ICRA Lanka revises the issuer rating of Associated Motor Finance Company PLC

May 15, 2018

Instrument*	Rated Amount	Rating Action
Issuer rating	N/A	Revised to [SL]BB- (Negative) from [SL]BB (Stable)

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has revised the issuer rating of Associated Motor Finance Company PLC (AMF or the Company) to [SL]BB- (Pronounced SL double B minus) from [SL]BB (Pronounced SL double B). The outlook is revised from stable to negative.

Rationale

ICRA Lanka has taken a consolidated view of Associated Motor Finance PLC (AMF) and its 94% owned subsidiary Arpico Finance Company PLC (AFCP) for arriving at the rating. The combined entity henceforth is referred to as AMF-group.

The rating revision factors in the group's deteriorating capital profile and stretched liquidity profile as the portfolio expanded at a robust pace of 47% during 9MFY2018 (56% in FY2017). AMF group's gearing[1] increased to 12.6 times in Dec-17 as compared with 10.2 times in Mar-17 (9.4 times in Mar-16). Further, AMF's and AFCP's total capital adequacy ratios were at -1.1% and 9.7% respectively in Dec-17, below the regulatory minimum of 10%. The liquidity profile of the AMF group is stretched, characterized by high ALM mismatches[2] of 28% in the <1-year bucket as of Dec-17, which exposes the group to significant interest rate and refinance risks. ICRA Lanka also notes that during 9MFY2018, the group witnessed an increase in the softer delinquencies, with the 90+ day past due (dpd) at 12.5% in Dec-17 as compared with 9.5% in Mar-17. Maintaining asset quality under control going forward, in view of the robust portfolio expansion, is a key rating monitorable. The rating takes note of the competitive operating environment for vehicle financing in Sri Lanka and susceptibility of vehicle leasing business to adverse regulatory changes. ICRA Lanka takes cognizance of the declining profitability; however, the same is presently adequate, in view of the shift in the product profile, with a RoA (on PBT) of 2.2% in Dec-17 (3.1% in Mar-17).

The rating also takes note of the group's established track record and experienced management team. ICRA Lanka takes note of the steady shift of the group's portfolio towards safer asset classes such as cars and vans, which accounted for 39% of the group portfolio in Dec-17 (33% in Mar-17). The group's envisaged increase in microfinance exposure however, would be a key monitorable in terms of its ability to maintain credit quality. ICRA Lanka notes that AMF and AFCP are expected to merge by Nov-19, which would strengthen the business franchise and support business growth.

[1] Total debt / net worth (adjusting for goodwill/ revaluation reserve)

[2] Cumulative mismatch/ total assets

Outlook: Negative

The negative outlook takes cognisance of the expected weakening in the group's capital structure and liquidity profile as the group's growth plans are quite significant in relation to the internal generation and as growth is expected to be supported by shorter-term funding. The outlook may be revised to 'stable" in case of steady improvement in AMF group's capital and liquidity profile. The rating may be downgraded in case of deterioration in the asset quality and, further deterioration in the capital and liquidity profiles of the group.

Key rating drivers

Credit strengths

Established track record and experienced management team- AMF and AFCP have an established track record of over 50-years in operation as finance companies in Sri Lanka. AMF operates out of head office and its sole branch in Kurunegala, but it has presence in about 220 dealer locations while AFCP operates with 10 branches, including its head office. AMF is expected to merge with AFCP by November 2019, which is expected to improve the overall synergies. AMF, post-merger, is expected to operate as a strategic business unit within the merged entity, specialising in 2-wheeler financing. AMF group's promoters are experienced professionals in financing business and are actively involved in the day to day business operations and decision making and also hold board positions in both AMF and AFCP.

Steady shift towards safer asset classes; expected increase in microfinance exposure however is a monitorable - AMF group's portfolio grew by about 47% (annualised) in 9MFY2017 to about LKR 19 Bn in Dec-17 (LKR 14 Bn in Mar-17). ICRA Lanka notes that the growth was largely achieved by focussing on asset classes such as leasing of cars and vans, which accounted for 39% of the group portfolio in Dec-17 (33% in Mar-17); consequently, the share of 2-wheelers reduced to about 43% in Dec-17 vis a vis 53% in Mar-17 (60% in Mar-16). The group has also increased its exposure to corporate loans, Islamic finance loans, microfinance loans and personal loans which accounted for about 7%, 4%, 3% and 2% respectively of the portfolio in Dec-17. Over the next 2 years, the group envisages a portfolio mix consisting of 2-wheelers, 4-wheelers, loans to corporate and others (including personal loans) and microfinance accounting for 40%, 30%, 20% and 10% respectively of the total portfolio. The group's ability to keep credit quality under control as the portfolio diversifies into non-asset backed loans would be a key monitorable.

