Lanka Rating Agency

Rating Report

PMF Finance PLC

Report Contents

Rating History					
Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
01-Mar-2023	B+	A4	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The rating reflects the small relative position of PMF Finance PLC (PMF or the Company) in the leasing and finance sector. Following the change in ownership from People's Bank to Sterling Capital Investments (Pvt) Ltd. (SCI) in 2019, the Company's management changed which improved the performance of the Company. PMF intends to follow its five-year strategic plan and achieve an LKR 25bn asset base and an LKR 1bn profit after tax by FY26. Due to the current economic conditions, the Company plans to focus on short-term lending products. Subsequent to the rights issue in March and December 2021, it increased its Capital Adequacy Ratio (CAR) to ~37.7% as of FY22. It however decreased to~31% as of 1HFY23. The sponsorship PMF receives from Sterling Capital Investments (Pvt) Ltd. (SCI) will provide comfort for the Company to obtain foreign funding in the future. Despite the unstable economic conditions in the country, PMF recorded gross and net Non-Performing Loans (NPL) of ~7.2% and ~1.5% as of 1HFY23, which are below industry averages. The Net Interest Margin (NIM) took a hit during the six months ended in FY23 to ~41% (FY22: ~62%) as a result of the considerable rise in interest expenses. The core spread of the Company reduced to ~4.3% as of 1HFY23 due to the significant escalation of deposit cost in the macro environment. Going forward, the Company's ability to expand its portfolio, whilst maintaining its credit risk would be critical for the Company.

The rating is dependent on the Company's ability to navigate its way through unpredictable macroeconomic conditions. Any upward revision in the ratings will be dependent upon improving the quality of the portfolio while managing the book well under these macroeconomic conditions. The Company's ability to geographically diversify whilst maintaining low operational costs will be critical. The rating will rely on the management of credit risk and maintaining the quality of the portfolio

Disclosure	
Name of Rated Entity	PMF Finance PLC
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Non-Banking Finance Companies Rating(Jun-22)
Related Research	Sector Study | Leasing & Finance Companies(Jun-22)
Rating Analysts	Amreetha Mahindapala | amreetha@lra.com.lk | +92-42-35869504

Profile

Structure PMF Finance PLC ("PMF" or "the Company") is a public limited liability company, incorporated in 1983 under the Companies Act No. 17 of 1982 and listed on the Colombo Stock Exchange ("CSE") in 1994.

Background PMF commenced operations as a joint venture between People's Bank and Guinness Mahon & Company Ltd., of UK in 1983. In 2019, Sterling Capital Investments (Pvt) Ltd. ("SCI") became the major shareholder by acquiring ~68% of the Company.

Operations The principal business activities include, acceptance of deposits, granting micro loans, small and medium enterprises ("SME") loans, leasing, gold loans, real estate services and issuance of debt instruments. The Company has a branch network of 11 branches and one pawning center.

Ownership

Ownership Structure SCI holds the largest share of the Company with ~81.6% shares. People's Bank and People's Leasing & Finance PLC holds 8.35% and 6.17% respectively.

Stability The ultimate parent Company, Rush Japan Corporation is a prominent customer of Mizuho Bank of Japan. The recent acquisition of PMF by SCI along with capital injection and long-term presence in Sri Lanka provide comfort to the long-term stability in shareholding of the Company.

Business Acumen Prior to the import restriction imposed in the country, SCI imported around 1,700 – 2,000 vehicles every month to Sri Lanka. SCI holds ~65% - ~70% market share in reconditioned vehicles in Sri Lanka. It also has an investment arm that has invested close to LKR 2bn in the CSE.

Financial Strength SCI has invested close to LKR 6 to 7bn in Sri Lanka and has an asset base of LKR 10bn - 15bn. It is a geographically diversified Company and exports to Asia, Africa, Europe, and New Zealand.

Governance

Board Structure The board consists of five non-executive directors, out of which three are independent and two are non-independent. The largest shareholder has representation on the Board.

