Lanka Rating Agency

Rating Report

Sarvodaya Development Finance PLC

Report Contents

Rating History				
Dissemination Date	Long Term Rating	Outlook	Action	Rating Watch
21-Sep-2022	BB	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The rating reflects the stable growth Sarvodaya Development Finance PLC (SDF or the Company), has experienced in the past five years and its unique accessibility to the rural sector through the Sarvodaya Movement. The brand name and the legacy of the Sarvodaya Movement add credibility to the Company. The Company got listed on the Colombo Stock Exchange in December 2021 and has adhered to the statutory requirements for Capital Adequacy Ratio (CAR) and core capital. The Company, while having unique access to Small and Medium Enterprises (SMEs) and the rural sector, also faces the risk of the current economic turmoil in the country affecting a large portion of its customer base. SDF has been successfully maintaining its gross Non-Performing Loan (NPL) ratio below industry levels since FY21. However, the current economic conditions in the country have impacted its gross NPL levels to increase from ~8.9% as of FY22 to ~10.8% as of 1QFY23. Steady growth is observed in the Company since SDF earned an interest income of LKR 1.8bn and profit-after-tax of LKR 215mn in FY22, which is a ~15% and ~18% growth respectively. Ratings reflect the Company's small industry position given its share of ~0.9% in the leasing industry. Recently, the Company has significantly increased its leasing portfolio which leads to an Advance to Funding ratio of over 150% which amplifies the risk. Going forward, the Company's successful credit risk management of portfolio amidst challenging economic scenario and bringing Advance to Funding ratio below will remain critical for the ratings.

The rating is dependent on the Company's ability to confront the volatile macroeconomic climate persistent in the country and sustain its position. Maintaining its growth momentum will be imperative for the Company. The rating will rely on the Company's capability to expand its asset base while preserving the asset quality.

Disclosure	
Name of Rated Entity	Sarvodaya Development Finance PLC
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Criteria | Rating Modifiers(Jun-22),Methodology | Non-Banking Finance Companies Rating(Jun-22)
Related Research	Sector Study | Leasing & Finance Companies(Jun-22)
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Profile

Structure Sarvodaya Development Finance PLC ("SDF" or "the Company") is a public limited liability company, incorporated in 2010, under the Companies Act No. 07 of 2007 and the Finance Business Act No. 42 of 2011. SDF listed in the Colombo Stock Exchange ("CSE") in December 2021.

Background The Company was incorporated as Deshodaya Development Finance Company Limited in 2010 and assumed its current name in 2015.

Operations The principle business activities include acceptance of deposits and granting loans and leases. The Company has 51 branches, of which more than 80% are situated outside the Western Province. SDF is connected to 5,400 societies (through Sarvodaya Movement) which has more than 800,000 members.

Ownership

Ownership Structure The largest share of the company is owned by Sarvodaya Economic Enterprises Development Services (Gte) Ltd ("SEEDS"), with an ownership of ~36%, while the Sarvodaya Movement collectively owns ~55% of the Company. Gentosha Total Asset Consulting Inc., Janashakthi Capital Limited and Senthilverl Holdings (Pvt) Ltd owns ~9%, ~7.6% and ~8.1% respectively, while the rest of the ~21% is owned by others.

Stability SEEDS was established in 1986 as the economic arm of the Sarvodaya Movement. The ownership of SEEDS has not gone through a major change, since it has been able to maintain its shareholding, post listing in CSE.

Business Acumen SEEDS is involved in assisting communities in their economic activities, training in entrepreneurship, and orientation to business activities.

Financial Strength The Sarvodaya Movement has multiple companies and independent units under the Movement. The Company does not have a written financial guarantee from the parent entity or the other shareholders.

Governance

Board Structure The Board of Directors comprises seven non-executive Directors, of which three are independent and four are non-independent.

Members' Profile The board members have expertise in fields, such as banking, sales, marketing, IT, and consulting. They are well qualified in their respective domains along with decades of experience. The Chairman, Mr. Channa De Silva has held senior management positions in many reputed firms, including financial institutions and banks.

Board Effectiveness The Company has formed five board committees, namely, i) Board Integrated Risk Management Committee ("BIRMC"), ii) Board Audit Committee ("BAC"), iii) Board Remuneration and Nomination Committee ("BRNC"), iv) Related Party Transaction Review Committee ("RPTRC"), v) Board Credit Committee ("BCC").

