ICRA Lanka revises the ratings of Vallibel Finance PLC

April 17, 2018

Instrument*	Rated Amount	Rating Action
Issuer rating	N/A	Revised to [SL]BBB (Stable) from [SL]BBB-(Stable)
Unsecured subordinated redeemable debenture programme	LKR 500 Mn	Revised to [SL]BBB- (Stable) from [SL]BB+ (Stable)
Guaranteed subordinated redeemable debenture programme	LKR 1,000 Mn	[SL]AA-(SO) (Stable); Reaffirmed

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has revised the issuer rating of Vallibel Finance PLC (VFP or the Company) to [SL]BBB (Pronounced SL triple B) with a stable outlook from [SL]BBB- (Pronounced SL triple B minus) with stable outlook. ICRA Lanka has also revised the issue rating of the LKR 500 Mn unsecured, subordinated, redeemable debenture programme to [SL]BBB- (Pronounced SL triple B minus) with stable outlook from [SL]BB+ (Pronounced SL double B plus) with stable outlook. ICRA Lanka has also reaffirmed the issue rating of [SL]AA-(SO) with stable outlook for the LKR 1,000 Mn guaranteed, subordinated, redeemable debenture programme.

Rationale

The rating revisions factor in VFP's ability to grow its portfolio while maintaining a comfortable asset quality and profitability indicators. VFP's portfolio reported a robust 33% growth during FY2017 (21% annualized, in 9MFY2018), higher than the systematic average, in a competitive environment. The gross NPAs remained below the systematic average and stood at 2.93% in Dec-17(2.93% in Mar-17 and 3.76 in Mar-16). VFP' net profitability remained range bound at 2.6-2.8% levels for the last 4 years, notwithstanding some compression in interest margins, as credit cost declined following the improvement in asset quality profile. ICRA Lanka however notes that the provision coverage moderated to 72% in Dec-17 compared to 86% in Mar-16; the same however remains adequate. The ratings continue to factor in the expected financial and managerial support from the Vallibel group of companies, its experienced senior management team, adequate internal controls and systems. The ratings however take note of the expected increase in competitive pressures, exposure to customers with a moderate credit profile and its high gearing level (9.7 times in Dec-17). ICRA Lanka takes note of the proposed rights issue, which is expected to support its near-term capital profile, however considering the growth plans, the gearing is expected to remain high at about 8 to 9 times over the next 2 years. Going forward, VFP's ability to maintain a healthy asset quality, adequate profitability and, a comfortable risk-adjusted capital structure, would be crucial from a rating perspective.

The rating for the guaranteed subordinated redeemable debentures is based on the strength of the unconditional and irrevocable guarantee from Hatton National Bank PLC (HNB) covering the principal and two interest installments (semi-annual) and, the undertaking from the Trustee to declare the entire guaranteed amount as payable in the event the issuer does not meet the scheduled interest payment on any due date or in the event the issuer does not redeem the debenture in full on any redemption date, to redeem the instrument in full. The guarantor undertakes the obligation to pay, on demand from the Trustee, LKR 1,102.5 Million, being the total principal sum and two half-yearly interest installments of the proposed

Guaranteed Subordinated Redeemable Debentures. The rating also assumes that the guarantee will be duly invoked by the Trustee, as per the terms of the underlying Trust deed, Trustee' undertaking and guarantee agreements, in case there is a default in payment by VFP (Issuer).

Outlook: Stable

ICRA Lanka believes that VFP would continue to benefit from the support from the Vallible group. The outlook may be revised to 'Positive' in case of steady improvement in VFP' capital profile. The outlook may be revised to 'Negative' in case of weakening in the asset quality or a significant deterioration in the profitability and capitalisation profile from current levels.

Key rating drivers

Credit strengths

Expected financial and managerial support from the Vallibel group: Vallibel Investments (Pvt) Ltd (VIPL) is the main shareholder of VFP, holding 72.9% equity holdings as of Dec-17. VFP is part of the Vallibel group promoted by Mr. Dammika Perera. Vallibel group has interests in financial services, trading, manufacturing and leisure sectors. The company has access to the managerial support from the Vallibel group in strategic decision making VFP also gets financial support by way of long-term deposits from the group; about 8% of the total deposits in Dec-17 were from the group entities. The company is also in the process of raising capital in the form of rights issue (LKR 1,034), with support from the group.

Experienced senior management team and adequate risk management systems: VFP's board consisted of 7 board members including 3 independent members. The company has an experienced senior management team, with CEO/ Managing director having over 30 years of experience in the NBFI industry. The company has an elaborate organization structure covering all key business functions, including, business development, credit, collections, recoveries, finance and administration. Each business function is headed by an experienced senior manager. The company has a prudent loan origination system and an effective loan monitoring and collection mechanism, as reflected by its healthy asset quality. The mechanism provides VFP with early warning signals and helps them in adjusting the loan policies in line with the evolving credit trends. The credit and recovery functions are centralized at the Head Office. The centralized approach supports VFP in optimizing its collection and recovery activities. The company has implemented adequate internal control and risk management processes. The internal controls and risk management processes are reviewed by an external team and are updated on a regular basis. The company also has an in-house internal audit team that undertakes timely review of the operations.