Members' Profile The board members have expertise in banking, insurance, microfinance and not-for-profit entities, real estate, and start-ups. The Chairman of the Company, Mr. Abeywickrema, is a senior commercial banker and has over 30 years of experience.

Board Effectiveness The Board of Directors has formed seven board sub-committees and the BAC is headed by Mr. Rangana Koralage, who has finance and audit-related experience, along with related qualifications.

Financial Transparency The external auditors of the company, KPMG, issued an unqualified audit opinion pertaining to annual financial statements for FY22.

Management

Organizational Structure The organization is divided into 10 departments which reports to the CEO, through the Deputy Chief Executive Officer ("DCEO"). The head of the organization remains the Board of Directors.

Management Team The management team is headed by Mr. Nalin Wijekoon, who has been with the Company since 2020. He has 40 years of experience and is a Fellow member of Institute of Chartered Accountants of Sri Lanka, Chartered Institute of Management Accountants, UK and Sri Lanka Institute of Credit Management.

Effectiveness PMF has formed three management committees, namely, i) Assets and Liability Management Committee, ii) Executive Committee, iii) Investment Committee. The Company has prepared a succession plan based on the Central Bank of Sri Lanka ("CBSL") directions.

MIS The Company plans to move into a new Core Banking system from the Legacy system. Along with the new core banking system, PMF is planning to initiate mobile, internet and agent banking as well as implement LankPay integration to receive Common Electronic Fund Transfer Switch ("CEFT") facilities. it also plans to initiate systems for loan origination and a Customer Relationship Management ("CRM") system.

Risk Management Framework The Company has developed a risk management framework that monitors the risk under three defense lines. A risk officer is appointed to each branch to monitor the risks. Other types of risks are identified centrally. The findings made through internal controls will be discussed with the senior management and will also be presented to the Board Audit Committee.

Business Risk

Industry Dynamics At present, there are 36 LFCs in Sri Lanka, out of which, 29 are listed in the CSE. The profit after tax for the six months ending September 2022 saw a decline of 11%. The loan loss provisions declined by ~LKR 6bn in the six months to September compared to the previous financial year, which aided the sector earn profits. The total asset base of the LFC sector stood at LKR 1.5tn as of 4QFY21, which represents 5.6% of Sri Lanka's financial system. The gross and net NPLs deteriorated to ~16.76% and ~11.73% by September 2022.

Relative Position The Company is a small player in the industry with ~0.5% (Mar 2021: ~0.3%) assets compared to assets in the industry in FY22. The equity, deposits and loans, and advances have also increased during FY22, compared to the sector, while the investments have decreased during the financial year.

Revenues The Company increased its interest income by ~69% to LKR 794mn (Mar 2021: 471mn) in FY22, the net interest income grew by ~112% to LKR 494mn (Mar 2021: 233mn). Although the core spread took a hit in FY21, it increased to ~7% as in FY22. However, as at 1HFY23, the core spread was recorded at ~4.3%. PMF recorded a Net Interest Income of LKR 341mn and a loss for the period of LKR 88mn.

Performance PMF was recording losses continuously since FY13. They broke the cycle in FY21 by earning LKR 68mn profit after tax. It increased its' profit after tax by ~182% to LKR 192mn in FY22. Once the ownership changed from People's Bank to SCI in 2019, the Company changed its management and the board. PMF was able to improve its portfolio and recoveries as well. However, under current circumstances improving performance will remain a challenge.

Sustainability The Company intends to achieve LKR 25bn asset base and LKR 1bn profits by FY26. The Company intends to initiate agent banking in rural areas, which will also help the Company to reduce the cost-to-income ratio. PMF plans to focus more on short-term lending products such as gold loans and entrepreneur loans. Due to the current import restrictions, PMF will not continue with trade finance.

