

ICRA Lanka reaffirms the ratings of First Capital Treasuries PLC

December 27, 2019

Instrument*	Previous Rated Amount (LKR Mn)	Current Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	N/A	[SL]A- with stable outlook; Reaffirmed
Subordinated Unsecured Redeemable Debenture programme	500	500	[SL]BBB+ with stable outlook; Reaffirmed
Proposed Subordinated Unsecured Redeemable Debenture programme	-	750	[SL]BBB+ with stable outlook; Assigned

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of [SL]A- (pronounced SL A minus) with stable outlook for First Capital Treasuries PLC (FCT or "the Company"). ICRA Lanka has also reaffirmed the issue rating of [SL]BBB+ (pronounced SL triple B plus) with stable outlook for the LKR 500Mn Subordinated Unsecured Redeemable Debenture programme of the company. Further, ICRA Lanka has assigned the issue rating of [SL]BBB+ (pronounced SL triple B plus) with stable outlook for the proposed LKR 750Mn Subordinated Unsecured Redeemable Debenture programme of FCT.

Rationale

The ratings continue to factor in FCT's position as one of the leading standalone primary dealers (PD) in Sri Lanka with an established track record, franchise and clientele. The ratings also take comfort from the low credit risk profile, as all the exposures are towards Government securities. ICRA Lanka notes that while the portfolio has modest credit risk, it is however susceptible to adverse movements in interest rates. The ratings take note of the gearing which stood at 8.13 times in September 2019 (gearing adjusted for the deferred tax asset stood at 9.55 times) vis-à-vis 8.99 times in March 2019. The capitalization is adequate with the total capital adequacy ratio standing at 15.0% as at September 2019 compared with 14.7% in March 2018; ICRA Lanka notes that capital adequacy has remained fairly stable despite an increase in the trading portfolio and duration during the same period (to 3.05 years from 1.49 years).

The ratings also take cognizance of the short-term nature of the borrowings profile and the short term asset liability mismatch, with the overnight negative mismatch at 35.0% of the total earning assets in June 2019 vis-à-vis 42.8% in June 2018, and the 90-day negative cumulative mismatch at 8.9% of the total earning assets in June 2019 vis-à-vis 7.8% in June 2018. Nevertheless, the highly liquid nature of the portfolio and access to funding lines provide comfort from a liquidity perspective. Going forward, FCT's ability to reduce its leverage, have an adequate buffer over regulatory requirements and generate commensurate internal generation would be crucial from a ratings perspective.

Outlook: Stable

The Stable outlook factors in FCT's adequate capitalization and its track record as one of the leading primary dealers in Sri Lanka. The outlook may be revised to "Positive" based on FCT's ability to operate profitably across cycles while maintaining a comfortable capital and liquidity profile. The outlook may be revised to "Negative" in case of significant weakening in the earnings, liquidity and capitalization profile or in case its exposure profile shifts away from Government securities.

Key rating drivers

Credit strengths

Position as a leading stand-alone primary dealer in Sri Lanka: FCT is one of the leading standalone primary dealers in Sri Lanka, with a market share of 38% as in December 2018 (in terms of total assets), and a total asset base of LKR 33.4Bn in September 2019. The company has an established track-record as a PD, a large client base, and repo funding arrangements with most of the leading commercial banks in Sri Lanka.

Modest credit risk: FCT's portfolio stood at about LKR 32.8Bn in September 2019. The same has increased from LKR 31.4Bn in March 2019 and LKR 26.4Bn in September 2018. The portfolio comprises of treasury bills, bonds and reverse repos on government securities (which are highly liquid assets), and therefore carries no significant credit risk. However, FCT is exposed to interest rate risk as the trading portfolio is marked to market based on systemic interest rates; the weighted average portfolio duration stood at 3.05 (in years) in September 2019, and has increased from 2.14 (years) in March 2019 and 1.87 (years) in June 2018.

