FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades LB Finance's National Rating to 'BBB+(lka)'; Removes RWN; Outlook Stable

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Fitch Ratings - Colombo - 17 Oct 2023: Fitch Ratings has downgraded Sri Lanka-based LB Finance PLC's National Long-Term Rating to 'BBB+(lka)' from 'A-(lka)' and removed the Rating Watch Negative (RWN). The Outlook is Stable.

KEY RATING DRIVERS

Heightened Market Risk Exposure: The rating downgrade reflects Fitch's view that LB's credit profile has weakened relative to that of similarly rated peers. This is due to weakening in its risk profile following increased gold loan concentration, which, in Fitch's view, materially raises its exposure to collateral price risk, despite the better-than-peer asset quality and high profitability of this large exposure. Fitch does not expect a significant reduction in this exposure in the near to medium term, despite the resumption in lending in other product classes amid lower interest rates.

Less Severe Economic Risk: The removal of the RWN reflects our view that downside to the rating 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 the gradual economic recovery with easing inflation and interest rates.

Reduced economic risk will temper the pressure on the sector's operating performance and liquidity profile, although the pace of recovery may vary with individual entities' business mix and franchise strength. Fitch expects sector growth to remain weak with lingering asset quality pressure in the financial year ending March 2024 (FY24), but this may improve in FY25 as the economy recovers. Declining interest rates should ease funding cost pressure, but could hit asset yields for lenders with shorter asset-repricing cycles.

Economic Headwinds Pressure Business Model: LB's business profile reflects persistent domestic risks that limit its ability to generate and defend business volumes while controlling risks. This is evident in the company's rising concentration in gold-backed lending (44% of gross loans at end-FY23), a segment that Fitch views as risky given the exposure to underlying gold price volatility and typically weak borrower repayment capacity. LB's high-risk profile also reflects its exposure to high-risk customer segments with weak credit quality in the domestic market.

Sustained Asset-Quality Risks: We expect LB's asset-quality metrics to remain weak in the near term due to its large exposure to customer segments that are susceptible to weak economic conditions. The company reported a gross non-performing loan (NPL) ratio of 6.7% at end-1QFY24, based on loans 90 days past due (FY23: 4.5% on 120 days past due). This ratio remains one of the lowest among Fitch-rated finance and leasing companies (FLCs) and is masked by LB's large exposure to gold-backed lending where NPLs are negligible.

Falling Rates Hamper Profitability: We expect declining domestic interest rates to weigh on LB's profitability as its large short-term gold-backed loans reprice faster than its liabilities, resulting in narrower net interest margins. LB's growing exposure to high-yielding gold-backed loans helped the company's profitability to stay higher than the peer average, with its pre-tax income/average assets ratio at 9.4% in 1QFY24 compared with the Fitch-rated large FLCs peer average of 4%.

Leverage Above Peers: We expect a modest increase in LB's debt/tangible equity in the near to medium term as the growth resumes. The company's leverage ratio stayed broadly stable at around 3.7x over FY21-1QFY24, but remained higher than the Fitch-rated large FLCs peer average of 2.9x.

Liquidity Risk to Abate: The sovereign's DDO plan and the reduced economic risks have alleviated some of the stress on LB's funding and liquidity profile. We view LB's financial flexibility - as measured by the share of unsecured debt in total debt - as high given its large share of deposit funding (85% of total funding at end-1QFY24). We expect this ratio to moderate in the near term as the company shifts to secured wholesale funding to support its loan growth.

RATING SENSITIVITIES

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

The National-Long-Term Rating is sensitive to changes in LB'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 the business mix towards riskier products and more vulnerable customer segments, as well as rising liquidity risk, 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 Sri Lanka's 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.

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.

REPORT OF ISSUER’S APPEAL

The issuer appealed the decision of the original rating committee. In accordance with Fitch Ratings' policies, the issuer's request was reviewed by an appeal review panel, which determined that an appeal committee was not warranted due to insufficient new information. Therefore, the outcome of the original committee, as detailed within this rating action commentary, was not affected.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR

LB Finance PLC	Natl LT Downgrade	BBB+(lka) Rating Outlook Stable	A-(lka) Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

Non-Bank Financial Institutions Rating Criteria (pub. 06 May 2023) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

Potential Conflicts Resulting from Revenue Concentrations

ENDORSEMENT STATUS

LB Finance PLC	-

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