Financial Transparency The external auditors of the company, Ernst & Young, issued an unqualified audit opinion pertaining to annual financial statements for FY22. The Internal Audit Department plays an active role in creating a culture of accountability and risk management in the Company. The department carries out annual audits for all the 51 branches. It further carries out approximately 22 spot audits.

Management

Organizational Structure The head of the organisation remains the Board of Directors, with 11 separate divisions to carry out its operations. The Compliance Department and the Risk Department report to the BIRMC, while the Internal Audit Department reports to the BAC.

Management Team The management team is headed by the Chief Executive Officer ("CEO"), Mr. Nilantha Jayanetti. The CEO has extensive knowledge in business management and strategic leadership and has experience in the banking and financial sectors.

Effectiveness SDF has formed four management committees, namely, i) Assets and Liability Management Committee ("ALCO"), ii) Management Credit Committee ("MCC"), iii) Management Committee ("MC") and iv) Product Development Committee ("PDC").

MIS The main ERP system the Company uses is the eFinancials system, provided by Scienter Technologies (Pte) Ltd. The Company is also connected to the LankaPay CEFT network, Shared ATM Switch ("SAS"), and Common ATM Switch ("CAS"). The Company has plans to establish 10 of its own ATMs in strategic locations. SDF has also rolled out handheld devices (POS machines) to 100 Sarvodaya Societies to increase financial inclusiveness in the rural community.

Risk Management Framework The BAC has the responsibility to ensure the integrity of the financial reporting and the effectiveness of the internal control systems. Risk reports are submitted to the BIRMC for each type of risk identified with a rectification plan. Heads of Departments have the responsibility to identify and focus on potential risks in their respective areas of operations.

Business Risk

Industry Dynamics There are 36 Licensed Finance Companies ("LFC") in Sri Lanka, out of which, 29 are listed in the CSE. The gross and net Non-Performing Loan ("NPL") ratios improved in Mar 2022 to 9% (Mar 2021: 11%) and 2% (Mar 2021: 3%) respectively. The gross NPL and the net NPL ratios depleted in Jun 2022 to 17.20% and 12.05% respectively due to current economic conditions. Resultantly, the Central Bank of Sri Lanka ("CBSL") has instructed the LFC sector to provide moratoria to individuals and businesses which are affected by the current economic conditions. The moratorium will be valid for a period of six months, from 20th July 2022.

Relative Position SDF remains a small player in the industry, as it accounts for 0.9% (FY21: 0.7%) of assets and 1.0% (FY21: 0.9%) of equity as of FY22, compared to the total sector.

Revenues The Company increased its interest income by ~15% to LKR 1.82bn in FY22 (FY21: 1.58bn). SDF reduced its interest expense by ~10% to LKR 562mn (FY21: 623mn) and as a result, increased its net interest income by ~31% to LKR 1.26bn in FY22 (FY21: 961mn). The composition of the lease income has gradually increased to ~48% (FY20: 21%) in FY22, while the loan income has dropped to ~50% (FY20: 75%).

Performance The Company improved its profit after tax in FY21 by ~80% and by ~18% in FY22, compared to the respective previous financial years, by earning LKR 215mn and LKR 183mn in FY22 and FY21 respectively. The growth in profits have decelerated in FY22, due to the net impairment for loans, adversely increasing by ~221% to LKR 193mn. The core spread of the company has been increasing gradually, from ~6.2% in FY20 to ~9.5% in FY22, which reduced to ~8% in 1QFY23.

Sustainability Due to the current economic conditions, SDF is concentrating on improving its existing product lines. The Company plans to open a few branches around Colombo, in order to improve its customer deposits.

Financial Risk

Credit Risk The Company has improved its NPLs since FY20 as it recorded a gross NPL of 8.93% as at FY22 (FY21: 9.99%). The Company recorded a gross NPL of LKR 937.1mn in FY22 (FY21: 838.3mn). The Company's gross NPL increased to 10.79% in Jun 2022, due to the current economic conditions in the country.

