FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms LB Finance at 'A-(lka)'; Outlook Stable

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Fitch Ratings - Colombo - 11 Sep 2020: Fitch Ratings (Lanka) has affirmed LB Finance PLC's National Long-Term Rating at 'A-(lka)'. The Outlook is Stable. At the same time, Fitch has affirmed the company's Sri Lanka rupee-denominated senior unsecured debt at 'A-(lka)' and its rupee-denominated subordinated debt at 'BBB(lka)'.

KEY RATING DRIVERS

NATIONAL RATINGS AND SENIOR DEBT RATINGS

LB's National Long-Term Rating is driven by its intrinsic financial strength and reflects its established domestic franchise as Sri Lanka's third-largest finance and leasing company (FLC), accounting for 10% of total FLC-sector assets as at the financial year ending March 2020 (FY20). It also reflects high profitability from high-yielding products and satisfactory capital levels. This is counterbalanced by a high risk appetite due to a large and increasing exposure to gold-backed lending.

Our assessment of the operating environment for Sri Lankan FLCs incorporates the significant economic disruption caused by the pandemic, particularly, the negative implications for FLCs through the effect on their largely sub-prime clientele and any extension of motor-vehicle import restrictions. We expect the country's GDP to contract by 1.3% in 2020, and for GDP growth to recover in 2021, although growth prospects will partly depend on how the pandemic develops in Sri Lanka and globally.

Fitch regards LB's risk appetite as high relative to that of peers due to its large exposure to gold loans (FY20: 25% of gross loans). We expect this exposure to further increase in the near to medium term, supported by rising gold prices, and as such, compensating for the slowdown in its vehicle-financing business. LB has so far managed its gold-loan exposure through regular monitoring and risk control measures, such as maintaining adequate margins to protect against a drop in the market price. However, in FY19, LB lowered this margin requirement to 8%, from 15% in FY18, indicating its increased appetite for gold-backed lending.

We expect asset-quality pressure to be more pronounced for FLCs, such as LB, given their exposure to more vulnerable customer segments. LB's asset quality, as measured by its five-month gross non-performing loan ratio, deteriorated to 6.6% in 1QFY21 (FY20: 3.9%, FY19: 2.7%) as a result of the pandemic and the lockdown that followed. Defaults on its gold-backed lending portfolio remain minimal, despite having increased during the period. However, we believe a sharp fall in global gold prices could threaten LB's asset quality as its safety margins erode and borrowers deliberately default.

LB's profitability metrics, in Fitch's view, are expected to deteriorate in FY21 as a result of thinner net interest margins as well as higher credit costs amid potential loan-book contraction that would offset the benefits from a reduction in income taxes and the removal of the debt-repayment levy. LB's pre-tax profit/average total assets more than halved in 1QFY21 to 3.1%, from 7.0% in FY20, due to a drop in business volumes and a surge in credit costs during the lockdown period. The company's profitability is supported by its significant exposure to high-yielding products, such as gold-backed lending and registered three-wheeler financing.

Increased bank borrowings to support liquidity has offset higher internal-capital generation, resulting in broadly unchanged levels of balance-sheet leverage from FY20. LB's leverage is among the highest of domestic peers, at 5x, but we expect it to moderate on lower lending expectations and reasonable profitability. Its regulatory capital ratios are in line with those of peers and it also benefits from capital-efficient product classes, such as gold-backed lending. This is evident in its low risk density relative to peers. However, we believe risks to capital impairment have increased, as seen in a higher unprovided share of impaired loans/equity ratio of 35% in FY20, from 21% in FY19.

We expect LB to rely on unsecured deposit funding (1QFY21: 75% of funding) alongside secured, wholesale, term borrowings from banks. LB's non-deposit funding increased by around 12% in 1QFY21, to account for 25% of total funding (FY20: 22%), as it drew down its unutilised credit lines from banks in anticipation of a tighter liquidity position and potential flight to quality. Furthermore, lack of new lending has helped reduce LB's liquidity risk, with its share of liquid assets in total assets improving to 15.6% in 1QFY21 (FY20: 10.5%).

LB's senior debentures are rated in line with the company's National Long-Term Rating, as they rank equally with claims of the company's other senior unsecured creditors.

SUBORDINTED DEBT

The subordinated debentures are rated two notches below LB's National Long-Term Rating to reflect the subordination to senior unsecured obligations, in line with the Bank Rating Criteria. Fitch's baseline notching of two notches for loss severity reflects our expectation of poor recovery. we have not applied additional notching to the notes for non-performance risk, as they have no going-concern loss-absorption features, in line with Fitch criteria.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade is not probable in the near-term due to the pressure on the sovereign rating (B-/Negative) and operating environment. In the medium to longer term, an upgrade is contingent on LB achieving lower leverage relative to peers, lower-risk asset exposure and a sustained improvement in its liquidity position.

LB's senior and subordinated debt would be upgraded if the company's National Long-Term Rating is upgraded

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A deterioration of the operating environment, which could be triggered by a further worsening of the economy beyond our base-case expectations, resulting in additional weakening of key credit metrics, such as asset quality, profitability and capitalisation, could trigger a downgrade. This could be in the form of higher capital impairment risks.

LB's senior and subordinated debt would be downgraded if the company's National Long-Term Rating is downgraded.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
LB Finance PLC	Natl LT	A-(lka) Rating Outlook Stable	Affirmed	A-(lka) Rating Outlook Stable
• senior unsecured	Natl LT	A-(lka)	Affirmed	A-(lka)
• subordinated	Natl LT	BBB(lka)	Affirmed	BBB(lka)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Non-Bank Financial Institutions Rating Criteria (pub. 29 Feb 2020) (including rating assumption sensitivity)

Bank Rating Criteria (pub. 29 Feb 2020) (including rating assumption sensitivity)

National Scale Rating Criteria - Effective from 8 June 2020 to 22 December 2020 (pub. 08 Jun 2020)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

LB Finance PLC	-

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