

## ICRA Lanka reaffirms the issuer rating of Arpico Finance Company PLC

September 28, 2020

Instrument	Rated Amount	Rating Action
Issuer rating	N/A	[SL]B+ (Negative); Reaffirmed

### Rating action

ICRA Lanka Limited has reaffirmed the issuer rating of Arpico Finance Company PLC (AFCP or the Company) at [SL]B+ (Pronounced SL B plus) with Negative outlook.

### 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 reaffirmation with a negative outlook factors in the continued weakness in AMF-group's asset quality indicators and its weak capital profile. The group's gross NPA ratio (GNPA%) remains at about 12.8% as of Mar-20 compared to about 12.9% as of Mar-19 (4.4% as of Mar-18), largely because of macro-economic challenges prevailing in the economy. However, ICRA Lanka takes note that the deterioration in group's gross NPA ratio was also driven by sharp contraction of the total gross portfolio to LKR 15.8 Bn as of Mar-20 from LKR 21.2 Bn as of Dec-18. The decline in gross portfolio was due to management's decision to focus on credit quality of the portfolio. The rating also takes comfort from the increase in asset backed exposures of AMF group over the last 2 years. Asset-backed lending increased to about 90% of the overall portfolio in Mar-20, from about 85% in Dec-18. ICRA Lanka also takes cognizance of the improvement in the overall liquidity profile, where the Group cumulative asset liability mismatches (ALM) in <12-months' bucket improved to about 5% in Mar-20, vis-à-vis 6% in Mar-19. Overall group liquidity is also supported by the healthy deposit renewal rate of about 85-90% and its un-utilised sanction limits.

AMF-group's capital position is considered on a group perspective by the Central Bank of Sri Lanka (CBSL) and the group's total capital adequacy ratio (CAR) remained below regulatory requirement (10.5%) at 8.5% as of Mar-20. However, CBSL has not taken any action against AMF group as the deadline to meet minimum capital adequacy levels was extended from July-20 to July-21 for all NBFIs due to COVID-19. The Group's liquidity was characterized by negative ALM mismatches<sup>1</sup> of 5% in the <1-year bucket as of Mar-20, vis-à-vis 15% in Dec-18. Going forward, the group's ability to improve asset quality and the capitalization profile would be crucial from a rating point of view.

<sup>1</sup> Cumulative mismatch/ total assets

## Outlook: Negative

The Negative outlook notes that the Company's asset quality and capital profile would remain weak in the near to medium term. The outlook may be revised to 'Stable' in case of steady improvement in AMF-group's capital, asset quality and liquidity profiles going forward. The rating may be downgraded in case of any further deterioration in its asset quality and capitalisation, or overall financial risk profile. Any regulatory action on the Company, which could impact its business and financial performance, would also be a credit negative.

## Key rating drivers

### Credit strengths

**Established track record** - AMF and AFCP have an established track record of over 50-years in operation as finance companies in Sri Lanka. AMF operates out of the head office and its sole branch in Kurunegala, but it has presence in about 100 dealer locations while AFCP operates with 10 branches, including its head office. AMF is expected to merge with AFCP by December 2020, which would improve the overall synergies. AMF's current business, 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.

