Lanka Rating Agency

Rating Report

Sarvodaya Development Finance PLC

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
02-Oct-2023	BB	-	Stable	Maintain	-
21-Sep-2022	BB	A3	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Sarvodaya Development Finance PLC (SDF or the Company) rating reflects its strong presence and connectivity in the rural community. Over the years, the Company has improved its earnings. Despite the economic downturn and difficult macroeconomic conditions prevalent in the country in FY23, the Company earned its highest profit after tax of LKR 221.65mn (FY22: LKR 215.47mn). However, its profit after tax decreased significantly in 3MFY24 as SDF earned a profit after tax of LKR 10mn, a ~70% drop compared to the same period of the previous financial year. SDF's top net interest earnings diminished during FY23 by ~1.6% to LKR 1.24bn (FY22: LKR 1.26bn), as its interest expenses rose at a staggering rate in comparison to its interest income. The Company has high exposure to the agriculture and transportation segments in the country. Its main customer segment is the Small and Medium-sized Enterprises (SME). SDF also has a large leasing portfolio of ~47%, which largely focuses on agriculture-based leases. These segments are more susceptible to adverse effects of the economic conditions of the country. However, SDF has managed to enter into buy-back agreements with distributors to reduce the default risk of its customers. The Company struggles with its asset quality as Non-Performing Loans (NPL) increased in 3MFY24, after moderately dropping in FY23. SDF recorded 120 day and 90 day gross NPLs of ~17.4% (FY23: ~14.4%; FY22: ~15.9%) and ~21.8%, and a net NPLs of ~12% (FY23: ~9%; FY22: ~10.6%) and ~16.6%, respectively, as at 3MFY24. Going forward, successful credit management will remain critical for the Company.

The rating is dependent upon the Company's ability to preserve its unique accessibility to the rural segment in the island. Sustaining its growth momentum while improving margins will be key for the Company. The rating will rely on the successful execution of the Company's strategy to grow its asset base while preserving the asset quality.

Disclosure

Name of Rated Entity	Sarvodaya Development 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(Aug-23)
Rating Analysts	Amreetha Mahindapala | amreetha@lra.com.lk | +92-42-35869504

Profile

Structure Sarvodaya Development Finance PLC ("SDF" or "the Company") is a public limited liability company, incorporated in 2010, under the Companies Act No. 07 of 2007 and the Finance Business Act No. 42 of 2011. SDF was listed on the Colombo Stock Exchange ("CSE") in December 2021.

Background The Company was incorporated as Deshodaya Development Finance Company Limited in 2010 and assumed its current name in 2015.

Operations The principle business activities include acceptance of deposits and granting loans, leases and other facilities. The Company has 51 branches, of which more than 80% are situated outside the Western Province. SDF is connected to 5,400 societies (through Sarvodaya Movement) with more than 800,000 members.

Ownership

Ownership Structure The largest share of the company is owned by Sarvodaya Economic Enterprises Development Services (Gte) Ltd ("SEEDS"), with an ownership of ~36%, while the Sarvodaya Movement collectively owns ~55% of the Company. Janashakthi Capital Limited, Senthilverl Holdings (Pvt) Ltd and Gentosha Total Asset Consulting Inc. own ~10.8%, ~10.4% and ~9% respectively.

Stability SEEDS was established in 1986 as the economic arm of the Sarvodaya Movement. The ownership of SEEDS has not gone through a major change, since it has been able to maintain its shareholding, post listing in CSE.

Business Acumen SEEDS is involved in assisting communities in their economic activities, training in entrepreneurship, and orientation to business activities.

Financial Strength The Sarvodaya Movement has multiple companies and independent units under the Movement. The Company does not have a written financial guarantee from the parent entity or other shareholders.

Governance

Board Structure The Board of Directors comprises of six non-executive Directors, of which three are independent and three are non-independent.

Members' Profile The board members have diverse expertise in banking, sales, marketing, IT, and consulting. They are well qualified in their respective domains along with decades of experience. The Chairman, Mr. Channa De Silva has held senior management positions in many reputed firms, including financial institutions and banks.

Board Effectiveness The Company has formed five board sub-committees, namely, i) Board Integrated Risk Management Committee ("BIRMC"), ii) Board Audit Committee ("BAC"), iii) Board Remuneration and Nomination Committee ("BRNC"), iv) Related Party Transaction Review Committee ("RPTRC"), v) Board Credit Committee ("BCC").

