Senkadagala Finance PLC

Key Rating Drivers

Weakened Asset Quality Drives Downgrade: Senkadagala Finance PLC's (Senka) exposure to more cyclically sensitive borrowers has led to greater asset-quality weakness in recent years, against its past better-than-peer performance. Its reported 90-day past-due loan ratio rose to 19.8% in 1QFY24 (financial year end-March) amid worsening borrower repayment capacity. Fitch Ratings expects asset-quality pressure to persist in the near term even as the economy gradually recovers, offset by above-industry capitalisation and longer-tenor funding support.

RWN Resolved: The removal of the Rating Watch Negative (RWN) reflects our view that further downside to Senka's ratings is less imminent following the completion of the local-currency portion of the sovereign's domestic debt optimisation (DDO), which addresses one element of risk to sector funding and liquidity. The operating environment will remain weak in light of strained household finances and fragile investor confidence, but should stabilise on a gradual economic recovery with easing inflation and interest rates.

Eased macroeconomic risk will temper the pressure on the sector's operating performance and liquidity profile, although the pace of recovery may vary depending on individual entities' business mix and franchise strength. Fitch expects sector growth to remain weak with lingering asset-quality pressure in FY24, but this may improve in FY25 as economic growth recovers. Declining interest rates should ease pressure on funding costs but could hit asset yields for lenders with shorter asset-repricing cycles.

Modest Franchise in Vehicle Financing: Senka is a mid-sized finance and leasing company (FLC) with about 2% share of sector assets and 1% of deposits. Its main business is in vehicle financing with a higher exposure than peers to commercial vehicles, such as buses, lorries and tractors. These segments are more susceptible to economic weakness and have driven greater asset-quality deterioration for Senka in recent years.

The company caters primarily to lower- to middle-income self-employed individuals, and small- to mid-sized enterprises. It has developed enhanced tools to identify better-quality customer profiles and price for higher credit risk, although the effectiveness of the tools is yet to be tested.

Volatile Profitability: Gradually easing funding costs should help support the net interest margin (NIM), but the high impairment ratio continues to pose risks to credit costs and profitability. Pretax profit/average assets narrowed to 2.3% in FY23 (FY22: 4.1%) amid higher funding costs and operating expense inflation, while interest-earning assets also contracted. Management aims to maintain operating cost control while expanding the branch network gradually to tap newer growth areas.

Reduced Leverage: Senka's leverage declined to around 3.4x debt/tangible equity by FYE23 (FYE22: 4.0x) with its core capital ratio increasing to 25.5% by end-1QFY24 (industry: 21.8%) due to more contained growth. This provides a reasonable buffer to absorb credit and other losses. We expect management to maintain relatively conservative capitalisation and modest growth in the near term.

Confidence-Sensitive Funding, Liquidity: Funding conditions are gradually improving relative to the stress over the past 12-18 months, but we believe the funding and liquidity environment remains highly susceptible to shocks. Senka's greater usage of wholesale funding can leave it more sensitive to lender confidence, although this profile has also helped it maintain a positive short-term asset-liability maturity profile, unlike many peers. Roughly 45% of total liabilities were due beyond one year at FYE23.

Ratings

National Rating	
National Long-Term Rating	BBB(lka)
Sovereign Risk	
Long-Term Foreign-Currency IDR	RD
Long-Term Local-Currency IDR	CCC-
Country Ceiling	B-
Outlooks	
National Long-Term Rating	Stable

Applicable Criteria

Non-Bank Financial Institutions Rating Criteria (May 2023)

National Scale Rating Criteria (December 2020)

Bank Rating Criteria (September 2023)

Related Research

Fitch Downgrades Senkadagala Finance's National Rating to 'BBB(lka)', Removes RWN; Outlook Stable (October 2023)

Fitch Upgrades Sri Lanka's Long-Term Local-Currency IDR to 'CCC-' (September 2023)

Sri Lanka Financial Institution Ratings Not Affected by Sovereign Downgrade (September 2023)

Sri Lanka's Government Debt Plan Tempers Funding Risk for NBFIs (July 2023)

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Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

The National-Long-Term Rating is sensitive to changes in Senka's standalone credit profile relative to Fitch-rated issuers on Sri Lanka's national scale. A downgrade could result from higher leverage or a substantial erosion of capital buffers due to asset-quality deterioration and weakening profitability. Increased risk appetite, as evident in a shift of business mix towards riskier products and more vulnerable customer segments, could also lead to negative rating action.

Fitch may also take negative rating action if there is renewed weakness in market variables or funding and liquidity conditions, leading to increased risk to the company's asset exposures, profitability and balance-sheet buffers. If extreme, such stresses could result in a multiple-notch downgrade.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An improved operating environment, together with enhancement in the company's credit profile relative to peers on the Sri Lankan national scale could lead to an upgrade of the company's ratings. A significant shift towards less-risky asset classes with sustained asset-quality performance, profitability and adequate capital buffers could also lead to positive rating action.

Key Qualitative Factors

Sector Risk Operating Environment

A gradual recovery in the country's economy, together with normalising inflation and borrowing costs, should help ease the pressure on the FLCs' asset quality, earnings and funding conditions – although risks remain to the downside due to the sovereign's weak credit profile. Sri Lankan FLCs' asset quality and business volumes have been challenged by multiple external shocks in recent years, including the Easter attacks in 2019, the Covid-19 pandemic from 2020 onwards, and further economic volatility and restrictive policies due to the sovereign's very weak fiscal position.

GDP contraction narrowed to 3.1% yoy in 2Q23 after three quarters of double-digit deceleration, while inflation and government policies have been easing since the start of the year. Fitch expects the economy to shrink at a more modest 1.4% in 2023 before expanding by 3.3% in 2024.

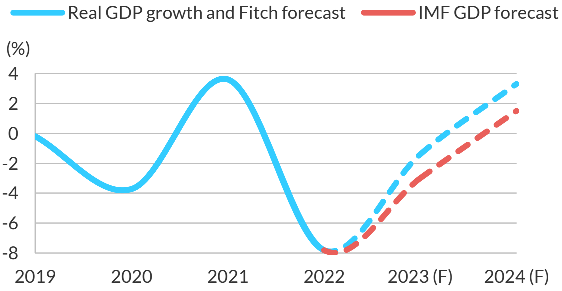
Business Profile

Senka has a longstanding presence in Sri Lanka's non-bank financing industry, since its incorporation in 1968. It runs a broad network of around 100 branches nationwide. We expect the company to remain focused on vehicle financing and leasing, which comprised around 85% of gross loans in 1QFY24 (FY23: 81%). Its loans and leases are primarily against four-wheeler vehicles for commercial purposes in sectors such as trading, manufacturing and transportation.

A prolonged vehicle import ban and sustained economic weakness have constrained vehicle financing growth over the past few years. This has led Senka, like many other FLCs, to diversify into other products such as gold-backed loans and, more recently, margin financing. Nonetheless, the company retained a below-industry exposure to gold loans at end-June 2023 (industry: 18%), and its margin financing exposure is likely to be similarly contained in the near term.

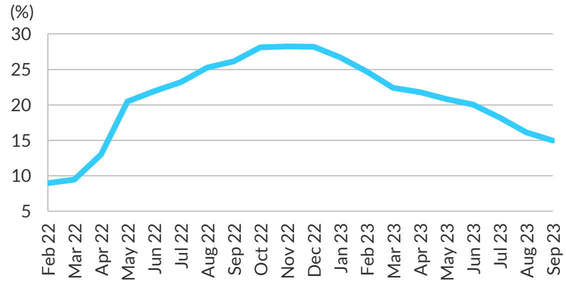
The Balasuriya family and related parties hold around 79% of the company. We do not perceive any material governance issues arising from the ownership structure, relative to Senka's rating level. Related-party receivables are modest as a proportion of capital, and related-party transactions must be on commercial terms and reviewed by the relevant board committee. The ownership structure also brings benefits via the provision of additional equity and funding resources from time to time, to support growth and boost capital buffers.

Sri Lanka GDP Growth



Source: Fitch Ratings, Central Bank of Sri Lanka (CBSL), IMF

AWPLR Easing Since 2023



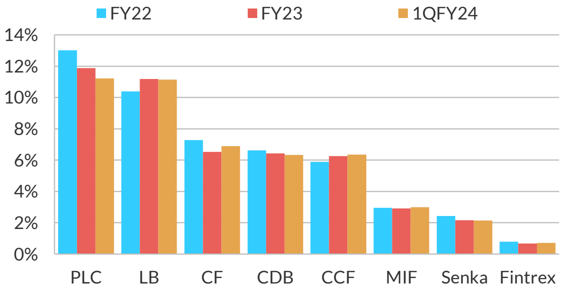
Note: AWPLR is average weighted prime lending rate, monthly
Source: Fitch Ratings, CBSL

Management and Strategy

Senka's senior management team comprises experienced executives in banking and finance, including several from major local banks. The Balasuriya family holds a number of key board and senior management positions, but day-to-day operations are overseen by a professional management team. Three independent directors on the six-member board provide a further degree of high-level oversight.

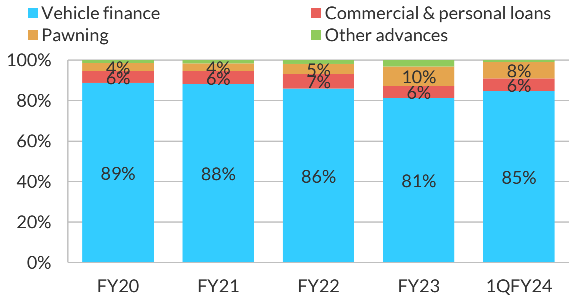
We expect economic conditions to remain generally sluggish, which will continue to present risks to business strategy and management execution. Senka may face execution uncertainties as it expands in non-vehicle-backed products, such as gold-backed loans and margin financing. A recent expansion into gold-backed pawning did not result in a large exposure but nonetheless encountered challenges, which management is working to rectify.

Asset Market Share



Source: Fitch Ratings, FLCs

Loan Mix by Product



Source: Fitch Ratings, Senka

Risk Profile

Business risks are primarily credit risk on Senka's loans and leasing portfolio, and market risks relating to collateral valuation, interest rate repricing, liquidity matching and the hedging of foreign-currency borrowings.

Management continues to deploy its enhanced customer-scoring model, with results on recent disbursements generally performing to plan. Still, the model has a relatively short performance record. It is uncertain if the company will be able to attract good-quality exposures at sufficient scale, given its historical focus on lower- to middle-income borrowers. Meanwhile, the gradual withdrawal of vehicle import curbs raises the risk of a domestic vehicle price correction as supply increases. On this aspect, we expect any correction to be moderate as supply is likely to remain controlled, while import tariffs are likely keep domestic vehicle prices high.

Greater reliance on wholesale funding is typically viewed as a risk in liquidity crises, as wholesale lenders can be more confidence-sensitive than retail depositors. For Senka, its higher composition of term wholesale funding, some at fixed rates, has helped it maintain positive short-term asset-liability maturity gaps and smooth interest-rate repricing over the past year.

Senka's higher proportion of foreign-currency funding (FY23: 18% of total funding, FY22: 22%) raised repayment risk amid a foreign-currency liquidity shortage in Sri Lanka in 2022. This was due to potential counterparty risk on its foreign-currency deposits with local banks, which are held to offset the foreign-currency risk on its offshore borrowings. Such exposure remains a risk in the event of renewed foreign-currency liquidity shocks, but Sri Lanka's improved foreign reserve position helps to temper the immediate risk of such an event.

Investments in domestic Treasury securities of around 5% of total assets at FYE23 were moderate as a proportion of the balance sheet, and held mainly to comply with regulatory requirements on liquid assets. Senka's entrance into the margin trading business may expose the company to equity price risk because of the market inefficiencies within Sri Lanka's capital markets. However, management plans to limit this product to 5%-10% of the loan book.

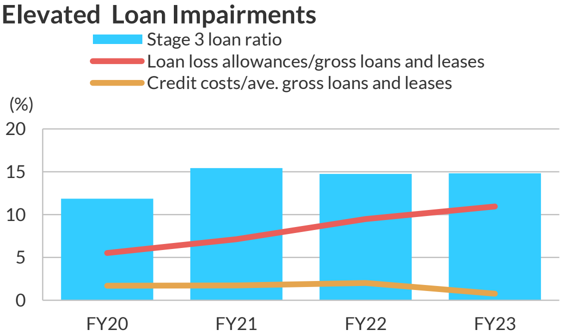
Financial Profile

Asset Quality

We expect the impaired loans ratio to stay high in the next few quarters as the company works to remediate its stock of problem loans. For instance, the pressures on asset quality in the commercial loan portfolio are likely to take longer to resolve. We perceive further risk of slippage in asset quality, as borrower repayment capacity may take time to recover after the significant stresses over the past few years.

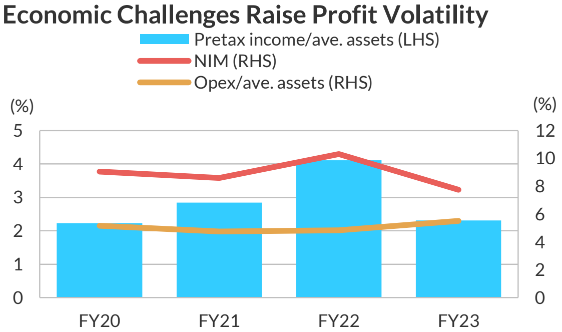
Against this, loan impairment provisions of around 11%-12% of gross loans and the company's mostly secured loan book should help to temper future credit impairment charges. Annualised loan impairment charges of around 1.6% of average gross loans in 1QFY24 (FY23: 0.8%; FY22: 2.0%) remained modest relative to gross impaired loans. However, a significant correction in vehicle collateral values would pose greater risks to credit impairment costs.

Elevated Loan Impairments



Source: Fitch Ratings, Fitch Solutions, Senka

Economic Challenges Raise Profit Volatility



Source: Fitch Ratings, Fitch Solutions, Senka

Earnings and Profitability

The group-reported NIM contracted to 7.7% in FY23 (FY22: 10.2%) amid sharply higher funding costs, although it remained above the industry average. Most FLCs were challenged by rising borrowing and deposit costs in FY23, and Senka was able to offset the pressures more effectively than the industry at large. Its average borrowing costs rose less than the sector average, on our estimates. We attribute this partly to its use of fixed-rate offshore borrowings and a strategy of allowing price-sensitive deposits to run off as interest rates climbed.

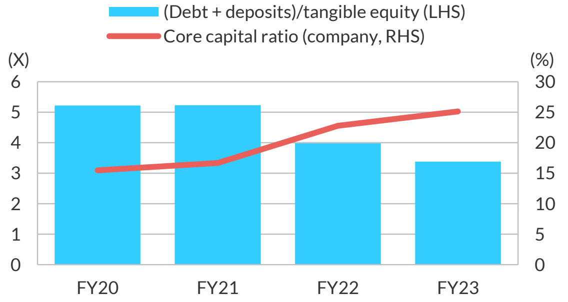
The pressure on the NIM should start to ease because market interest rates have declined from the highs over the past 12 months. This should benefit profitability for the remainder of the year. Easing vehicle import restrictions and lending rates may also support a pick-up in credit demand, which can help to support profitability. Even so, we expect full-year profitability to face some pressure from the lagged effect of higher interest rates over the past 12-18 months, and still-elevated credit costs as the company gradually resolves its delinquent loans.

Capitalisation and Leverage

Internal capital generation is likely to remain sluggish amid profitability pressure. However, we expect loan growth to remain muted in the coming year, without placing any significant burden on the capital position.

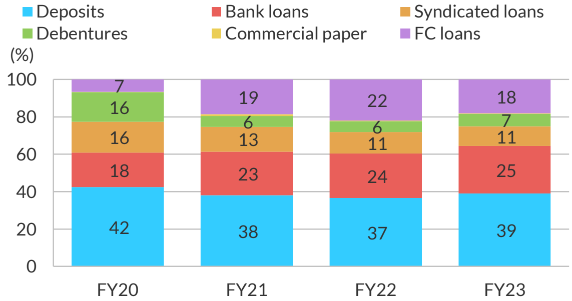
Senka's gross debt/tangible equity position overstates its leverage due to the hedging structure on its US dollar borrowings. It deposits the US dollar funds received with local banks as collateral against corresponding local-currency borrowings. Netting these balances, the adjusted debt/equity of around 3.1x at end-1QFY24 was below the industry average of 3.4x.

