FitchRatings

Non-Bank Financial Institutions
Finance & Leasing Companies
Sri Lanka

Sarvodaya Development Finance Limited

Key Rating Drivers

Standalone Profile Drives Rating: Sarvodaya Development Finance Limited's (SDF) rating reflects its weak financial profile, particularly the pressure on its capitalisation, deteriorating asset quality and high-risk appetite. The rating also factors in SDF's small franchise and less-established and evolving business model. SDF benefits from its linkages to the Sarvodaya Shramadana Movement (SM), which provides the company with a rural customer base.

Pressure on Asset Quality: SDF's asset quality is likely to continue to be weighed down in the medium term by the unseasoned nature of its portfolio and the economic impact from the Covid-19 pandemic on its largely sub-prime clientele by local standards. SDF's six-month reported regulatory non-performing loan (NPL) ratio rose sharply to 11.9% by the end of the financial year to March 2020 (FY20) and 12.9% by end-September 2020, from 9.0% at FYE19, and impaired loans (stage 3 loans) increased to 24.8% by FYE20 from 17.6% a year earlier.

Credit Costs to Affect Profitability: Rising credit costs will dampen SDF's profitability in the medium term. SDF benefits from high yields, but relies on high-cost wholesale borrowings for additional funding due to its current inability to raise deposits, which weakens its operating profit buffers.

Risks to Capitalisation: SDF's debt/equity ratio of 5.8x in FY20 is not commensurate with its risk appetite and business model as its customers tend to be more vulnerable to economic conditions. An aggressive growth trajectory and a high share of unprovided NPLs have exposed SDF's capitalisation to credit shock. The company plans to inject capital to meet regulatory minimum requirements, which, if successful, would also support its leverage.

Regulatory Sanction Curbs Funding: The Central Bank of Sri Lanka (CBSL) has limited SDF's deposits to LKR5.5 billion because the company failed to maintain a minimum prescribed capital level. This sanction can hamper SDF's financial flexibility, despite deposits making up 74% of funding at end-March 2020.

SDF has a short funding duration and inadequate liquid lines to support its negative maturity gaps. However, it has developed a rural-based funding base by sourcing deposits from its parent group's rural members.

Evolving Business Model: SDF started as a microfinance lender, but it has since quickly expanded its non-microfinance loan segments, with relatively large-ticket lending, such as SME, housing, and vehicle loans, forming 70% of its portfolio at end-September 2020 (from 12% in March 2016). Its evolving underwriting standards and risk controls, which are not commensurate with expanding operations, highlight risk around its risk appetite.

Rating Sensitivities

Upside Limited: Positive rating action appears unlikely in the near term in light of the economic downturn. A capital injection and improvement in SDF's franchise strength, business-model stability and risk controls would be positive for its rating in the longer term.

Pressure on Capitalisation and Funding: Increased asset-quality risks contributing to a further weakening in its capital position would trigger a downgrade. Furthermore, capital impairment through continued asset-quality deterioration could heighten funding and liquidity risks, while an inability to raise new capital to meet regulatory requirements could constrain operational and funding-access and would be negative for the rating.

Ratings

National

National Long-Term Rating	B+(lka)

Sovereign Risk

Long-Term Foreign-Currency IDR	CCC
Long-Term Local-Currency IDR	CCC
Country Ceiling	B-

Outlooks

National Long-Term Rating	Stable

Financial Data

Sarvodaya Development Finance Limited

	31 Mar 20	31 Mar 19
Total assets (USDm)	43.6	42.3
Total assets (LKRm)	8,215.2	7,550.0
Total equity (LKRm)	1,195.7	1,098.5

Source: Fitch Ratings, Fitch Solutions

Applicable Criteria

Non-Bank Financial Institutions Rating Criteria (February 2020)

National Scale Rating Criteria (December 2020)

Related Research

Fitch Downgrades Sri Lanka to 'CCC' (November 2020)

Fitch Assigns Sarvodaya Development Finance First-Time 'B+(lka)'; Outlook Stable (October 2020)

