



RATING ACTION COMMENTARY

Fitch Maintains LB Finance's National Rating of 'A-(Ika)' on Watch Negative

Fitch Ratings - Colombo - 20 Oct 2022: Fitch Ratings has maintained Sri Lanka-based LB Finance PLC's National Long-Term Rating of 'A-(Ika)' on Rating Watch Negative (RWN). Fitch has also maintained LB's senior and subordinated debt ratings of 'A-(Ika)' and 'BBB(Ika)', respectively, on RWN.

KEY RATING DRIVERS

Risks Remain Significant: The RWN on LB's National Long-Term Rating reflects the potential for deterioration in finance and leasing companies' (FLC) creditworthiness relative to other entities on the Sri Lankan national rating scale, given the heightened stress on its funding and liquidity.

We think Sri Lankan FLCs' funding and liquidity conditions are tied to those of the banks due to direct funding and deposit relationships, as well as the banking sector's importance to the domestic financial system. We believe that any signs of funding or liquidity stress in the banking sector would carry contagion risks for FLCs.

Significant Operating Environment Pressure: FLCs' credit profiles are under pressure from Sri Lanka's challenging operating environment, with elevated near- to medium-term downside risks arising from the sovereign's debilitated credit profile (Long-Term Local-Currency Issuer Default Rating: CCC/Under Criteria Observation). This could impair the economy and weigh on financial market performance. This would also weaken FLCs' asset quality and earnings due to their focus on more vulnerable clientele with weaker credit quality.

Elevated Liquidity Risk: Similar to peers, we expect LB's funding and liquidity profile to

remain vulnerable to funding market dislocations and the highly volatile local-currency liquidity in the market as a result of the weakened sovereign profile. However, we believe LB's financial flexibility - measured by the share of unsecured debt to total debt is high due to its

large share of deposit funding at 75% of total funding at the end of the first quarter of the financial year to March 2023 (1QFY23).

Volatility Weighs on Business Profile: LB's high concentration in the weak and unstable Sri Lankan economy makes its business profile, similar to peers, highly vulnerable to intensifying risks in the domestic market. This limits the company's ability to generate business volume while controlling risks. LB has an established domestic franchise as Sri Lanka's third-largest FLC, accounting for 10% of total FLC-sector assets and 11.2% of deposits at end-June 2022.

Concentrated Risk Profile: LB's elevated risk profile, similar to other FLCs, stems from the challenging operating environment in Sri Lanka given its focus on high-risk customer segments with weak credit quality in the domestic market. This is exacerbated by its large concentration in gold-backed lending, which we think has since increased materially from the 32% of gross loans reported at FYE22 and is expected to rise further.

Asset Quality Pressure to Rise: Fitch expects LB's reported non-performing loan (NPL) ratio to increase in the near-to-medium term as borrowers' repayment capacity weakens amid rapidly deteriorating economic conditions. LB's regulatory NPL ratio (over 120 days) was 5.1% at end-1QFY23 as severe fuel shortages crippled loan repayments.

Profitability to Weaken: We believe that increasing economic headwinds pose significant downside risks to LB's profitability. The company's pretax profit/average asset ratio declined to 8.6% by 1QFY23 from 9.3% in FYE22 as net interest margins narrowed due to upward deposit repricing alongside the sharp increase in domestic interest rates. However, LB's profitability metrics are better than that of most peers, despite the decline, due to its high-yielding gold-backed lending.

Leverage Higher Than Peers: Fitch expects LB's leverage, calculated as debt/tangible equity, to remain broadly stable through FY23-FY24, supported by its internal capital generation, which should be sufficient to support its growth. The leverage ratio is higher than that of domestic large FLCs.

RATING SENSITIVITIES

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

The RWN reflects rising risks to LB's rating from funding stresses, which could lead to a multiple-notch downgrade. We expect to resolve the RWN once the impact on the FLC's

credit prole becomes more apparent, which may take more than six months. Developments that could indicate funding and liquidity stresses may include:

- inability to service LB's obligations as a result of asset-liability mismatches, fundingstress or disruptions from intervention by authorities
- a temporary negotiated waiver or standstill agreement following a payment default on a large nancial obligation, or where Fitch believes that LB has entered into a grace or cure period following non-payment of a large nancial obligation.

A deterioration in the LB's credit prole relative to that of other local Fitch-rated entities may also result in negative rating action, including multiple-notch downgrades. This would include a greater deterioration in asset quality, funding costs and/or protability, leading to more pronounced capital erosion relative to peers.

A downgrade of the sovereign rating stemming from a default event could also lead to a downgrade of LB's rating.

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

There is limited scope for upward rating action given the RWN.

DEBT AND OTHER INSTRUMENT RATINGS: KEY RATING DRIVERS

LB's outstanding Sri Lankan rupee-denominated senior debt is rated at the same level as its National Long-Term Rating, in accordance with Fitch criteria. This is because the debt ranks equally with the claims of the entity's other senior unsecured creditors.

Its Sri Lankan rupee-denominated subordinated debt is rated two notches below its National Long-Term Rating. This is in line with our baseline notching for loss severity for this type of debt and our expectations of poor recovery.

DEBT AND OTHER INSTRUMENT RATINGS: RATING SENSITIVITIES

The senior and subordinated debenture ratings will move in tandem with LB's National Long-Term Rating.

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		A-(Ika) Rating Watch Negative
	Natl LT	A-(Ika) Rating Watch Negative
		Rating Watch Maintained
senior unsecured		A-(Ika) Rating Watch Negative
	Natl LT	A-(Ika) Rating Watch Negative
		Rating Watch Maintained
subordinated		BBB(Ika) Rating Watch Negative
	Natl LT	BBB(Ika) Rating Watch Negative
		Rating Watch Maintained

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APPLICABLE CRITERIA

[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)

[Non-Bank Financial Institutions Rating Criteria - Effective from 31 January 2022 to 5 May 2023 \(pub. 01 Feb 2022\) \(including rating assumption sensitivity\)](#)

[Bank Rating Criteria \(pub. 08 Sep 2022\) \(including rating assumption sensitivity\)](#)

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LB Finance PLC

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