Credit challenges

Deterioration of the group's capital profile- The AMF-group's gearing has increased to 12.6 times as of Dec-17 vis a vis 10.2 times as of Mar-17 (9.4 times in Mar-16) because of the sharp growth in the portfolio during FY2017 and in 9MFY2018. The gearing of AMF and AFCP stood at 5.6 times and 9.6 times respectively as of Dec-17. The total risk weighted capital ratio of AMF and AFCP was at -1.1% and 9.7% (10.3% estimated after considering Q3FY2018 un-audited profits) respectively as of Dec-17. The total risk weighted capital ratio of AMF was affected due to the large leveraged investment in AFCP in FY2015; Central Bank of Sri Lanka (CBSL) has allowed AMF to operate below the regulatory requirement pending the merger. AFCP's capital profile, however, has been affected because of the high growth in the portfolio recorded over the last 2-3 years. ICRA Lanka takes note of the initiatives taken by the group to secure equity and tier-II capital for AFCP. However, the consolidated capital profile will remain weak as AMF would have to leverage further to participate in any equity capital raising program of AFCP. ICRA Lanka expects the group's capital profile to remain weak and stretched in the short to medium term, as the group envisages a portfolio growth of about 35-40% per annum, unless significant external equity support is secured. In addition, according to the CBSL direction for Licensed Finance Companies (LFCs), AMF's and AFCP's core capital is required to be increased up to LKR 1.5 Bn by January 2019 and each year thereafter by LKR 500 Mn until it reaches LKR 2.5 Bn by 2021. While AFCP, with a core capital of about LKR 1.3 Bn in Dec-17 would be in a comfortable position to meet the immediate requirement of LKR 1.5 Bn, ICRA Lanka estimates AMF would need about LKR 300 Mn capital infusion to meet the same given its internal generation of about LKR 200 Mn per year. AMF's core capital stood at about LKR 1.1 Bn in Dec-17. AMF's ability to meet regulatory requirements on a timely basis is a key rating monitorable. However, as the consolidated group core capital as at Mar-17 stood at about LKR 1.5 Bn, the group, at consolidated level, will be in compliance with the CBSL requirement.

Stretched liquidity profile- AMF group's ALM profile is characterized by significant mismatches in the <1-year bucket (28% of total assets in Dec-17) as majority of borrowing are short term compared to long-term nature of the lending portfolio. The standalone mismatch of AMF was comfortable (at about positive 3%), but the same for AFCP was higher at 43%. While ICRA Lanka takes note of the healthy deposit renewal rate of about 85-90% and its un-utilised sanction limits (LKR 800 Mn un-utilised bank facilities as of Feb-18), it would be crucial for the group to improve its liquidity position to offset refinance and interest rate risks as the share of long tenure assets increases in its overall portfolio.

Ability to control credit quality- ICRA Lanka notes that despite the improvement in group's NPA generation ratio, the delinquencies in the softer bucket has increased over the period and the group's ability to control the same would be a key monitorable. AMF's delinquencies in 90+dpd increased to 17% in Dec-17 from 10% in Mar-17 while the same for AFCP increased to 11% in Dec-17 from 9% in Mar-17. The group's NPAs (6 month lagged basis) stood at 5.0% in Dec-17 and 5.1% in Mar-17 (4.4% in Mar-16). The reported gross NPA ratio of AFCP however improved to 3.3% in Dec-17 from 4.1% in Mar-17 (4.9% in Mar-16) largely on account of aggressive growth in the portfolio and write offs during period. On the other hand, AMF's gross NPA ratio deteriorated to 6.5% in Dec-17 vis a vis 3.5% in Mar-17 (2.8% in Mar-16), as its vulnerable customer base has been affected by the recent drought and macro-economic conditions. The group's credit costs (including provision & write-offs) increased to 2.3%[3] for 9MFY2018 vis a vis 1.9% for FY2017 largely because of losses in disposal of repossessed stock.