Financial Risk

Credit Risk PMF recorded a gross and net NPL of ~6.1% and ~0.8% as at FY22 which increased to ~7.2% and ~1.5% respectively. High NPLs are recorded for loans and leases since FY21. The concentration of the top 20 customers is around 16% recorded as at FY22. It has been reducing over the years as a result of the loans & advances and leases & hire purchases portfolios increasing by ~130% and ~95% respectively in FY22.

Market Risk PMF's total investments have reduced from LKR 1.3bn in FY21 to LKR 215mn in FY22 and its investment in government securities makes up ~96 of its investments.

Liquidity And Funding The Company depended on customer deposits for funding until FY21. It reduced to ~62% in FY22, while bank borrowings constituted ~35% of its funding. As per the maturity analysis as of August 2022, the Company needs to manage its maturity gap for liabilities within one year. The advances to funding ratio reduced to ~122% in 1HFY23 and it has been decreasing since FY21 but remain higher as compared to industry.

Capitalization The capital adequacy rate stood at ~37.7% as at FY22, which reduced to ~31% 1HFY23. The core capital of PMF has recorded at LKR 2.8bn as of FY22. The debt-to-equity ratio is at 2.6x as at 1HFY23. The debt-to-equity ratio has been increasing over the years as a result of the Company increasing its deposit base by ~41% in FY22 and the Company acquiring bank borrowings in FY22.

Lanka Rating Agency

People's Merchant Finance PLC
Listed Public Limited

LKR mln

	Sep-22	Mar-22	Mar-21	Mar-20
	6M	12M	12M	12M
A BALANCE SHEET				
1 Total Finance-net	7,683	6,631	3,075	1,518
2 Investments	124	215	1,311	737
3 Other Earning Assets	1,077	836	32	1,248
4 Non-Earning Assets	608	553	204	172
5 Non-Performing Finances-net	269	46	82	140
Total Assets	9,760	8,280	4,704	3,815
6 Funding	6,780	5,225	2,387	2,193
7 Other Liabilities	235	221	186	69
Total Liabilities	7,015	5,446	2,573	2,262
Equity	2,746	2,834	2,131	1,553
B INCOME STATEMENT				
1 Mark Up Earned	838	794	471	564
2 Mark Up Expensed	(496)	(300)	(238)	(300)
3 Non Mark Up Income	18	116	112	42
Total Income	359	610	346	305
4 Non-Mark Up Expenses	(355)	(509)	(333)	(275)
5 Provisions/Write offs/Reversals	(72)	100	88	(98)
Pre-Tax Profit	(68)	201	101	(68)
6 Taxes	(20)	(10)	(33)	(12)
Profit After Tax	(88)	192	68	(80)
C RATIO ANALYSIS				
1 PERFORMANCE				
a Non-Mark Up Expenses / Total Income	98.8%	83.4%	96.4%	90.1%
b ROE	-6.3%	7.7%	3.7%	-5.2%
2 CREDIT RISK				
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	122.0%	135.1%	149.6%	97.4%
b Accumulated Provisions / Non-Performing Advances	54.6%	89.3%	83.5%	77.3%
3 FUNDING & LIQUIDITY				
a Liquid Assets / Funding	17.9%	20.6%	29.9%	68.7%
b Borrowings from Banks and Other Financial Institutes / Funding	24.3%	35.3%	0.0%	0.1%
4 MARKET RISK				
a Investments / Equity	4.5%	7.6%	61.5%	47.5%
b (Equity Investments + Related Party) / Equity	0.2%	0.2%	0.1%	0.1%
5 CAPITALIZATION				
a Equity / Total Assets (D+E+F)	28.1%	34.2%	45.3%	40.7%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	-6.2%	9.0%	4.4%	-5.2%