Healthy portfolio growth supported by asset backed lending; VFP operates with 25 branches and 8 service centers. The company's portfolio stood at LKR 28,741 Mn as of Dec-17, with exposures largely towards cars (47%), vans (16%), Lorries (14%) and 3-wheelers (5%). VFP's gold loan exposure was quite modest at about 4% as in Dec-17. Closer to 90% of the portfolio is secured by vehicles. VFP has steadily increased the share of cars & vans, a segment with a relatively superior asset quality; share of cars & vans increased to current levels from 53% in Mar-16. The Company reported 33% growth in FY2017 and 21% annualized growth in 9MFY2018. Going forward, the company is expected to grow its portfolio at 30-35%. Key focus will be on short term (12 months) vehicle backed loans, business loans and gold loans.

Healthy asset quality indicators: The company has been able to maintain gross and net NPA ratios below the systematic averages for the last 4 years. As of Dec-17, VFP's gross & net NPA were 2.93% and 0.46%.

During the quarters ended Jun-17 and Sep-17, gross NPA increased to 3.37% and 3.22% due to adverse macro-economic conditions. Although, compared to systematic averages of 5.71% in Jun-17 and 6.04% in Sep-17 the company was able to maintain its portfolio quality at a comfortable level. The company improved its asset quality in Q3FY2018 by promptly discontinuing and slowing down the poor performing segments and tightening recoveries. VFP's ability to control incremental slippages would be crucial going forward. The company has a comfortable provision coverage of 71.6% as in Dec-17, notwithstanding the moderation from 86.2% in Mar-16 (74.1% in Mar-17).

Good and stable profitability indicators: VFP reported an adequate NIM[1]of 8.4% for 9MFY2018 (FY2017 – 8.2%, FY2016 – 8.8%). VFP's operating costs in relation to the total assets have remained range-bound at about 5.1-5.3%, while credit costs remained low (0.3% in 9MFY2018 and 0.1% in FY2017). The company, therefore reported a healthy ROA of 2.7% in FY2017 (2.6% in FY2016) and 2.8% in 9MFY2018. VFP's ability to maintain its operating expenses and credit costs as the business expands and, as it ventures to newer asset classes would be critical from a profitability perspective.

Credit challenges

Stretched capital profile: VFP reported a gearing of 10.6 times in Mar-17 and 10.5 times in Mar-16; gearing stood at 9.7 times in Dec-17. ICRA Lanka notes that the company's gearing is higher than the systematic average of 6 to 7 times. The proposal to raise equity capital (LKR 1,034Mn) via a rights issue would support the near-term capital structure. The company however is expected to operate at a high leverage of about 9-10 times over the medium to long term.

Exposure to customers with modest credit profile: VFP is serving SME's and individuals who have a moderate risk profile and are susceptible to adverse economic cycles. ICRA Lanka however takes note of the adequate internal controls put in place, which provides comfort from a credit perspective.

Competitive business environment and tightened regulatory regime: The NBFI industry was experiencing high competition from banks in some key asset segment, including vehicle financing. The banks are aggressively promoting leasing by offering competitive rates. The LTV changes implemented by CBSL during the last two years have impacted the industry growth and have further increased the competitive intensity. Any adverse change in the regulatory environment is expected to have further impacted the operating environments for NBFIs. Going forward, the NBFIs will have to differentiate their product offering and customer service and maintain adequate and prudent risk policies to support good quality portfolio growth.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below**.**

Links to applicable criteria: [ICRA Lanka's Credit Rating Methodology for Non-Banking Financial Institutions]

[1]NIM calculated including the fee income pertaining to the loans extended

About the company - Vallibel Finance PLC

VFP was incorporated in 1974 as Rupee Finance Limited. In 2005, Vallibel Investment (Pvt) Ltd acquired the company and renamed it as Vallible Finance PLC. Vallibel Investment (Pvt) Ltd holds 72.9% shareholding as in Dec-17. The company is listed on the main board of the Colombo stock exchange. VFP currently operates through its 25 branches and 8 service centers. The principal activities of the company include extending finance leases, hire purchase asset financing, granting of mortgage loans, gold loans and mobilization of deposits. VFP also extends vehicle backed overdraft facilities and business loans.

During the year ended March 2017, VFP reported a PAT of LKR 726 Mn on a total asset base of LKR 30.6 Bn as compared to a net profit of LKR 513 Mn on a total asset base of LKR 22.7 Bn in the previous financial year. For 9MFY2018, VFP reported a PAT of LKR 675 Mn on a total asset base LKR 34.4 Bn.

About the guarantor – Hatton National Bank PLC

Hatton National Bank PLC (HNB) is one of the large private sector commercial banks in the country with total assets amounting to LKR 955 Bn as at Dec-17. It accounted for 10.6% of sector assets, 11.2% of sector loans and advances and 10.9% of sector deposits as at Dec-17. The bank was incorporated in the present form in the year 1970. Stassen's group with 17.8%, Employee Provident Fund with a 9.7% and Sri Lanka Insurance Corporation Ltd with 8.2% are the major shareholders of the bank. The bank recorded a net interest income of LKR 39.6 Bn for the CY2017 and LKR 34.3 Bn for the CY2016. The net profits of the bank amounted to LKR 16.4 Bn for the CY2017 and LKR 14.1 Bn for the CY2016, which resulted in ROAA of 1.79% and 1.82% for the respective periods. The bank had gross NPA ratios of 2.28% and 1.80% as at Dec-17 and Dec-16 and net NPA ratios of 0.77% and 0.46% respectively for the said periods. The bank had a net worth of LKR 108.1 Bn as of Dec-17 with tier 1 capital adequacy ratio of 13.72% and total capital adequacy ratio of 17.04%.

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