Financial Transparency The external auditors of the company, Ernst & Young, issued an unqualified audit opinion pertaining to annual financial statements for FY23. The Internal Audit Department plays an active role in creating a culture of accountability and risk management in the Company. The department carries out annual audits for all the 51 branches. It further carries out approximately 22 spot audits.

Management

Organizational Structure The Company has 14 separate divisions to carry out its operations. The Compliance Department and the Risk Department report to the BIRMC, while the Internal Audit Department reports to the BAC.

Management Team The management team is headed by the Chief Executive Officer ("CEO"), Mr. Nilantha Jayanetti. The CEO has extensive knowledge in business management and strategic leadership and has experience in the banking and financial sectors.

Effectiveness SDF has formed five management committees, namely, i) Assets and Liability Management Committee ("ALCO"), ii) Management Credit Committee ("MCC"), iii) IT Steering Committee ("ITSC"), iv) Management Committee ("MC"), v) Product Development Committee ("PDC").

MIS The main ERP system of the Company is the eFinancials system, provided by Scienter Technologies (Pte) Ltd. The Company has plans to establish 10 of its own ATMs in strategic locations. SDF has also rolled out handheld devices (POS machines) to 100 Sarvodaya Societies to increase financial inclusiveness in the rural community.

Risk Management Framework The BAC has the responsibility to ensure the integrity of the financial reporting and the effectiveness of the internal control systems. Risk reports are submitted to the BIRMC for each type of risk identified with a rectification plan. Heads of Departments have the responsibility to identify and focus on potential risks in their respective areas of operations.

Business Risk

Industry Dynamics There are 36 Licensed Finance Companies ("LFC") in Sri Lanka, out of which, 28 are listed on the CSE. The sector profitability was recorded at LKR 4.59bn (FY23: LKR 31.46bn) as at 3MFY24. Although the asset quality improved in FY22, the gross and net Non-Performing Loan ("NPL") ratio further depleted to ~16% and ~10.7%, respectively, as at FY23. The gross and net NPLs have further plummeted to 20.4% and 14.3% in 3MFY24. The interest rates have come down since July 2023 and this is expected to improve the sector's spread, going forward.

Relative Position SDF remains a small player in the industry and accounts for 0.7% (FY22: 0.7%) of sector's assets and 0.9% (FY22: 1%) of equity as of FY23.

Revenues The Company earned a net interest income of LKR 1.24bn as at FY23 (FY22: 1.26bn), a 2% drop from previous year. The interest income from loans and receivables and leases increased by ~31% and ~26% to LKR 1.2bn (FY22: LKR 918mn) and LKR 1bn (FY22: LKR 867mn), respectively. The interest expense due to banks and depositors increased by ~97% and ~138% to LKR 432mn (FY22: LKR 219mn) and LKR 772mn (FY22: LKR 325mn), respectively as a result of the high interest rates in FY23. SDF earned a Net Interest Income of LKR 353mn as at 3MFY24.

Performance The Company maintained its profitability in FY23 to LKR 222mn (3% increase from FY22) as a result of higher net fee and commission income and impairment improving during the year. The Profit after Tax dropped by ~70% to LKR 10mn in 3MFY24 (3MFY23: LKR 34mn) compared to the same period of the previous financial year as a result of the rise in operating expenses and effective tax rate. It is important that the Company recoups its profitability and sustain its growth plans.

Sustainability The Company expects to increase its asset base to LKR 20bn as per the instructions of the Central Bank of Sri Lanka ("CBSL") by FY25 and open seven new branches in the current financial year to increase the branch network to 58 branches. The Company has also expressed interest in acquiring Sri Lanka Savings Bank Ltd. to the State Owned Enterprise Restructuring Unit, under the Ministry of Finance. However, this remains at initial stages.

Financial Risk

Credit Risk The Company has improved its NPLs since FY20. It recorded gross and net NPLs of ~14.4% (FY22: 15.9%) and ~9% (FY22: 10.6%) as at FY23. The gross and net NPLs deteriorated to ~17.4% and ~12% on 120 Days classification criteria in 3MFY24, which is above the industry average. These ratios would be 21.8% and 16.6% on 90 Days classification criteria for SDF. The Company has a granular customer base as top 20 customers account for ~4.2% (FY22: 5.5%) of total portfolio as at FY23.