### Credit challenges

**Weak asset quality likely to persist** - AMF group's gross NPA ratio stood at 12.8% as of Mar-20 vis-a-vis 12.9% as of Mar-19 (4.4% as of Mar-18). The deterioration in asset quality was largely attributable to the macro economic situation of the country, where industry wide GNPA% increased to 16% in Jun-20 while credit growth slowed down. ICRA Lanka notes that AMF group has slowed down the pace of slippages and improved the recoveries during FY20; however GNPA% ratio remains high at 12.8% as of Mar-20 (compared to the NBFI sector average of 11.4% in Mar-20) due to the sharp de-growth in total gross portfolio. From a group point of view, ICRA Lanka notes that AFCP accounts for about 84% of the group GNPA's as in March 2020, while AMF accounts for about 16%. In terms of the asset classes, Two-wheelers and passenger vehicles have contributed to the bulk of the non-performing loans. The reported GNPA% of AFCP stood at 15.5% as of Mar-20 (14.8% as of Mar-19), while the GNPA% for AMF stood at 6.5% as of Mar-20 (6.6% as of Mar-19, respectively). The group's credit costs (including provision & write-offs) increased to 4.6% in FY19 from 2.4% in FY18 largely because of losses in disposal of repossessed stock. However, as a result of collection and recovery process, credit costs (loan provisioning /ATA<sup>2</sup>) improved to 3.2% as of Mar-20. Also, ICRA Lanka notes that the NPA provisioning coverage of AMF remained adequate at about 76% as in Mar-20 (75% in Mar-19), given the exposures are largely asset backed. Group solvency ratio (Net NPA/ Networth) stood at about

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<sup>2</sup> ATA= Average Total Assets (Deployed Assets)

33.7% as in Mar-20, compared to 41.1% Mar-19. The group's ability to control the further slippages from its portfolio and improve the asset quality would be a key monitorable going forward.

**Weak capitalisation profile masked by high leverage and capital ratios below regulatory levels -**

The AMF-group's consolidated gearing improved to 11.9 times as of Mar-20, largely because of muted portfolio growth ( negative 25% YoY as in Mar-20). Further, the gearing of AMF and AFCP stood at 4.9 times and 9.1 times respectively as of Mar-20. Based on the CBSL approval granted for the merger plan, the group's capital position is considered by the regulator on a consolidated basis, till the merger is completed. After Covid-19, CBSL announced an extension of one year to comply with core capital requirements. AMF-group's total capital adequacy ratio (CAR) however continued to remain below the regulatory requirement (10.5%) at 8.5% as of Mar-20. The core capital of AMF group stood at about LKR 1.8 Bn as at Mar-20, and expects to comply with the minimum core capital requirement of LKR 2 Bn by Jan-21 (Revised to Jan-21 by CBSL after COVID-19) through internal generation. ICRA Lanka notes that the Group's CAR ratios will remain under pressure going forward until it secures commensurate fresh external equity post-merger, based on the CBSL approved plan, subject to required regulatory approvals.

**Modest scale of operations and competitive business environment-** AMF group's franchise is limited with 12 branches (AMF-2 branches and AFCP-10 branches). The group's portfolio declined to LKR 15.8 Bn as of Mar-20 compared to LKR 19.6 Bn as of Mar-19 due to group's conservative risk appetite given unfavourable macro situation prevailing in the country. As of Mar-20, about 91% of the portfolio was backed by vehicles (via leasing and Islamic financing products). The leasing portfolio largely comprised of 2-wheelers, and cars & vans which accounted to about 55% and 30% as of Mar-20. In a group perspective, the expected portfolio composition is about 90% leases to 10% other loans. The exposure to 2Ws is expected to be limited around 50% of the Group portfolio. The operating environment for vehicle financing is quite competitive with established NBFIs and banks competing for market share. In addition, the unregistered vehicle leasing business is largely susceptible to adverse regulatory changes as observed in the recent past.

**Declining group profitability with low return ratios -** AMF-group's return on assets - RoA (after tax) moderated to negative 0.7% in FY2020 from 1.9% in FY2019. AMF's stand-alone RoA (after tax) decreased to 0.3% in FY2020 vis a vis 2.0% in FY2019. In FY2020, AMF's loan provisioning cost stood at 2.2% vis-à-vis 2.6% in FY2019. AFCP's RoA moderated to negative 1.1 % in FY2020 from 2.2% in FY2019. However, during FY2020, AFCP's credit costs decreased to about 3.3% from 5.3% in FY2019 in the same period, largely due to the reduction in slippages and improvement made in recoveries. Going forward, it will be crucial for the Group to improve profitability by controlling the credit cost and operating expenses, as the room for lending margin expansion will be limited.

