FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Mercantile Investments and Finance at 'BBB-(lka)'; Outlook Stable

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Fitch Ratings - Colombo - 14 Aug 2024: Fitch Ratings has affirmed Mercantile Investments and Finance PLC's (MIF) National Long-Term Rating at 'BBB-(lka)'. The Outlook is Stable.

KEY RATING DRIVERS

Standalone Profile Drives Rating: MIF's rating reflects its moderate franchise, exposure to cyclically sensitive borrowers and a high operating cost structure, which contribute to its modest profitability. MIF has weaker capitalisation compared with other mid-sized peers, and we expect its leverage to rise amid higher asset growth. This is balanced against an improved deposit franchise that supports its funding profile.

Stabilising Operating Environment: The operating environment for Sri Lanka's finance and leasing companies continues to stabilise with an improvement in GDP growth (1Q24: 5.3% yoy; 2023: -2.3%), normalising inflation and reduced interest rates. It should support the ongoing recovery in the sector's credit growth, asset quality and profitability. A gradual lifting of vehicle import bans will further underpin industry growth prospects.

Core Vehicle-Lending Business: MIF's business model is dominated by vehicle financing, which formed 88% of total loans at the end of the financial year to March 2024 (FYE24), while gold-backed lending accounted for just 4% of loans. MIF targets to increase the share of gold loans significantly through an aggressive growth strategy and has increased distribution of gold loans across its branch network. That said, we believe vehicle-backed lending will continue to dominate the portfolio mix, as this franchise is more established and demand for vehicle lending is recovering gradually.

Reducing Concentration Risk: MIF plans to reduce exposure to large-ticket corporate and property-backed loans and increase the share of small gold-backed loans, which should reduce lending concentrations. That said, it remains exposed to riskier loan types, particularly interest-only products, and its underwriting standards remain weaker than those of higher-rated peers with a high growth appetite.

Improving Asset Quality: MIF's stage 3 loans ratio declined to 9.9% by FYE24, from 12.1% at FYE23, aided by improved collections in its core vehicle loans and resolutions for certain delinquent corporate loans. We expect asset quality to improve in the medium term amid gradual stabilisation in macroeconomic conditions, improvement in borrowers' repayment capability and loan growth.

Recovering Margins: MIF's pretax profit/average assets improved to 2.8% in FY24, from 1.0% in FY23, as the net interest margin recovered (FY24: 10.1%, FY23: 6.6%) and borrowing costs fell amid declining benchmark rates. That said, its profitability remains weaker compared with other mid-sized peers, given its high cost structure with an operating cost to net operating revenue ratio of 70% in FY24. MIF plans to improve operating efficiency through branch and employee rationalisation over the next two years. This, along with an improved margin, should improve medium-term profitability if it is effective.

Leverage to Increase: MIF's debt/tangible equity remained moderate at 3.2x at FYE24, but we expect it to rise in the medium term as management pursues a strategy of high loan growth. However, we expect leverage to remain commensurate with its current rating level due to sufficient headroom.

Its Tier 1 ratio of 16.5% at FYE24 is lower than the rated peer average but above the regulatory requirement of 8.5%. We believe the company's regulatory capital ratios should still comply with the regulatory requirement even if leverage rises in line with our expectations, given the planned higher growth in gold loans with lenient risk weights. Revaluation reserves, which contributed to 24% of MIF's equity, are excluded from the calculation of regulatory Tier 1 capital.

Improved Funding Profile: MIF's unsecured debt rose significantly to 94% of total debt by FYE24, from 78% at FYE22, supported by an increased focus on raising deposits. Cash and cash equivalents, increasing unutilised bank credit lines and a high deposit renewal ratio mitigate the liquidity risk from its negative asset-liability mismatches.

RATING SENSITIVITIES

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

The National Long-Term Rating is sensitive to changes in MIF's standalone credit profile relative to Fitch-rated issuers on the Sri Lankan national scale.

A negative rating action could result from a material rise in debt/tangible equity that reduces MIF's loss absorption capacity, or a substantial erosion of regulatory capital buffers due to aggressive growth, in the absence of adequate equity infusions.

An increased risk appetite, as evident in a material shift in the business mix towards riskier product segments, such as gold loans, could also lead to a downgrade. Fitch may also take rating action if there is renewed stress in macroeconomic conditions, leading to heightened asset-quality risk with severe weakening in profitability and the capital buffer.

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

An enhancement in MIF's credit profile relative to peers on the Sri Lankan national scale could lead to an upgrade of its ratings. A significant shift towards less-risky asset classes with improved operating environment, capitalisation and profitability could also lead to positive rating action.

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
Mercantile Investments and Finance PLC	Natl LT Affirmed	BBB-(lka) Rating Outlook Stable	BBB-(lka) Rating Outlook Stable

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

Mercantile Investments and Finance PLC	-

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