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Company Summary

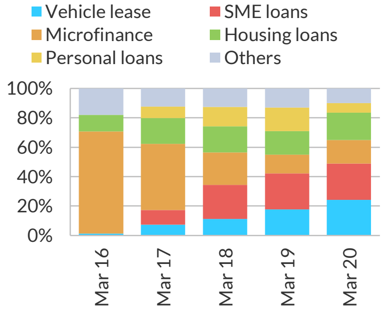
Small Rural-Centric Franchise

SDF was incorporated in January 2010 as Deshodaya Development Finance Company Limited, and was renamed in 2015. It focuses on providing financing to rural borrowers in Sri Lanka and has a small market share of 0.6% of assets in the finance and leasing sector. It started as a rural micro-financier and later rolled out products that cater to rural borrowers, such as micro leasing, small-business loans to SMEs and small-ticket housing loans.

SDF benefits from being an offshoot of SM, a large Sri Lanka-based non-government organisation. SM started in 1958 and covers 15,000 villages in Sri Lanka. The organisation works on employment generation activities to benefit the rural population. SDF is able to tap SM's ecosystem to reach borrowers and depositors.

SDF's share of non-microfinance lending is likely to increase in the medium term as it has gradually reduced the microfinance portfolio to 14% of total assets in September 2020 from 69% in March 2016. SDF also aims to expand its new gold-backed loan business among its rural borrower base.

Evolving Loan Mix



Source: Fitch Ratings, Fitch Solutions, SDF

Key Qualitative Assessment Factors

Operating Environment

The operating environment for Sri Lankan finance and leasing companies (FLCs) is similar to that for Sri Lankan banks given their bank-like business model, same prudential regulator and similar exposure to the domestic operating environment. Fitch believes the impact of the Covid-19 pandemic on earnings of individuals and businesses would severely reduce their loan repayment ability. FLCs' financial profiles are likely to come under significant pressure from as a result, and their key credit metrics are likely to be weak despite regulatory relief measures.

The true asset quality of FLCs is likely to be clearer in FY22, as regulatory relief in the form of loan-repayment moratoriums will temporarily halt the recognition of credit impairments until March 2021.

Management and Strategy

SDF's senior management does not have much experience in the newer lending segments rolled out by the company. The strategic objectives reflect a focus on short-term business and financial performance, which could shift due to economic environment volatility. The CBSL imposed a deposit ceiling on the company in January 2019 because it did not meet the minimum required level of equity. SDF has not yet added capital despite nearly two years under the deposit ceiling.

Risk Appetite

SDF has a high risk appetite with rapid growth, including in new business lines to sub-prime customers over the past few years, which raises questions about the sufficiency of SDF's risk controls in the future.

Vehicle leasing expanded most quickly, by CAGR of 72% from March 2018 to end-September 2020. The new business segments – leasing, SME and housing finance – target rural borrowers and the company benefits from its understanding of the borrower base. However, these new products have relatively larger ticket sizes and longer tenors than microfinance, and involve more nuanced underwriting and valuation principles. Moreover, SDF started lending against gold in 2020, which is a high-risk segment, in the absence of sufficient regulatory provisions such as standardised valuation principals of the gold collateral.

Key Financial Metrics

Asset Quality

Fitch assesses SDF's asset quality as weak. SDF's NPL ratio (loans overdue by three months) increased to 21.6% by September 2020 from 17.6% in March 2019, mainly due to weaker economic conditions after the terrorist attack in April 2019, as well as disruptions caused by the Covid-19 pandemic. We expect further deterioration in asset quality due to the continued economic stress, which will put more pressure on SDF's sub-prime customer base, especially customers in segments such as SME and microfinance loans.

The company had extended the regulatory moratorium on loan repayment to a large part of its portfolio. We expect delinquencies to rise from this stressed book given the continued weak operating conditions. SDF's loan-loss coverage ratio is lower than that of industry peers. While management is confident of improvement in recoveries when the health crisis passes, we believe the risk of under-recovery could be higher in rural areas.

