FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Citizens Development Business at 'BBB(lka)'; Outlook Stable

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Fitch Ratings - Colombo - 04 Oct 2024: Fitch Ratings has affirmed Citizens Development Business Finance PLC's (CDB) National Long-Term Rating at 'BBB(lka)' with a Stable Outlook. Fitch has also affirmed CDB's subordinated debt rating at 'BB+(lka)'.

KEY RATING DRIVERS

Standalone Profile Underpins Rating: CDB's National Long-Term Rating reflects its established market presence, with 6%-7% market share in sector assets and deposits, and majority exposure to lower-risk motor cars, which underpin its asset-quality performance. These advantages are offset by its moderate profitability, higher leverage and lower loss-absorption buffers compared with other Fitch-rated large finance and leasing companies (FLCs).

Stabilising Operating Environment: The operating environment for Sri Lankan FLCs continues to stabilise, with improving GDP growth (1H24: 5.0% yoy; 2023: -2.3%), normalising inflation and reduced market interest rates. This should support the sector's credit growth, asset quality and profitability. A gradual easing in vehicle import bans may further underpin growth, albeit with some collateral value risk.

Large Motor-Car Portfolio: CDB is one of Sri Lanka's largest FLCs with key exposure to vehicle financing and gold-backed lending, which accounted for 75% and 18% of gross loans, respectively, at the end of the financial year to March 2024 (FY24), from 73% and 19% at end-FY23.

Within vehicle financing, motor cars constituted the majority (55%) of gross loans, while three-wheelers accounted for 17% at end-FY24 (end-FY23: 47% and 21%). We expect three-wheeler exposure to decline further while gold and four-wheeler loans continue to grow. This should be mildly positive for blended asset quality, if managed well.

Largely Collateralised Portfolio: CDB's loan portfolio is nearly 98% secured by vehicles, gold articles, properties, fixed deposits and shares. The collateral coverage helps to mitigate credit losses in the case of delinquencies. CDB's overall risk profile should also improve incrementally as its exposure to riskier three-wheelers gradually declines. Nonetheless, CDB has a high growth appetite that may lead to unintended risks and weaken loss-absorption buffers despite its intention to target lower-risk lending products.

Lingering Provisioning Risk: We expect the improved economic conditions and CDB's appetite for lower-risk products to sustain its asset quality. Its reported stage 3 non-performing loan (NPL) ratio, comprising 90-day past due loans net of interest in suspense (IIS), fell to 12.1% by end-FY24 (end-FY23: 15.7%). Credit cost stayed low at 0.8% of average gross loans in FY24, but may rise moderately as CDB resolves its lingering NPLs. Its stage 3 provision coverage ratio (including IIS) of 38.8% at end-FY24 was lower than the rated peer average but slightly higher than the sector average of 35.8%.

Recovering Profitability: Fitch expects the lagged effect of lower interest rates to support CDB's profitability in the near-to-medium term. The company's pre-tax return on average assets increased to 3.9% in FY24 (FY23: 2.9%) as increased lending and investments in high-yielding treasury bills boosted interest income and supported higher net interest margins. That said, we expect CDB's profitability to remain lower than rated peers' due to its focus on lower-yielding motor car loans, despite its better operating efficiency.

Leverage Above Peers: CDB's debt/tangible equity ratio increased to 5.2x by end-FY24, from 4.7x a year ago, and remains the highest among the Fitch-rated standalone FLCs. We believe CDB's growth plan may place further pressure on its capitalisation and leverage, which could reduce rating headroom at the current rating level. CDB's Tier 1 and total capital ratios stood at 15.5% and 15.9% at end-FY24 (FY23: 16.2% and 17.4%, respectively), but the total capital ratio improved to 18.7% by end-1QFY25, supported by a LKR3 billion subordinated facility qualifying as Tier 2 capital.

Reduced Negative Maturity Gap: We believe that the improved market liquidity benefits the company's access to wholesale term borrowings, similar to peers. CDB's cumulative 12-month negative asset-liability maturity gap narrowed significantly to -5.2% of total assets by end-FY24, from -11.5% at end-FY23, as an USD30 million long-term foreign loan helped to improve its liability maturity profile.

Nonetheless, a significant part of CDB's funding is likely to remain short-tenor - like that of other deposit-funded FLCs. Public deposits comprised 71% of its funding at end-

FY24, of which 91% are short term.

RATING SENSITIVITIES

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

The National Rating is sensitive to a change in CDB's credit profile relative to other rated Sri Lankan issuers. Negative action may result from a sustained deterioration in the risk profile caused by aggressive growth into risky loan products without adequate risk mitigation and an enhanced risk buffer. A sustained increase in debt/tangible equity beyond our expectation, or material reduction in loan-loss provision and capital buffers, would also place pressure on the rating.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

The rating may be upgraded if the operating environment improves and CDB is able to enhance its credit profile, including reducing leverage to a level that is more comparable with that of peers, while maintaining moderate asset quality, stable risk profile and acceptable profitability relative to peers.

DEBT AND OTHER INSTRUMENT RATINGS: KEY RATING DRIVERS

CDB's subordinated debentures are rated two notches below its National Long-Term Rating to reflect their subordination to senior unsecured obligations. This is in line with Fitch's baseline notching for loss severity for subordinated debt and reflects our expectations of poor recoveries in the event of default. There is no additional notching for non-performance risk, as we believe it is adequately captured in the National Long-Term Rating.

DEBT AND OTHER INSTRUMENT RATINGS: RATING SENSITIVITIES

The ratings of the subordinated debentures will move in tandem with CDB's National Long-Term Rating.

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.

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	PRIOR ⬍

Citizens Development Business Finance PLC	Natl LT	BBB(lka) Rating Outlook Stable		BBB(lka) Rating Outlook Stable
	Affirmed			
subordinated	Natl LT	BB+(lka)	Affirmed	BB+(lka)

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. 18 Jan 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

Potential Conflicts Resulting from Revenue Concentrations

ENDORSEMENT STATUS

Citizens Development Business Finance PLC	-

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