Market Risk The Company held 71.1% (FY22: 69.5%) investments in government securities in FY23, an increase of ~9%, to earn better returns. It has a larger exposure to the Small and Medium Enterprises ("SME") and the agriculture and transportation sectors. A larger portion of its portfolio could be impacted, since these segments could be more vulnerable to the current economic conditions. However, recent decrease in inflation and stability in macroeconomy is expected to have a positive impact.

Liquidity And Funding The reliance on customer deposits has increased from ~66% in FY22 to ~79% during the FY23. Bank and other borrowings have dropped from ~32% in FY22 to ~19% during the FY23. SDF is currently in the process of acquiring a foreign currency loan of USD 3mn from European Development Financial Institution ("EDFI"). SDF will borrow in local currency against the foreign currency fixed deposit in a local bank to reduce the foreign exchange risk.

Capitalization The Company recorded a Capital Adequacy Ratio ("CAR") and core capital of ~34% (FY22: ~31%) and LKR 3.4bn (FY21: LKR 3.2bn) in FY23 respectively. The CAR stood at ~30.8% as at 3MFY24.

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Sarvodaya Development Finance PLC	Jun-23	Mar-23	Mar-22	Mar-21
Listed Public Limited	3M	12M	12M	12M

A BALANCE SHEET

	Jun-23	Mar-23	Mar-22	Mar-21
1 Total Finance-net	8,714	8,346	8,582	6,904
2 Investments	846	810	767	590
3 Other Earning Assets	140	604	42	84
4 Non-Earning Assets	517	476	487	456
5 Non-Performing Finances-net	1,409	1,434	1,296	1,002
Total Assets	11,627	11,670	11,174	9,037
6 Funding	7,717	7,821	7,199	6,443
7 Other Liabilities	450	399	670	412
Total Liabilities	8,167	8,221	7,870	6,855
Equity	3,460	3,449	3,305	2,181

B INCOME STATEMENT

	Jun-23	Mar-23	Mar-22	Mar-21
1 Mark Up Earned	703	2,461	1,822	1,585
2 Mark Up Expensed	(350)	(1,222)	(562)	(623)
3 Non Mark Up Income	41	124	96	140
Total Income	394	1,363	1,357	1,101
4 Non-Mark Up Expenses	(259)	(867)	(800)	(704)
5 Provisions/Write offs/Reversals	(79)	(51)	(181)	(41)
Pre-Tax Profit	56	446	375	356
6 Taxes	(46)	(224)	(160)	(173)
Profit After Tax	10	222	215	183

C RATIO ANALYSIS

	Jun-23	Mar-23	Mar-22	Mar-21
1 PERFORMANCE				
a Non-Mark Up Expenses / Total Income	65.7%	63.6%	59.0%	63.9%
b ROE	1.2%	6.6%	7.9%	10.9%
2 CREDIT RISK				
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	137.3%	130.4%	144.9%	130.1%
b Accumulated Provisions / Non-Performing Advances	25.1%	22.7%	29.8%	32.1%
3 FUNDING & LIQUIDITY				
a Liquid Assets / Funding	11.1%	15.9%	8.7%	7.9%
b Borrowings from Banks and Other Financial Institutities / Funding	16.8%	19.3%	32.2%	26.8%
4 MARKET RISK				
a Investments / Equity	24.5%	23.5%	23.2%	27.1%
b (Equity Investments + Related Party) / Equity	0.0%	0.0%	0.0%	0.0%
5 CAPITALIZATION				
a Equity / Total Assets (D+E+F)	29.8%	29.6%	29.6%	24.1%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	1.2%	4.4%	4.2%	15.3%

Credit Rating

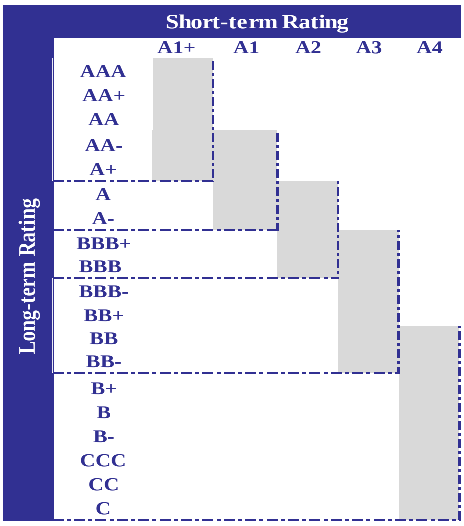
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

Regulatory and Supplementary Disclosure

(Credit Rating Companies Regulations, No. 19 of 2021)

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