**Analytical approach:** ICRA Lanka has taken a consolidated view of AMF and AFCP. 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 - Arpico Finance Company PLC (AFCP)

Arpico Finance Company PLC (AFCP) is one of the older finance companies in Sri Lanka, with a track record of over six decades. The company is listed on the Main Board of the Colombo Stock Exchange. The controlling interest of AFCP was acquired by Alliance Finance Group in 1967 from the original shareholders. With the consolidation drive initiated by the Central bank, Alliance Finance Group divested its controlling interest to Associated Motor Finance PLC. The company's major shareholder presently is Associated Motor Finance Company PLC with a stake of 94%. AFCP's primary customer segments are Retail and Small and Medium Enterprises (SME) sectors. The company's key areas of operations are Deposits, Leasing & Hire Purchase, Loans and Islamic Finance. The company operates through 10 branches.

During FY2020, AFCP reported a net loss of LKR 168 Mn on a total asset base of LKR 13,434 Mn as compared to a PAT of LKR 373 Mn on a total asset base of LKR 15,947 Mn in the previous financial year.

## Associated Motor Finance Company 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 FY2020, AMF reported a PAT of LKR 23 Mn on a total asset base of LKR 7,714 Mn as compared to a PAT of LKR 134 Mn on a total asset base of LKR 7,419 Mn in FY2019.

AMF-group reported a net loss of LKR 145 Mn on a total asset base of LKR 20,336 Mn during FY2020 as compared to a PAT of LKR 469 Mn on a total asset base of LKR 22,440 Mn in FY2019.

## Key financial indicators- AMF group

	FY18**	FY19*	FY20*
Net Interest Income	1,854	2,255	1,471
Profit after Tax	39	469	(145)
Net worth (adjusted) <sup>3</sup>	1,113	1,567	1,445
Total Assets	24,494	22,440	20,336
Return on Equity	3.5%	23.6%	-7.6%
Return on Assets	0.2%	1.9%	-0.7%
Gross NPA	4.4%	12.9%	12.8%
Net NPA	-1.8%	3.3%	3.1%
Gearing (adjusted)	12.1	12.9	11.9

\*Audited financials \*\*Restated financials

<sup>3</sup> Networth = Total Equity-Revaluation - Goodwill

## Key financial indicators- AMF

	FY18**	FY19*	FY20*
Net Interest Income	534	511	467
Profit after Tax	57	134	23
Net worth	1,074	1,207	1,232
Total Assets	7,986	7,419	7,714
Return on Equity	5.3%	10.8%	1.9%
Return on Assets	0.7%	2.0%	0.3%
Gross NPA	6.4%	6.6%	6.5%
Net NPA	-1.8%	0.9%	1.7%
Gearing (times)	6.2	4.9	4.9

\*Audited financials \*\*Restated financials

## Key financial indicators- AFCP

	FY18**	FY19*	FY20 *
Net Interest Income	1,320	1,744	1,005
Profit after Tax	16	373	(168)
Net worth	1,206	1,527	1,604
Total Assets	17,885	15,947	13,435
Return on Equity	1.3%	27.3%	-10.7 %
Return on Assets	0.1%	2.2%	-1.1 %
Gross NPA	3.7 %	14.9%	15.5%
Net NPA	-1.8 %	4.0 %	3.7%
Gearing (adjusted)	14.5	10.1	9.1

\*Audited financials \*\*Restated financials

## Rating history for last three years:

Instrument	Current Rating (FY21)			Chronology of Rating History for the past 3 years		
	Type	Amount Rated (LKR Mn)	Date & Rating	Date & Rating in FY20	Date & Rating in FY19	Date & Rating in FY18
Issuer rating	N/A	N/A	Sept-20 [SL]B+ (Negative)	May-19 [SL]B+(Ne gative)	Apr-18 [SL]BB- (Negative)	Apr-17 [SL]BB (Stable)

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