Credit Rating

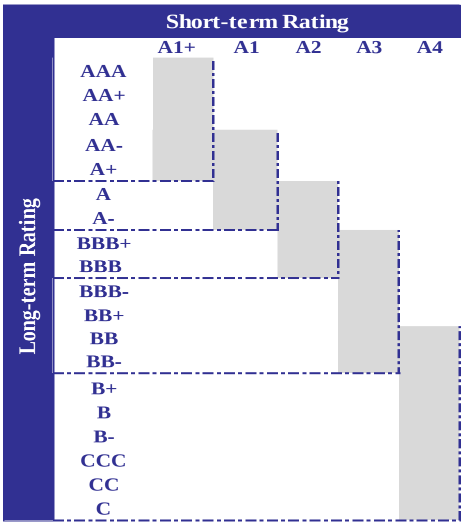
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk “CCC” Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. “CC” Rating indicates that default of some kind appears probable. “C” Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. ‘Stable’ outlook means a rating is not likely to change. ‘Positive’ means it may be raised. ‘Negative’ means it may be lowered. Where the trends have conflicting elements, the outlook may be described as ‘Developing’.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating

Rating Team Statements
(1) Credit Rating Agency means a body corporate engaged in the business of assessing and evaluating the credit- worthiness of any issuer or a specific issue of securities. (https://www.sec.gov.lk/index.php/credit-rating-agency/)

2) **Conflict of Interest**
i. LRA shall not engage in any other business which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained (Section 33- Draft Rules Credit Rating Agency - 2021)

Restrictions
(3) LRA is not entitled to outsource any part of its work, which has a direct bearing on the act of rating. However, if any other function other than the core function of rating is to be outsourced, such fact shall be brought to the attention of the Client and be included in the Credit Rating Agreement entered into with the Client. (Section 22- Draft Rules Credit Rating Agency - 2021)
(4) LRA cannot appoint any individual as a member of the Rating Committee who has a business development function of the Credit Rating Agency, or who initiates or participates in discussions regarding fees or payments with any Client of Credit Rating Agency. (Section 26- Draft Rules Credit Rating Agency -2021)

Conduct of Business
(5) Prior to the commencement of a rating, LRA does not promise, assure or guarantee to a client that a particular rating will be assigned.
(6) LRA performs a rigorous and formal periodic review of all its methodologies. Such methodologies shall be made available to the Commission for perusal, upon request. (Section 39- Draft Rules Credit Rating Agency -2021)

Independence & Conflict of interest
(7)LRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on LRA´s opinions or other analytical processes. In all instances, LRA is committed to preserving the objectivity, integrity and independence of its ratings.
(8)LRA does not engage in any other business activity which in the view of the Commission creates a conflict of interest unless prior written approval of the Commission is obtained (Section 33- Draft Rules Credit Rating Agency -2021)
(9) LRA structures its rating teams and processes to promote continuity, consistency and avoid bias in the rating process. (Section 45 - Draft Rules Credit Rating Agency -2021)

Monitoring and review
(10) For purposes of transparency, LRA publishes sufficient information about an entity/security rated, frequency of default and whether a rating grade assigned has changed over time. The definitions and computation methods for the default rates stated in the default studies are also be disclosed. (Section 42- Draft Rules Credit Rating Agency -2021) LRA monitors below factors specifically, (a) all internal records to support our credit rating opinions; (b) all particulars relating to Clients at our office which shall include the name and registered address and contact numbers of such Client's, names and addresses of their Directors as at the date of rating, its issued share capital and the nature of business; and (c) a comprehensive written record of all complaints received from Clients and action taken thereon by LRA.
(11) LRA ensures confidentiality of all information at all times relating to Clients including such Client's identity and transactions carried out for such Client unless and to the extent such disclosure is required by law. (Section 48 - Draft Rules Credit Rating Agency -2021)
(12) LRA does not destroy, conceal or alter any records, property or books relating to the business of the LRA which are in its possession or under its control with the intention of defeating, preventing, delaying or obstructing the carrying out of any examination. (Section 51 - Draft Rules Credit Rating Agency - 2021).
Probability of Default
(13) LRA's Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e., probability).
Proprietary Information
(14) All information contained herein is considered proprietary by LRA. Hence, none of the information in this document can be copied or, otherwise reproduced, stored or disseminated in whole or in part in any form or by any means whatsoever by any person without LRA's prior written consent