Earnings and Profitability

SDF's has a weak profitability profile with pre-tax return on assets of 3% in FY20. SDF benefits from stable yields, with most products rolled out in rural areas where price competition is less intense than in urban areas. The company has had to turn to high-cost bank borrowings to fund growth due to the limit on raising deposits imposed by the CBSL, which has narrowed its net interest margin.

SDF has a high operating cost structure, in line with other small FLCs, and therefore increasing business volumes become critical to cover the fixed costs, which may put pressure on underwriting standards and risk control.

Medium-term profitability may remain volatile based on higher expected credit cost due to its lower loan-loss allowances in conjunction with its riskier assets, which are exacerbated by the pandemic. However, we believe the impact on profitability may be partly offset by the growth in SDF's loan book at a pace above the industry rate, which leads to higher cost efficiencies.

Capitalisation and Leverage

SDF's equity was LKR1.2 billion at end-March 2020, still below the regulatory minimum absolute capital requirement of LKR1.5 billion in core capital that it had to meet by 1 January 2019. This led to a limit by the CBSL on total deposits. Without an equity infusion, SDF's weak capital buffers (debt/equity ratio of 5.8x at end-March 2020) will continue to be undermined by its high loan growth and vulnerable to swings in its profitability.

Funding and Liquidity

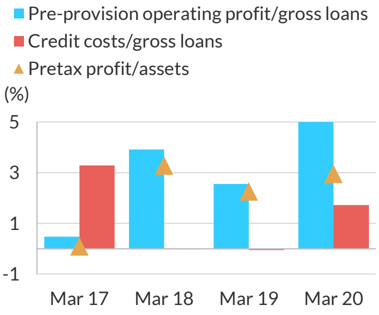
SDF's share of unsecured debt in its funding mix is high at 82%. SDF has a better funding profile than similar-sized peers as SDF sources deposits from rural members connected to its parent group's social activities, which has resulted in SDF having a higher market share of system deposits. The limit on deposits will be lifted once the company meets the minimum capital requirement, but we expect the current stressed market conditions to weigh on its funding and liquidity profile. This is mainly due to SDF's negative asset-liability mismatches, and lower available liquidity lines to aid in an unexpected shock, as SDF mainly relies on deposit renewals.

Issuer Disclosure on Regulatory Action

The Central Bank of Sri Lanka has imposed a cap of LKR5.5. billion for total deposits on 23 January 2019 as SDF did not comply with capital requirement of LKR1.5 billion as at 1 January 2019 as per direction No. 02 of 2017 - Minimum Core Capital.

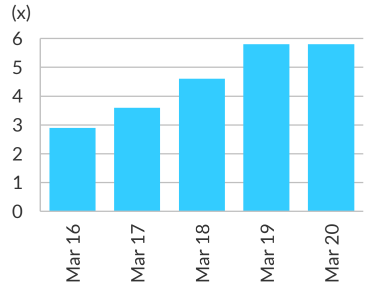
The "Issuer Disclosure on Regulatory Action" sub-heading was provided by the issuer and is included pursuant to applicable regulatory requirements. Fitch Ratings Lanka is not responsible for the contents of such information.

Volatile Profitability



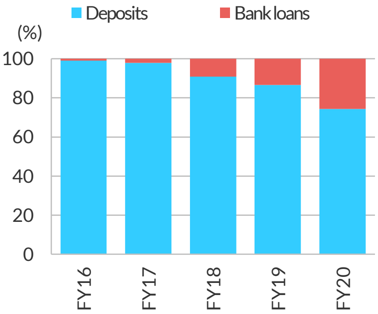
Source: Fitch Ratings, Fitch Solutions, SDF

Debt/Tangible Equity



Source: Fitch Ratings, Fitch Solutions, SDF

Funding Mix



Source: Fitch Ratings, Fitch Solutions, SDF

Summary Financials and Key Ratios

	31 Mar 20		31 Mar 19	31 Mar 18	31 Mar 17
	Year end	Year end	Year end	Year end	Year end
	(USDm)	(LKRtrn)	(LKRtrn)	(LKRtrn)	(LKRtrn)
	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified
Summary income statement					
Net interest and dividend income	4.9	931,562	826,753	762,964	602,856
Net fees and commissions	0.2	29,581	24,993	30,837	25,720
Other operating income	0.1	27,025	19,287	21,144	23,473
Total operating income	5.2	988,168	871,033	814,946	652,049
Operating costs	3.7	700,912	717,895	630,190	635,628
Pre-impairment operating profit	1.5	287,256	153,139	184,756	16,421
Loan and other impairment charges	0.3	62,998	-3,532	-1,188	113,411
Operating profit	1.2	224,258	156,670	185,944	-96,990
Other non-operating items (net)	0.0	7,832	47	-1,088	101,159
Tax	0.7	130,374	115,500	92,673	38,704
Net income	0.5	101,716	41,216	92,182	-34,536
Other comprehensive income	-0.0	-4,583	2,043	-8,147	-4,229
Fitch comprehensive income	0.5	97,134	43,259	84,035	-38,764
Summary balance sheet					
Assets					
Gross loans	39.0	7,357,073	6,520,511	5,457,806	3,980,876
- Of which impaired	9.7	1,822,624	1,149,120	0	0
Loan loss allowances	2.2	423,521	304,341	149,302	220,277
Net loans	36.8	6,933,552	6,216,170	5,308,504	3,760,599
Interbank	n.a.	n.a.	n.a.	n.a.	n.a.
Derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Other securities and earning assets	3.0	571,034	561,190	282,269	268,211
Total earning assets	39.8	7,504,586	6,777,360	5,590,773	4,028,810
Cash and due from banks	0.4	73,226	140,903	116,978	138,046
Other assets	3.4	637,403	531,561	652,425	706,037
Total assets	43.6	8,215,216	7,449,824	6,360,176	4,872,893
Liabilities					
Customer deposits	27.0	5,101,976	5,385,342	4,624,835	3,563,700
Interbank and other short-term funding	8.5	1,595,036	835,134	463,277	75,856
Other long-term funding	n.a.	n.a.	n.a.	n.a.	n.a.
Trading liabilities and derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Total funding	35.5	6,697,012	6,220,475	5,088,112	3,639,556
Other liabilities	1.7	322,525	130,804	141,254	186,562
Preference shares and hybrid capital	n.a.	n.a.	n.a.	n.a.	n.a.
Total equity	6.3	1,195,679	1,098,546	1,130,810	1,046,775
Total liabilities and equity	43.6	8,215,216	7,449,824	6,360,176	4,872,893
Exchange rate		USD1 = LKR188.6,236	USD1 = LKR176.13	USD1 = LKR155.9	USD1 = LKR151.735

Source: Fitch Ratings, Fitch Solutions, SDF

Summary Financials and Key Ratios

	31 Mar 20	31 Mar 19	31 Mar 18	31 Mar 17
Ratios (annualised as appropriate)				
Profitability				
Net interest income/average earning assets	12.9	13.4	15.9	16.3
Pre-impairment op. profit/average total assets	4.5	2.2	3.3	0.4
Net income/average equity	8.9	3.7	8.5	-3.2
Net income/average assets	1.3	0.6	1.6	-0.8
Asset quality				
Impaired loans ratio	24.8	17.6	10.9	14.7
Growth in gross loans	12.8	19.5	37.1	36.6
Loan loss allowances/impaired loans	23.2	26.5	25.2	37.8
Loan impairment charges/average gross loans	1.7	-0.1	0.0	3.3
Capitalisation				
Equity/total assets	14.6	14.7	17.8	21.5
Debt to tangible equity (x)	5.8	5.8	4.6	3.6
Other ratios				
Unsecured debt/total debt	81.9	86.9	91.3	98.4
Customer deposits/funding	74.3	86.6	90.9	97.9

Source: Fitch Ratings, Fitch Solutions, SDF

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.