Market Risk SDF's investment in government securities increased to LKR 533mn during FY22, which makes up ~70% of the investments. It has a larger exposure to the Small and Medium Enterprises ("SME") and the agriculture and transportation sectors. A larger portion of its portfolio could be impacted, since these segments could be more vulnerable to the current economic conditions.

Liquidity And Funding The customer deposits increased to LKR 4.73bn in FY22 (FY21: LKR 4.55bn), while the bank borrowings have increased to LKR 2.47bn in FY22 (FY21: LKR 1.89bn). Approximately, ~66% of the total funding is made up of Customer deposits, while ~34% is made up of bank borrowings. SDF's liquid assets make up ~8.7% (FY21: 7.9%) of the total funding and ~5.6% (FY21: 5.6%) of the total assets. The liquid assets increased to LKR 626mn during FY22 (FY21: LKR 506mn).

Capitalization The Company needed to increase its Capital Adequacy Ratio ("CAR") to comply with the regulatory rates. The Company increased its CAR and core capital to ~30.4% (FY21: ~21.8%) and LKR 3.2bn (FY21: LKR 2bn) in FY22, as a result of listing in CSE.

LRA

Lanka Rating Agency

LKR mln

Sarvodaya Development Finance PLC	Jun-22	Mar-22	Mar-21	Mar-20
Listed Public Limited	3M	12M	12M	12M
A BALANCE SHEET				
1 Total Finance-net	9,027	11,202	7,828	7,704
2 Investments	777	767	590	571
3 Other Earning Assets	53	42	84	204
4 Non-Earning Assets	461	487	456	507
5 Non-Performing Finances-net	918	835	804	1,369
Total Assets	11,236	13,333	9,761	10,355
6 Funding	7,658	7,199	6,443	6,869
7 Other Liabilities	239	2,829	1,725	953
Total Liabilities	7,898	10,028	8,168	7,822
Equity	3,339	3,305	2,181	1,196
B INCOME STATEMENT				
1 Mark Up Earned	525	1,822	1,585	1,682
2 Mark Up Expensed	(221)	(562)	(623)	(750)
3 Non Mark Up Income	30	96	140	63
Total Income	335	1,357	1,101	995
4 Non-Mark Up Expenses	(213)	(800)	(704)	(701)
5 Provisions/Write offs/Reversals	(48)	(181)	(41)	(62)
Pre-Tax Profit	75	375	356	232
6 Taxes	(41)	(160)	(173)	(130)
Profit After Tax	34	215	183	102
C RATIO ANALYSIS				
1 PERFORMANCE				
a Non-Mark Up Expenses / Total Income	63.5%	59.0%	63.9%	70.4%
b ROE	4.1%	7.9%	10.9%	8.5%
2 CREDIT RISK				
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	136.3%	174.8%	140.7%	139.4%
b Accumulated Provisions / Non-Performing Advances	35.0%	39.7%	35.1%	26.7%
3 FUNDING & LIQUIDITY				
a Liquid Assets / Funding	8.5%	8.7%	7.9%	9.9%
b Borrowings from Banks and Other Financial Institutions / Funding	30.2%	32.2%	26.8%	23.2%
4 MARKET RISK				
a Investments / Equity	23.3%	23.2%	27.1%	47.8%
b (Equity Investments + Related Party) / Equity	0.0%	0.0%	0.0%	0.0%
5 CAPITALIZATION				
a Equity / Total Assets (D+E+F)	29.7%	24.8%	22.3%	11.5%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	4.1%	9.9%	15.3%	8.5%

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.

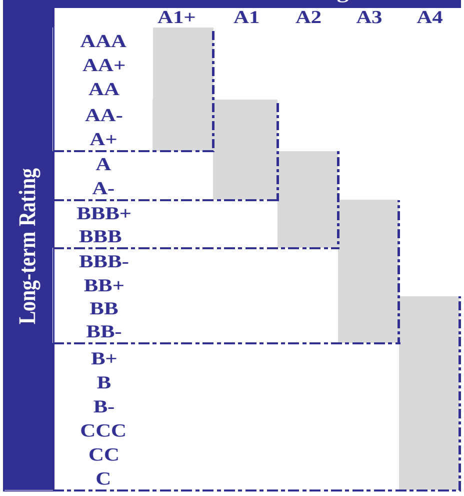
Long-term Rating

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.

Short-term Rating



**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/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).
Proprietary Information
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