Lanka Rating Agency

Rating Report

Alliance Finance Company PLC

Report Contents

Rating History

Dissemination Date	Long Term Rating	Outlook	Action	Rating Watch
10-Feb-2023	BBB-	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Alliance Finance Company PLC (AFC or the Company) is a licensed finance company and the rating reflects the ability of the Company to sustain its performance over the years. AFC adopted the Triple Bottom Line (TBL) philosophy in 2012 and as a result, the Company plans to develop its products in line with these values. The Company was listed on the Colombo Stock Exchange (CSE) in 1959 and currently records a Capital Adequacy Ratio (CAR) of ~14.6% as of 1HFY23. AFC has been successfully maintaining its Non-Performing Loans (NPL) below industry levels despite the volatile economic environment. AFC earned a Net Interest Income (NII) of LKR 5.2bn in FY22, which is a growth of ~22% since the previous financial year. It earned a net interest income as a percentage of interest income of ~66% and due to the high-interest rate environment in 2022, the ratio reduced to ~45% as of 1HFY23. AFC recorded high operating costs which affected its potential to earn higher profits during this period. Ratings reflect the Company's ability to raise foreign currency debt through its TBL initiatives. Its successful introduction of digital products and impact financing products will positively affect the rating in the future.

The rating is dependent on the Company's ability to confront the unstable macroeconomic climate persistent in the country and sustain its position. Financial inclusion and navigating its way through its sustainable initiative will be crucial for the Company. The rating will rely on the Company's ability to expand its portfolio while preserving the asset quality.

Disclosure

Name of Rated Entity	Alliance Finance Company 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(Jun-22)
Rating Analysts	Amreetha Mahindapala | amreetha@lra.com.lk | +94 114 500099

Profile

Structure Alliance Finance Company PLC ("AFC" or "the Company") was incorporated as a public company in 1956 under the provisions of the Companies Ordinance No. 51 of 1938 and re-registered under the Companies Act No. 07 of 2007. It was listed on the Colombo Stock Exchange (CSE) in 1959.

Background AFC is one of the oldest Finance Companies in Sri Lanka, with 66 years in the industry. It formally adopted the Triple Bottom Line ("TBL") philosophy in 2012.

Operations The principal business activities include acceptance of fixed and savings deposits and granting term loans, gold loans, and other credit facilities, leasing, vehicle trading and and hiring services.

Ownership

Ownership Structure The largest shareholder of the Company is Mr. R K E P De Silva, with an ownership of 34.53%. He is also the Deputy Chairman ("DC") and the Managing Director ("MD") of the Company.

Stability Mr. R K E P De Silva was appointed to the board in 1990 and serves as a non-executive director in AFC's associates and subsidiaries.

Business Acumen Mr. De Silva is a Fellow of the Institute of Credit Management. He also holds directorships in many companies and also is a member of multiple professional bodies.

Financial Strength AFC currently does not have a need for capital infusion. However, the sponsors are willing and able to provide financial support if AFC needs it.

Governance

Board Structure The Board has eight directors, out of which, four are Independent Non-Executive directors and four are Executive directors. Mrs. Dharmakirti-Herath leads the board members since 2020.

Members' Profile The Executive directors, has experience in Non-Banking Financial institutions ("NBFI"), micro financing, investment banking and marketing, both locally and internationally. The Non-Executive directors possess a wealth of experience in sectors such as healthcare, financial services, brand building, strategic planning and law.

Board Effectiveness The Company has formed four board sub-committees, namely, i) Board Audit Committee ("BAC"), ii) Board Integrated Risk Management Committee, iii) Related Party Transactions Review Committee ("RPTRC") iv) Board Remuneration Committee ("BRC").

Financial Transparency The external auditors of the company, Baker Tilly Edirisinghe & Co, issued an unqualified audit opinion pertaining to the annual financial statements for FY22.

Management

Organizational Structure The head of the organization remains on the Board of Directors. Four divisions in the Company report directly to Mr. De Silva. Other departments report to Mr. De Silva through the relevant Executive Directors.

Management Team The management team is headed by Mr. De Silva. The Managing Director is supported by a team of executive directors, CXOs, Assistant General Managers, and a team of managers for different functions and areas. The Company has a large corporate and middle management. They have acquired decades of experience in their respective careers.

Effectiveness AFC has formed seven management committees to run the operations smoothly in the Company.

MIS The Company is planning to move into its new core banking system, Finacle core banking solution, by the end of October 2023. It is planning to introduce a customer relationship management solution as well.

Risk Management Framework The internal audit department follows a comprehensive audit plan where all branches are audited at least once a year, while the gold loan divisions are audited twice a year. The risk management division focuses mainly on credit risk, market risk, and liquidity risk.

Business Risk

Industry Dynamics At present, there are 36 LFCs in Sri Lanka, out of which, 29 are listed in the CSE. The profit after tax for the six months ending September 2022 saw a decline of 11%. The loan loss provisions declined by ~LKR 6bn in the six months to September compared to the previous financial year, which aided the sector earn profits. The gross and net NPLs deteriorated to ~16.76% and ~11.73% by September 2022.

Relative Position AFC has improved its position in the industry by accounting for ~3.1% (FY21: ~2.5%) of the assets and ~1.8% (FY21: ~1.7%) of the deposits in the sector, as at FY22. Its position in loans and advances improved while the investments and equity position shrunk during the period.