Competitive business environment and susceptibility to unfavourable regulatory changes- AMF group's franchise is limited with 12 branches (AMF-2 branches and AFCP-10 branches). The group's portfolio largely consists of leasing (about 82% in Dec-17) with 43% and 39% exposure towards 2-wheelers and 4-wheelers respectively as of Dec-17. The operating environment for vehicle financing is quite competitive with established NBFIs and banks competing for market share. In addition, the leasing business is susceptible to adverse regulatory changes as observed in the recent past. AMF group, however, continues to be a key 2-wheeler financier in the country. The group has been able to expand the 4-wheeler portfolio at a robust pace to LKR 7.0 Bn in Dec-17 from LKR 4.1 Bn in Mar-17.

[3] Credit cost/Average total assets

Declining group profitability - AMF-group's RoA (before tax) stood adequate at 2.2% in Dec-17 though it has reduced from 3.1% in Mar-17 (4.0% in Mar-16). ICRA Lanka expects the group's RoA to moderate going forward because of the management's strategic decision to reduce the share of 2-wheeler leasing and as the leverage increases further. AMF's RoA (before tax) stood at 2.4% in Dec-17 vis a vis 3.5% in Mar-17. In 9MFY2018, AMF witnessed increase in credit to 3.1% from 2.3% in FY2017 largely on account of weakening asset quality. AFCP's RoA moderated to 2.4% in Dec-17 from 3.3% in Mar-17 largely because of increased borrowing costs and credit costs. The borrowing costs increased because of the increase in the share of high cost bank borrowings to fund the portfolio growth. The credit costs increased to about 2.0% from 1.5% in the same period, largely because of the losses incurred in the disposal of the repossessed stock.

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

About the company - Associated Motor Finance PLC (AMF)

Associated Motor Finance PLC (AMF) is one of the old Finance companies in Sri Lanka. AMF focuses on 2-wheelers as its key asset class. Imperial Imports and Exports (Pvt) Ltd (IIEP), which is a family owned company of Mr. Nalantha Dayamansa, holds 43.1% of the company. Mr. Nalantha Dayawansa directly holds another 42.8% of the company, while other Dayawansa family members hold 6.5% of the shares. Effectively, Dayawansa family controls close to 92.0% of the company. Imperial Imports and Exports (Pvt) Ltd is into motor trading business and it imports luxury vehicles and prime movers from UK.

During the FY2017, AMF reported a PAT of LKR 221 Mn on a total asset base of LKR 7,181 Mn as compared to a PAT of LKR 221 Mn on a total asset base of LKR 5,772 Mn in FY2016. For 9MFY2018, AMF reported a PAT of LKR 107 Mn on a total asset base of LKR 8,528 Mn.

AMF-group reported a PAT of LKR 422 Mn on a total asset base of LKR 17,518 Mn during FY2017 as compared to a PAT of LKR 541 Mn on a total asset base of LKR 12,637 Mn in FY2016. For 9MFY2018, AMF-group reported a PAT of LKR 312 Mn on a total asset base of LKR 24,305 Mn.

Key financial indicators- AMF group

	FY2016	FY2017	9MFY2018 (Unaudited)
Net Interest Income	1,258	1,553	1,367
Profit after Tax	541	422	312
Net worth	1,433	1,788	2,013
Loans and Advances	8,967	13,985	18,927
Total Assets	12,637	17,518	24,305
Return on Equity	44.8%	26.2%	21.9%
Return on Assets	4.8%	2.8%	2.0%
Gross NPA	4.2%	3.9%	4.1%
Net NPA	1.2%	1.2%	1.7%
Capital Adequacy Ratio	14.0%	10.6%	7.6%
Gearing (times)	9.4	10.2	12.6

Key financial indicators- AMF

	FY2016	FY2017	9MFY2018 (Unaudited)
Net Interest Income	448	558	466
Profit after Tax	221	221	107
Net worth	1,076	1,212	1,249
Loans and Advances	3,041	4,207	4,520
Total Assets	5,772	7,181	8,528
Return on Equity	22.1%	19.3%	11.6%
Return on Assets	5.5%	4.2%	2.1%
Gross NPA	2.8%	3.5%	6.5%
Net NPA	1.2%	1.5%	3.1%
Capital Adequacy Ratio	-1.8%	-0.7%	-1.8%
Gearing (times)	4.1	4.7	5.6

Rating history for last three years:

Instrument	Current Rating (FY2018)			Chronology of Rating History for the past 3 years		
	Type	Amount Rated (LKR Mn)	Date & Rating Apr-2018	Date & Rating in FY2017 Apr-2017	Date & Rating in FY2016 Mar-2016	Date & Rating in FY2015 -
Issuer rating	N/A	N/A	[SL]BB- (Negative)	[SL]BB (Stable)	[SL]BB (Stable)	N/A

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