



RATING ACTION COMMENTARY

Fitch Affirms LB Finance at 'A-(lka)'; Outlook Stable

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Fitch Ratings - Colombo - 01 Sep 2021: Fitch Ratings has affirmed LB Finance PLC's National Long-Term Rating at 'A-(lka)'. The Outlook is Stable. At the same time, Fitch has affirmed the company's Sri Lankan rupee-denominated senior unsecured debt at 'A-(lka)' and rupee-denominated subordinated debt at 'BBB(lka)'.

KEY RATING DRIVERS

NATIONAL RATINGS AND SENIOR DEBT RATINGS

LB's National Long-Term Rating is driven by its intrinsic financial strength and reflects its established domestic franchise as Sri Lanka's third-largest finance and leasing company (FLC), accounting for 10% of total FLC sector assets as of the financial year ended March 2021 (FY21). It also reflects high profitability from high-yielding products and satisfactory capital levels. This is counterbalanced by a high-risk appetite due to a large and increasing exposure to gold-backed lending.

The operating environment in Sri Lanka remains challenging. Sri Lanka's real GDP contracted by 3.6% in 2020 on disruption stemming from the coronavirus pandemic. Fitch forecasts an economic rebound in 2021 and 2022, but this depends on how the pandemic evolves. Our assessment of the operating environment for Sri Lankan FLCs also incorporates the negative implications for FLCs through the effects on their largely sub-prime clientele and the prolonged restriction on motor vehicle importation.

Fitch is of the view that LB's risk appetite remains high with rising exposure to gold-back lending. We expect this exposure to further increase in the near to medium term, compensating for the slowdown in its vehicle financing business. LB has so far managed its gold loan exposure through regular monitoring and risk control measures, such as ensuring that adequate safety margins are maintained. However, we believe that potential volatility in global and local gold prices together with local exchange rates could pose a threat to LB's asset quality.

Asset quality risk remains a key concern for overall credit profiles of FLCs such as LB due to their high exposure to customer segments that are more susceptible to deteriorating economic conditions. Fitch expects asset quality pressures to persist in the near to medium term, due to credit migration amid a challenging operating environment. The company's five-month gross non-performing loan ratio deteriorated to 6.1% in 1QFY22 (FY21: 5.4%, FY20: 3.9%), driven mostly by its vehicle financing portfolio and gold loans where collections were hampered due to the country-wide lockdowns during that period. LB's stage 3 (impaired) loans ratio, including facilities over 90 days due, increased to 11.4% by end-FY21 from 10.7% at end-FY20.

Fitch expects a recovery in LB's profitability in the medium term, although slower loan book growth, thinner net interest margin and high credit costs could continue to affect near-term profitability. LB's core profitability metric - pretax profit/average assets - declined to 6.4% in 1QFY22 (FY21: 7.6%, FY20: 7.0%) due to a drop in yields amid protracted low loan growth as a result of the lockdown that prevailed during the period, which outweighed the benefit of continued downward deposit repricing.

Fitch expects LB's debt/tangible equity to remain broadly stable through FY22-FY23, supported by the still healthy internal capital generation that is likely to outpace the funding growth stemming from a potential pick up in loan growth. LB's leverage ratio improved to 3.7x by end-FY21 (FY20: 5.0x) and remained at these levels in 1QFY22 as its funding base contracted on muted lending alongside consistent internal capital generation. However, LB's leverage ratio remains one of the highest among large and mid-sized Fitch-rated FLCs in Sri Lanka.

Fitch expects LB's funding and liquidity profile to remain adequate, supported by an established domestic franchise. We expect LB to rely on mostly deposit funding (1QFY22: 80% of funding) alongside secured, wholesale, term borrowings from banks and other funding agencies (17% of total funding).

LB's senior debentures are rated in line with the company's National Long-Term Rating, as they rank equally with claims of the company's other senior unsecured creditors.

SUBORDINATED DEBT

The subordinated debentures are rated two notches below LB's National Long-Term Rating to reflect the subordination to senior unsecured obligations, in line with our Bank Rating Criteria. Fitch's baseline notching of two notches for loss severity reflects our expectation of poor recovery. We have not applied additional notching to the notes for non-performance risk, as they have no going-concern loss-absorption features, in line with Fitch's criteria.

RATING SENSITIVITIES

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

Upside to LB's National Long-Term Rating in the near term is limited due to the pressure on the operating environment. In the medium to longer term, an upgrade is contingent on LB achieving lower leverage relative to peers, lower-risk asset exposure and a sustained improvement in its liquidity position when loan growth picks up meaningfully.

LB's senior and subordinated debt will be upgraded if the company's National Long-Term Rating is upgraded

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

A downgrade of LB's National Long-Term Rating would most likely arise from a weakening in its overall credit profile relative to the national-rating universe of Sri Lankan rated entities. This could result from a deterioration in asset quality beyond our base-case expectations leading to weaker profitability and higher capital impairment risks.

LB's senior and subordinated debt will be downgraded if the company's National Long-Term Rating is downgraded.

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	Natl LT	A-(lka) Rating Outlook Stable	Affirmed	A-(lka) Rating Outlook Stable
● senior unsecured	Natl LT	A-(lka)	Affirmed	A-(lka)
● subordinated	Natl LT	BBB(lka)	Affirmed	BBB(lka)

[VIEW ADDITIONAL RATING DETAILS](#)**FITCH RATINGS ANALYSTS****Jeewanthi Malagala**

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APPLICABLE CRITERIA

[Non-Bank Financial Institutions Rating Criteria \(pub. 29 Feb 2020\) \(including rating assumption sensitivity\)](#)

[Bank Rating Criteria \(pub. 29 Feb 2020\) \(including rating assumption sensitivity\)](#)

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

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LB Finance PLC

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Non-Bank Financial Institutions Asia-Pacific Sri Lanka