Revenues AFC earned a net interest income of LKR 5.2bn (FY21: LKR 4.3bn), in FY22, which is a ~22% increase since the previous financial year. The growth in interest income was as a result of the loans and advances portfolio increasing by ~123% to LKR 14.8bn, which resulted in the interest income from loans and advances alone, to increase by ~48% to LKR 1,961mn. Its gross income and net interest income was recorded at LKR 5.9bn and LKR 2.5bn as at 1HFY23.

Performance The Company increased its profit after tax by ~161% in FY22 to LKR 1.5bn. The biggest contributor for it was the improvement in interest income, other operating income and the net Impairment charge for loans and other losses during the year. AFC earned a profit after tax of LKR 205mn (1HFY22: LKR 351mn) as at 1HFY23. The reduction in profit after tax, compared to the same period last year is as a result of high operating costs and impairment. The core spread dropped to ~4.1% as at 1HFY23 from ~11.1% recorded as at FY22.

Sustainability AFC plans to increase its exposure in impact financing, digital products, and gold loans.

Financial Risk

Credit Risk The Company has recorded gross and net NPLs of ~10.9% and ~6.8% respectively in 120 day NPL as at 1HFY23. AFC has maintained low NPL levels for gold loans. The Company has a higher concentration for three-wheelers, gold loans, and cars.

Market Risk The Company increased its investments by ~29% in 1HFY23 by investing in government securities. It increased its investment in government securities in 1HFY23 by ~31% to LKR 2.2bn.

Liquidity And Funding Deposits and bank borrowings constituted ~39% and ~61% of the funding in the Company as of FY22, which changed to ~42% and ~58% by 1HFY23. Around ~24% of its borrowings as of FY22 are foreign borrowings. The Company deposits foreign currency in the bank and gets the loan on its backing which reduces its foreign currency risk.

Capitalization The Capital Adequacy Ratio ("CAR") of the Company stood at ~15.1% as of FY22 (FY21: ~14%). The ratio is currently at ~14.6% as of 1HFY23. Its debt-to-equity ratio increased to 6.3X times as at 1HFY23 as a result of the funding increase in the Company.

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LKR mln

Alliance Finance Company PLC Listed Public Limited	Sep-22 6M	Mar-22 12M	Mar-21 12M	Mar-20 12M
A BALANCE SHEET				
1 Total Finance-net	42,592	40,472	26,382	26,019
2 Investments	2,623	1,913	2,020	2,242
3 Other Earning Assets	1,590	1,201	1,691	2,249
4 Non-Earning Assets	4,319	4,724	3,800	3,209
5 Non-Performing Finances-net	80	(171)	228	225
Total Assets	51,205	48,140	34,122	33,945
6 Funding	42,087	38,107	26,133	27,772
7 Other Liabilities	2,476	3,352	2,173	1,560
Total Liabilities	44,564	41,459	28,306	29,332
Equity	6,641	6,681	5,816	4,613
B INCOME STATEMENT				
1 Mark Up Earned	5,617	7,852	7,172	7,212
2 Mark Up Expensed	(3,069)	(2,651)	(2,913)	(3,321)
3 Non Mark Up Income	205	518	309	248
Total Income	2,752	5,719	4,569	4,139
4 Non-Mark Up Expenses	(1,623)	(2,776)	(2,261)	(2,237)
5 Provisions/Write offs/Reversals	(405)	(24)	(705)	(1,074)
Pre-Tax Profit	724	2,918	1,604	828
6 Taxes	(483)	(1,455)	(1,043)	(619)
Profit After Tax	241	1,463	561	209
C RATIO ANALYSIS				
1 PERFORMANCE				
a Non-Mark Up Expenses / Total Income	59.0%	48.5%	49.5%	54.1%
b ROE	7.2%	23.4%	10.8%	4.5%
2 CREDIT RISK				
a Gross Finances (Total Finance-net + Non-Performing Advances + Non-Performing Debt Instruments) / Funding	106.3%	110.2%	109.6%	101.7%
b Accumulated Provisions / Non-Performing Advances	96.3%	111.2%	89.9%	89.9%
3 FUNDING & LIQUIDITY				
a Liquid Assets / Funding	9.7%	7.9%	12.1%	14.2%
b Borrowings from Banks and Other Financial Institutes / Funding	56.9%	59.2%	50.6%	55.5%
4 MARKET RISK				
a Investments / Equity	39.5%	28.6%	34.7%	48.6%
b (Equity Investments + Related Party) / Equity	4.4%	3.8%	4.6%	4.3%
5 CAPITALIZATION				
a Equity / Total Assets (D+E+F)	13.0%	13.9%	17.0%	13.6%
b Capital formation rate (Profit After Tax - Cash Dividend) / Equity	3.2%	18.2%	12.2%	3.8%

Credit Rating

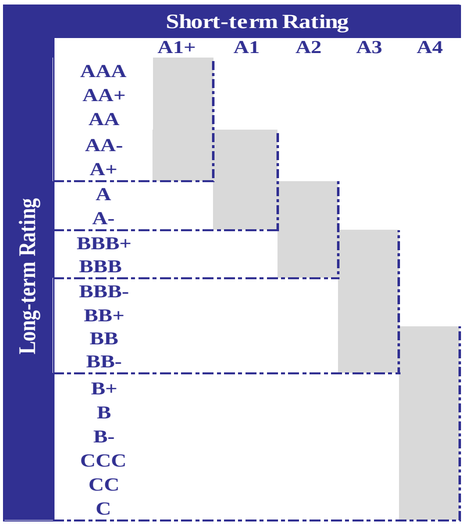
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

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