FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Colombo/Mumbai - 16 Oct 2023: Fitch Ratings has affirmed Mercantile Investments and Finance PLC's (MIF) National Long-Term Rating at 'BBB-(lka)' and removed the Rating Watch Negative (RWN). The Outlook is Stable.

KEY RATING DRIVERS

Standalone Profile Drives Rating: MIF's National Long-Term Rating reflects its primary operations in a weak operating environment as well as its moderate franchise within Sri Lanka's finance and leasing companies (FLC) sector. MIF has a high risk appetite with weak asset-quality and profitability profiles. