FitchRatings

Non-Bank Financial Institutions
Finance & Leasing Companies
Sri Lanka

Senkadagala Finance PLC

Key Rating Drivers

Standalone Profile Drives Rating: Senkadagala Finance PLC's (Senka) rating reflects its higher risk exposure to cyclically sensitive SME borrowers and moderate deposit franchise as a mid-sized finance company in Sri Lanka. These factors contribute to its modest profitability and greater reliance on secured wholesale funding than peers. Nonetheless, Senka's strategy and risk appetite have been steadier than those of lower-rated peers, and an adequately matched asset-liability maturity profile provides some protection against liquidity risk.

Operating Environment Under Strain: The Covid-19 pandemic continues to exert significant pressure on the operating environment of Sri Lankan finance and leasing companies (FLC). Fitch Ratings projects a gradual economic recovery in 2021 and 2022 after a 3.6% contraction in 2020 GDP, but this forecast is subject to considerable uncertainty due to the pandemic's unpredictability.

Persistent Asset-Quality Pressure: We expect continued near-term pressure on loan demand, asset quality and profitability in light of the challenging operating environment. Senka's regulatory reported gross non-performing loan (NPL) ratio (based on six-month arrears) remained elevated at 7.7% at end-June 2021, and we see a risk of further deterioration in the near term. Nevertheless, the company's mostly secured loan book, loan-loss provisions and pre-provision profitability provide a modest buffer against credit provisioning risk.

Narrower Profitability: We expect elevated loan impairment expenses to continue to weigh on profitability in the near term. Senka recorded a net loss in the first quarter of the financial year ending March 2022 (1QFYE22) as higher credit costs outstripped pre-provision profit. Nonetheless, Senka has remained profitable in the past year with pretax profit of around 2.8% of average assets in FY21 (FY17-FY20: 2.2%-5.0%) and we believe profitability will recover if current movement restrictions are eased.

Rights Issues Support Capitalisation: Senka's leverage, measured by debt/tangible equity, remains at the higher end of that of rated large and mid-sized finance companies. However, the ratio improved to 4.7x by 1QFYE22 (FYE21: 5.2x) amid slower loan growth and a modest equity infusion by Senka's major shareholders. Senka's core capital-adequacy ratio of 17.9% at 1QFYE22 formed a moderate buffer against capital impairment risk. Another planned rights issue of around LKR475 million should help to shore up the capital buffer further.

Moderate Deposit Franchise: We regard Senka's funding profile as more confidence-sensitive than that of peers due to its smaller deposit-funding franchise (38% of total FYE21 funding) and greater reliance on secured wholesale funding. Its deposit base is fairly concentrated, raising the risk of lumpy funding outflows. Nevertheless, Senka's established market presence helps to maintain the stability of its large deposit relationships. Its positive short-term liquidity gaps and considerable undrawn liquidity facilities also help to offset the risk of a liquidity shock.

Rating Sensitivities

Limited Near-Term Upside: Positive rating action is unlikely in the near term in light of the difficult operating environment. An upgrade is only possible in the medium-to-longer term if the company is able to diversify its funding profile and strengthen its deposit franchise and profitability materially, closer to that of larger peers, while reducing leverage towards the lower end of its peer group.

Credit Deterioration: Fitch may take negative rating action if persistent asset quality deterioration results in in material capital impairment, funding pressure or an increase in asset encumbrance.

Ratings

National

National Long-Term Rating	BBB+(lka)

Sovereign Risk

Long-Term Foreign-Currency IDR	CCC
Long-Term Local-Currency IDR	CCC
Country Ceiling	B-

Outlooks

National Long-Term Rating	Stable

Applicable Criteria

Non-Bank Financial Institutions Rating Criteria (February 2020)

Bank Rating Criteria (February 2020)

National Scale Rating Criteria (December 2020)

Related Research

Fitch Affirms Senkadagala Finance at 'BBB+(lka)'; Outlook Stable (September 2021)

Fitch Affirms Sri Lanka at 'CCC' (June 2021)

Sri Lanka Finance and Leasing Dashboard: 1Q21 (March 2021)

Analysts

Elaine Koh
+65 6796 7239
elaine.koh@fitchratings.com

Sugath Alwis
+94 11 2541 900
sugath.alwis@fitchratings.com

Brief Company Summary

Senka, founded in 1968, is a mid-sized finance company in Sri Lanka. It held a market share of roughly 2.7% of industry assets and 1.5% of industry deposits at end-March 2021.

The company focuses on vehicle-backed lending to SMEs and commercial borrowers. Vehicle financing accounted for about 88% of gross loans and leases at FYE21, with the bulk in four-wheel vehicles that are mostly used for commercial purposes in sectors such as trading, manufacturing and transportation.

Senka is owned by the Balasuriya family, which holds roughly 90% of its issued capital. The primary holding vehicle, E W Balasuriya & Co. (Pvt) Limited, also has interests in jewellery and hotels. We do not consider the family ownership as a major governance issue for the company. Four independent directors, including the chairperson, provide a degree of oversight on the company's operations and there were no related-party loans outstanding at FYE21.

Key Latest Developments

Operating Environment Clouded by Economic and Sovereign Challenges

The operating environment for Sri Lankan FLCs continues to be hampered by the country's weak sovereign credit profile and the economic challenges arising from the Covid-19 pandemic. We believe elevated sovereign stress could lead to a sharp deterioration in the operating environment for FLCs due to the threat of weakening public- and private-sector balance sheets, funding market dislocation and macroeconomic volatility, which will strain FLCs' business prospects, risk appetites and financial profiles.

A prolonged restriction on motor vehicle importation has curtailed the sector's growth and inflated second-hand vehicle prices. This is evident from slowing loan growth across the large and mid-sized Fitch-rated FLCs[1], and the sector as a whole. Higher vehicle resale values will help to support near-term loan recoveries, but may heighten collateral value risk in the medium-to-longer term. Meanwhile, the economic disruption caused by the pandemic will continue to have a disproportionate effect on FLCs' largely sub-prime clientele.

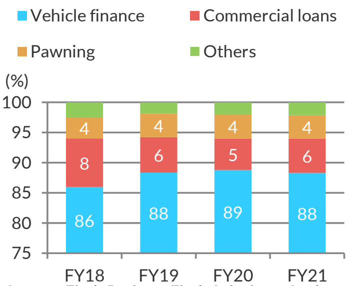
Presure on Underwriting Standards

Senka has maintained its core customer and product focus despite the reduction in market opportunities as a result of the pandemic. The vehicle import ban had a limited effect on Senka's portfolio mix, which remained largely exposed to second-hand registered vehicles in 1QFY22. The company has mostly shied away from products that Fitch considers higher-risk, such as short-tenor interest-only loans. Growth in gold-backed pawning loans has also been slower than the sector average (30%) in FY20 to 1QFY22.

However, the difficult economic environment is likely to erode the creditworthiness of Senka's borrowers and we believe the company will face pressure to be more opportunistic in sourcing loan growth in a bid to sustain its profitability, like the rest of the industry. The pace and quality of Senka's loan growth, and the risk migition employed, will remain material considerations for Fitch's ratings on the company.

[1] The large and mid-sized FLCs referred to in this report are People's Leasing & Finance PLC (PLC, A+(lka)/Stable), Central Finance Company PLC (CF, A+(lka)/Stable), LB Finance PLC (LB, A-(lka)/Stable), Senka and Mercantile Investments and Finance PLC (MIF, BBB-(lka)/Negative).

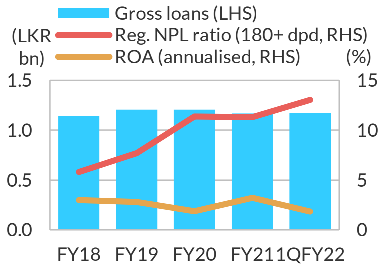
Loan Mix



Source: Fitch Ratings, Fitch Solutions, Senka

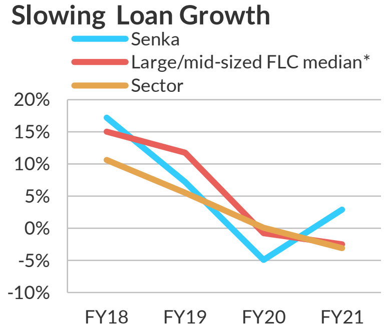
Industry Under Pressure

Finance & leasing sector data



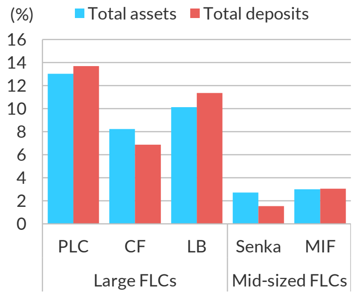
Source: Fitch Ratings, Sri Lanka central bank

Slowing Loan Growth



* Median of PLC, CF, LB, Senka and MIF
Source: Fitch Ratings, Fitch Solutions, FLCs

Market Share - FYE21



Source: Fitch Ratings, Fitch Solutions, FLCs

Key Financial Metrics – Latest Developments

Persistent Asset-Quality Risks

We expect pandemic-related restrictions to continue to weigh on Senka's asset quality in the near term, similar to the rest of the FLC sector. Its regulatory NPL ratio (based on six-month delinquencies) climbed to 7.7% in 1QFY22 amid renewed movement curbs after having eased to 6.5% by FYE21 (FYE20: 7.0%).

This is similar to the trend for other major FLCs, although Senka's regulatory NPL ratio remained significantly below the sector average of 13.0% at 1QFYE22 (FYE21: 11.3%; FYE20: 11.4%). Fitch's GDP forecast for Sri Lanka projects a modest recovery of 4.9% in 2021 and 3.2% in 2022, which should support a gradual improvement in asset quality if it is met. However, this is subject to a high degree of uncertainty. A prolonged extension of the current lockdown would heighten the risk of further credit impairment on Senka's book.

The company's largely secured loan portfolio and reported provision coverage ratio of 75.6% at 1QFYE22 provides a buffer against the risk of credit losses. However, provision coverage is significantly lower than the large stock of Stage 3 impaired loans and can be eroded quickly should impairments continue to climb sharply.

Credit Costs to Weigh on Earnings

Senka's net loss in 1QFY22 was largely due to higher impairment costs, and we expect tepid volume growth and elevated provisioning to place continued pressure on earnings and profitability in the coming year. Operating conditions may recover gradually towards the end of the fiscal year, in line with Fitch's GDP forecast. However, these expectations remain susceptible to significant risks. Senka's pretax income/average assets is typically lower than that of the large peers due to a combination of higher funding costs (11.2% in FY21 relative to the large-peer average of 10.2%) and less cost-efficient operations (cost/income ratio of 53% relative to the large-peer average of 40%).

Capitalisation and Leverage

We expect weakened internal capital generation and a significant stock of unprovided Stage 3 impaired loans to pressure capitalisation and leverage in the near term. Senka's leverage remains high relative to that of other Fitch-rated large- and mid-sized peers, which was at a median of 3.1x at FYE21.

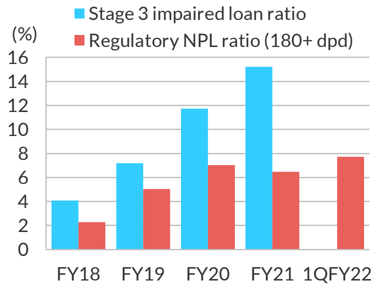
Nonetheless, leverage has fallen over the past year, while the regulatory Tier 1 capital-adequacy ratio has increased (FYE21: 16.7%; FYE20: 15.5%). The rights issue of around LKR475 million (8% of 1QFYE22 equity) should provide an additional boost to the capital base. The capital buffer, combined with loan-loss reserves of around 7.0% of gross loans at FYE21 (FYE20: 5.5%), provides a wider cushion against the threat of higher impairments over the coming year.

Funding, Liquidity and Coverage

We assess Senka's funding profile to be weaker than that of other Fitch-rated large- and mid-sized FLCs. Deposits comprised a moderate 38% of total funding at FYE21 and remained lower than the share for other rated large- and mid-sized entities of roughly 78%-94%, despite having increased from around 33% in FYE19. Nonetheless, the company has retained adequate access to funding despite the challenging economic environment.

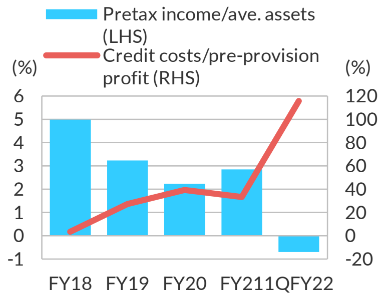
Significant regulatory support for domestic system liquidity has helped to maintain steady funding availability for FLCs, including Senka. The company's steady management of asset-liability maturity mismatches is a positive for its liquidity profile. Senka continued to maintain excess liquidity buffers in 1QFY21.

Significant Asset Quality Risk



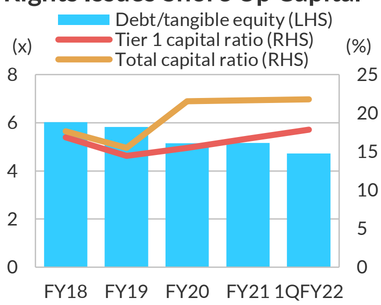
Source: Fitch Ratings, Fitch Solutions, Senka

Credit Costs Curb Profitability



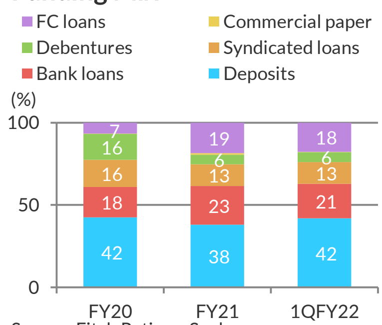
Source: Fitch Ratings, Fitch Solutions, Senka

Rights Issues Shore Up Capital



Source: Fitch Ratings, Fitch Solutions, Senka

Funding Mix



Source: Fitch Ratings, Senka

Income Statement

	31 Mar 2021	31 Mar 2021	31 Mar 2020	31 Mar 2019	31 Mar 2018
	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					
Operating and finance lease income net of depreciation	n.a.	n.a.	n.a.	n.a.	n.a.
Gross interest, leasing and dividend income	30	5,984	6,538	7,000	6,477
Total interest expense	16	3,212	3,678	3,755	3,405
Net interest income	14	2,772	2,860	3,245	3,072
Total non-interest operating income	2	423	232	261	253
Expenses					
Total non-interest expenses	9	1,698	1,817	1,878	1,675
Pre-impairment/provision operating profit	8	1,498	1,275	1,627	1,649
Impairment charges	2	497	499	444	56
Securities and other credit impairment charges	0	0	0	0	n.a.
Operating profit	5	1,001	776	1,183	1,594
Pre-tax income	5	1,016	785	1,164	1,660
Net income	3	590	252	886	1,002
Fitch comprehensive income	3	584	239	893	1,001
Exchange rate		USD1 = LKR199.0377	USD1 = LKR188.6236	USD1 = LKR176.13	USD1 = LKR155.9

Source: Fitch Ratings, Fitch Solutions, Senka

Balance Sheet

		31 Mar 2021	31 Mar 2020	31 Mar 2019	31 Mar 2018
	Year End	Year End	Year End	Year End	Year End
	USDm	LKRm	LKRm	LKRm	LKRm
Assets					
Loans and leases					
Gross loans	149	29,643	28,804	30,276	28,250
Net loans	138	27,562	27,233	29,070	27,802
Gross loans and leases	149	29,643	28,804	30,276	28,250
Loan loss allowances for receivables and loans	10	2,081	1,570	1,206	449
Net loans and leases	138	27,562	27,233	29,070	27,802
Other earning assets	1	266	270	278	282
Total earning assets	152	30,192	30,042	32,090	32,151
Total assets	189	37,525	33,995	36,353	35,779
Liabilities and equity					
Debt and deposits					
Total customer deposits	58	11,489	11,175	9,958	9,465
Total deposits	58	11,489	11,175	9,958	9,465
Total short-term debt funding	29	5,744	4,920	5,830	6,167
Total long-term funding	65	12,960	11,089	14,165	13,661
Total debt and deposits	152	30,193	27,184	29,953	29,293
Total interest-bearing liabilities	152	30,193	27,184	29,953	29,293
Total liabilities	159	31,619	28,674	31,168	30,796
Total equity	30	5,905	5,322	5,185	4,984
Total equity less non-controlling interest/minority interest	30	5,905	5,322	5,185	4,984
Total liabilities and equity	189	37,525	33,995	36,353	35,779
Exchange rate		USD1 = LKR199.0377	USD1 = LKR188.6236	USD1 = LKR176.13	USD1 = LKR155.9

Source: Fitch Ratings, Fitch Solutions, Senka

Summary Analytics

	31 Mar 2021 Year End	31 Mar 2020 Year End	31 Mar 2019 Year End	31 Mar 2018 Year End
Asset quality ratios (%)				
Impaired loans and leases/gross loans and leases	15.2	11.7	7.2	4.1
Regulatory non-performing loan ratio (six-month arrears)	6.5	7.0	5.0	2.3
Growth of gross loans and leases (yoy)	2.9	-4.9	7.2	17.2
Loan loss allowances for impaired loans and leases/impaired loans and leases	46.2	46.5	55.4	39.0
Impairment to capital ratio	43.6	34.7	19.4	16.8
Net charge-offs/average gross loans and leases	0.1	0.6	0.4	0.0
Earnings and profitability ratios (%)				
Pre-tax income/average assets	2.8	2.2	3.2	5.0
Non-interest expense/gross revenue	26.5	26.8	25.9	24.9
Pre-tax income/average equity	18.1	14.9	22.9	38.6
Impairment charges/pre-impairment operating profit	33.2	39.2	27.3	3.4
Capitalisation and leverage ratios (x)				
Debt+deposits/tangible equity	5.2	5.2	5.8	6.0
Funding, liquidity and coverage ratios (%)				
Unsecured debt/total debt (estimate)	56.8	57.9	46.7	52.8
Short-term debt/total funding	19.0	18.1	19.5	21.1
Cash dividends paid and declared/net Income	15.3	0.0	14.7	24.6

Source: Fitch Ratings, Fitch Solutions, Senka

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.