Reduced Leverage Amid Sluggish Growth



Source: Fitch Ratings, Fitch Solutions, Senka

Funding MIx



Source: Fitch Ratings, Fitch Solutions, Senka

Funding, Liquidity and Coverage

Funding and liquidity conditions are likely to remain sensitive to market confidence in the sovereign's debt sustainability path and Sri Lanka's economic recovery. However, we do not expect a return to the extreme stresses of the past year under our base scenario.

The company has maintained adequate funding stability despite extreme market stresses over the past year. Its greater usage of term wholesale funding, some of which is on fixed rates, has helped the company better manage its funding costs. Its blended borrowing rates rose by a smaller proportion in FY23 than most rated peers, other than the largest competitors in the industry.

Nonetheless, we view Senka's funding profile as more confidence-sensitive than the larger FLCs due to its greater exposure to wholesale funding. Deposits formed 43% of total funding at end-1QFY24, which was lower than most standalone rated peers. Foreign-currency funding had eased to about 18% of total funding by FYE23 (FYE22: 22%), which reduces potential foreign exchange mismatches due to Senka's exposure to foreign-currency counterparty credit risk. Senka fully hedges its foreign-currency borrowings via US dollar deposits with local banks.

Debt Ratings

Debt Ratings: Senkadagala Finance PLC

Rating level	Rating
Subordinated	BB+(lka)

Source: Fitch Ratings

Senka's Sri Lankan rupee-denominated subordinated debt is rated two notches below its National Long-Term Rating. This reflects our expectation of high loss severity and poor recoveries for such debt in the event of default. We apply the Bank Rating Criteria in rating this instrument, as we view the prudential capital framework for finance companies to be closer to that for banks in Sri Lanka. In line with Fitch criteria, we have not applied additional notching to the notes for non-performance risk because they do not contain going-concern loss-absorption features.

Debt Rating Sensitivities

Any change in Senka's National Long-Term Rating would lead to corresponding action on its subordinated debt rating.

Financials

Income Statement

	31 Mar 23		31 Mar 22	31 Mar 21	31 Mar 20
	Year end	Year end	Year end	Year end	Year end
	(USDm)	(LKRm)	(LKRm)	(LKRm)	(LKRm)
	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified
Revenue					
Net operating lease & rental income	n.a.	n.a.	n.a.	n.a.	n.a.
Interest income on loans	14	4,595	4,802	5,197	5,328
Other interest income	6	1,902	1,220	783	1,207
Finance lease income	n.a.	n.a.	n.a.	n.a.	n.a.
Total gross operating revenues	21	6,900	6,431	6,408	6,770
Total interest expense	12	3,868	2,430	3,212	3,678
Total net operating revenues	9	3,032	4,001	3,196	3,092
Memo: net interest income	8	2,628	3,591	2,768	2,856
Expenses					
Total operating expenses	6	2,036	1,840	1,698	1,817
Pre-impairment/provision operating profit	3	996	2,161	1,498	1,275
Impairment charges (reversals) on loans & finance leases	1	215	587	497	499
Securities and other credit impairment charges	0	-8	9	0	4
Operating profit	2	789	1,564	1,001	771
Pre-tax income	3	853	1,566	1,016	785
Net income (incl. non-controlling interests)	1	478	930	590	252
Fitch comprehensive income	1	483	966	584	239
Adjusted EBITDA	15	4,990	4,308	4,656	4,916
Income Statement Trailing Twelve Months (TTM)					
Total gross operating income (TTM)	21	6,900	6,431	6,408	6,770
Depreciation of lease & rental assets (TTM)	n.a.	n.a.	n.a.	n.a.	n.a.
Net gains on loans & leased assets sold (TTM)	n.a.	n.a.	n.a.	n.a.	n.a.
Interest expense (TTM)	12	3,868	2,430	3,212	3,678
Net interest income (TTM)	8	2,628	3,591	2,768	2,856
Impairment charges (reversals) on loans & finance leases (TTM)	1	215	587	497	499
Pre-tax income (TTM)	3	853	1,566	1,016	785
Adjusted EBITDA (TTM)	15	4,990	4,308	4,656	4,916
Exchange rate		USD1 = LKR327.286	USD1 = LKR293.872	USD1 = LKR199.038	USD1 = LKR188.624