Adequate capitalization profile: As in September 2019, the total capital base (Tier I and Tier II) of the company stood at LKR 3,400Mn (post adjustment for a deferred tax asset of LKR 541Mn); the total capital adequacy ratio stood at 15.00% (Tier 1 - CAR at 13.67%) above the regulatory minimum of 10%. As in September 2019, reported gearing for the company stood at 8.13 times, while gearing adjusted for the deferred tax asset, stood at about 9.55 times. Due to an adverse market environment, company earned a modest net profit of LKR 96Mn in FY2019 vis-à-vis a net profit of LKR 1,671Mn (inclusive of deferred tax gain of LKR 847Mn) in FY2018. However, in the 6 months ended September 2019, due to a favourable market environment, company reported a net profit of LKR 671Mn resulting in a higher accretion to net worth. While the current capitalization remains comfortable in relation to the risk profile, the impact of any future interest rate movements on the earnings and capital profile would be a key monitorable.

Credit challenges

Short term asset liability mismatch (ALM), especially in the overnight maturity: FCT intends to maximize net interest income by leveraging on short-term repo borrowings, whilst maintaining a medium term (about 2-3 years) duration on its overall portfolio. Hence, company is subject to a short term ALM mismatch; as in June 2019, the negative overnight mismatch was 35.0% of total earning assets compared to 42.8% in June 2018, whilst the 90-day negative cumulative mismatch was 8.9% of total earning assets in June 2019 compared with 7.8% in June 2018. However, the highly liquid nature of the portfolio and access to about LKR 1.55Bn in unutilized funding lines from commercial banks as at September 2019, provides comfort. Further, as a licensed primary dealer, FCT has access to overnight liquidity lines from the Central Bank of Sri Lanka (CBSL), as the lender of last resort.

Vulnerability to interest rate risk: Notwithstanding the lower credit risk, FCT's portfolio is exposed to market risk due to its susceptibility to adverse movements in the interest rates, where the company could

make trading losses and fair valuation losses based on systematic rate movements. Accordingly, based on the portfolio as at September 2019, ICRA Lanka estimates that a rise in interest rates by 100bps would reduce the total CAR by 360bps and increase gearing to around 11 times. During the 6 months ended September 30, 2019, company achieved a trading profit of LKR 892Mn and fair valuation loss of LKR 57Mn in the context of falling interest rates, whereas net interest income during the period stood at LKR 215Mn. However, ICRA Lanka takes comfort from the healthy capital profile of the company which would enable it to withstand negative interest rate movements.

Analytical approach: For arriving at the ratings, ICRA Lanka has applied its rating methodologies as indicated below.

Links to applicable criteria: [ICRA Lanka Rating Methodology for Primary Dealers](#)

About the company:

Incorporated in year 1982, FCT is a licensed primary dealer of government securities in Sri Lanka. The company is 94.44% held by First Capital Limited, while First Capital Limited is in-turn 100% held by First Capital Holdings PLC. First Capital Holdings PLC (FCH) is 83.02% held by Janashakthi PLC (JPLC), the parent of group companies in December 2019. Previously, FCH was held by JPLC via Dunamis Capital PLC (DCP).

With JPLC's acquisition of DCP, JPLC became the ultimate parent of FCT (in December 2018). On October 29, 2019, shareholder approval was obtained for the amalgamation of DCP and JPLC, resulting in DCP ceasing to exist and all of its subsidiaries (namely, FCH and Kelsey Development PLC) becoming the immediate subsidiaries of JPLC. Consequently, DCP was amalgamated with JPLC on December 6, 2019.

For the financial year ended March 31, 2019, FCT reported a net profit of LKR 96Mn on a total asset base of LKR 32.3Bn, vis-à-vis net profit of LKR 1,671Mn (including a deferred tax asset of LKR 847Mn) on a total asset base of LKR 25.5Bn during the previous fiscal. For 6 months ended September 30, 2019, FCT reported a net profit of LKR 671Mn on a total asset base of LKR 33.4Bn.

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