FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Singapore/Colombo - 16 Oct 2023: Fitch Ratings has affirmed Citizens Development Business Finance PLC's (CDB) National Long-Term Rating of 'BBB(lka)' and removed the rating from Rating Watch Negative (RWN). The Outlook is Stable.

A full list of rating actions is below.

KEY RATING DRIVERS

Less Severe Macroeconomic Risk: The removal of the RWN reflects our view that further downside is less imminent to CDB's rating following the completion of the local-currency portion of the sovereign's domestic debt optimisation (DDO), which addresses one element of risk to sector funding and liquidity. The operating environment will remain weak in light of strained household finances and fragile investor confidence, but should stabilise on the gradual economic recovery with easing inflation and interest rates.

Eased macroeconomic risk will temper the pressure on the sector's operating performance and liquidity profile although the pace of recovery may vary depending on individual entities' business mix and franchise strength. Fitch expects sector growth to remain weak with lingering asset-quality pressure in the financial year ending March 2023 (FY24), but this may improve in FY25 as economic growth recovers. Declining interest rates should ease pressure on funding costs but could hit asset yields for lenders with shorter asset-repricing cycles.

Standalone Profile Underpins Rating: CDB's National Long-Term Rating reflects its significant franchise as one of Sri Lanka's largest domestic finance and leasing companies (FLCs), which helps to support its operating efficiency and overall business profile. This is counterbalanced by both capitalisation and loan-loss allowance at levels lower than the industry, as well as a weaker liquidity buffer and rising exposure to market risks via its expanding gold-backed loan portfolio.

Established Franchise: CDB is one of the largest FLCs in Sri Lanka with 6%-7% shares of sector loans and deposits since FY19. Its scale advantage supports its relative earnings stability and operating efficiency against smaller-sized peers. Its operating expenses/average assets ratio of 4.4% over FY20-FY23 is one of the lowest among Fitch-rated peers and below the industry average of 5.8%.

Increased Gold Loan Exposure: CDB focuses on vehicle lending, but gold loans have expanded quickly since the country's vehicle import ban in 2020 (FYE23: 19% of total loans, FYE19: 3%). This shift increases portfolio diversification, but also renders CDB more susceptible to adverse gold price movements than more experienced incumbents in this specialised area. A greater tolerance for a higher loan-to-value ratio would reduce the collateral buffer against decline in the gold price.

Higher Reported NPLs: CDB's reported nonperforming loan (NPL) ratio - net of suspended interest - rose to 15.0% by end-1QFY24, from 11.0% at FYE23, on increased borrower repayment pressure and tightened NPL classification to 90-day past due from 1 April 2023 (previously 120-day past due). Its annualised credit cost ratio rose to 1.6% (FY23: 0.5%). These metrics were broadly near or below sector averages, but CDB's loan-loss allowance buffer was thinner than that of most Fitch-rated peers. This raises under-provisioning risk, especially if there is a sharp collateral price correction.

Falling Interest Rates to Aid Profitability: CDB's pretax profit contracted to 2.9% of average assets in FY23 (FY22: 5.8%) on sharply higher funding costs. Its net interest margin (NIM) narrowed, similar with many other FLCs, on shorter-tenor deposits and variable-rate borrowings repricing more quickly than its mostly fixed-rate loan receivables. We expect CDB's NIM and profitability to benefit as interest rates ease gradually, albeit potentially offset by higher credit costs stemming from its sustained asset-quality risk.

Leverage Above Peers: CDB has deleveraged moderately amid a more cautious lending strategy and reduced borrower demand. This led its debt/tangible equity ratio to fall to 4.4x by end-1QFY24 from 4.8x at FYE22. Nonetheless, this level is high against other standalone Fitch-rated FLCs. Similarly, CDB's Tier 1 and total capital ratios of 15.5% and 16.6%, respectively, as of end-1QFY24, were below the industry average of 21.8% and 23.1%, although above the regulatory minimum of 10% and 14%.

Increased Short-term Deposit Funding: CDB prioritised short-term deposit funding over bank borrowings to maintain repricing flexibility when interest rates were rising. Customer deposits and short-term funding were 75% and 86%, respectively, of its total funding at FYE23 (FYE22: 63% and 69%). This strategy also widened its negative asset-liability maturity (ALM) gap relative to larger peers, which carried larger holdings of liquid assets. We expect some improvement in CDB's ALM profile in the next few months as it pursues a more balanced funding strategy and interest rates decline.

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. This may result from its asset quality deteriorating below the industry average in terms of delinquencies and credit costs. A further worsening in the 12-month negative asset-liability gap or a material widening in CDB's leverage relative to the industry may also put pressure on the rating.

Fitch may also take negative rating action if there is renewed weakness in market variables or funding and liquidity conditions, leading to increased risk to the company's asset exposures, profitability and balance-sheet buffers. Such stresses if extreme could result in a multiple-notch downgrade.

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

An improved operating environment, together with enhancement in the company's credit profile relative to peers on the Sri Lankan national scale could lead to an upgrade of the company's ratings. Specifically, reducing leverage, coupled with adequate liquid asset coverage of short-term debt obligations while sustaining asset quality and profitability with a steady risk profile, could lead to positive rating action.

DEBT AND OTHER INSTRUMENT RATINGS: KEY RATING DRIVERS

CDB's subordinated debentures are rated two notches below its National Long-Term Rating anchor to reflect their subordination to senior unsecured obligations. This is in line with Fitch's baseline notching for loss severity for this debt class and reflects our expectations of poor recoveries in the event of default. There is no additional notching for non-performance risk, which we believe 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	Affirmed	BBB(lka) Rating Watch Negative
subordinated	Natl LT	BB+(lka)	Affirmed	BB+ (lka) Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 23 Dec 2020)

Non-Bank Financial Institutions Rating Criteria (pub. 06 May 2023) (including rating assumption sensitivity)

Bank Rating Criteria (pub. 02 Sep 2023) (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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