 48 - Draft Rules Credit Rating Agency -2021)
(12) LRA does not destroy, conceal or alter any records, property or books relating to the business of the LRA 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 51 - Draft Rules Credit Rating Agency - 2021).
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).
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