Source: Fitch Ratings, Fitch Solutions, Senka

Balance Sheet

	31 Mar 23		31 Mar 22	31 Mar 21	31 Mar 20
	Year end (USDm)	Year end (LKRm)	Year end (LKRm)	Year end (LKRm)	Year end (LKRm)
Assets					
Loans and leases					
Gross loans & finance leases	82	26,921	28,534	29,227	28,487
Less: loss allowances for loans, leases and receivables	9	2,947	2,702	2,081	1,570
Net loans and finance leases	73	23,974	25,833	27,147	26,917
Net operating lease & rental assets	n.a.	n.a.	n.a.	n.a.	n.a.
Total interest earning assets	99	32,353	35,594	34,102	30,341
Total assets	108	35,324	38,671	37,525	33,995
Liabilities and equity					
Debt and deposits					
Total customer deposits	31	10,177	10,782	11,489	11,175
Short-term borrowings (maturing in the next 12 months)	23	7,588	7,234	5,828	7,538
Long-term borrowings (maturing after 12 months)	22	7,239	10,277	11,485	7,036
Subordinated Debt - LT	5	1,769	1,769	1,768	1,780
Hybrid capital accounted for as debt	n.a.	n.a.	n.a.	n.a.	n.a.
Total borrowings	51	16,596	19,280	19,082	16,354
Total debt and deposits	82	26,772	30,062	30,570	27,529
Total liabilities	84	27,343	31,052	31,619	28,674
Total equity excl. hybrid capital accounted for as equity	24	7,981	7,618	5,905	5,322
Total equity	24	7,981	7,618	5,905	5,322
Total liabilities and equity	108	35,324	38,671	37,525	33,995
Exchange rate		USD1 = LKR327.286	USD1 = LKR293.872	USD1 = LKR199.038	USD1 = LKR188.624

Source: Fitch Ratings, Fitch Solutions, Senka

Summary Analytics

	31 Mar 23 Year end	31 Mar 22 Year end	31 Mar 21 Year end	31 Mar 20 Year end
Asset quality ratios (%)				
Impaired loans & finance leases/gross loans & finance leases *Note: Includes insurance receivables and other advances from company disclosure*	14.7	14.6	15.2	11.7
Growth of gross loans & finance leases YOY	-5.7	-2.4	2.6	-4.9
Loss allowances/impaired loans & finance leases	73.9	64.2	46.2	46.5
Impaired loans & finance leases less loss allowances/tangible equity	13.1	20.0	41.5	34.3
Net charge-offs/avg. Gross loans & finance leases	-0.1	0.0	0.1	0.6
Earnings and profitability ratios (%)				
Pre-tax income/average assets	2.3	4.1	2.8	2.2
Adj. EBITDA/total revenue	72.3	67.0	72.7	72.6
Operating expenses/total net revenue	67.1	46.0	53.1	58.8
Pre-tax income/average equity	10.9	23.2	18.1	14.9
Impairment charges/pre-impairment op. Profit	20.8	27.6	33.2	39.5
Capitalisation and leverage ratios (% unless stated otherwise)				
(Debt + deposits)/tangible equity (x)	3.4	4.0	5.2	5.2
(Debt + deposits)/adj. EBITDA (x)	5.4	7.0	6.6	5.6
Tangible equity/tangible assets	22.5	19.6	15.6	15.5
(Net income - dividends - share repurchases)/beginning equity	5.5	13.7	9.4	4.9
Regulatory core capital ratio (company)	25.12	22.75	16.69	15.48
Funding, liquidity and coverage ratios (% unless stated otherwise)				
Unsecured debt/(total debt + deposits, est.)	44.9	42.0	44.4	47.2
Adj. EBITDA/interest expense (x)	1.3	1.8	1.4	1.3
(Liquid assets + undrawn committed facilities)/short-term funding (x, est.)	0.4	0.4	0.3	0.2
(Liquid assets + undrawn committed facilities + adj. EBITDA)/short-term funding (x, est.)	0.7	0.6	0.6	0.6
(Short-term debt + deposits)/(total debt + deposits)	56.9	51.9	47.7	55.4
Dividends/net income	11.7	13.0	15.3	0.0

Source: Fitch Ratings, Fitch Solutions, Senka

SOLICITATION & PARTICIPATION STATUS

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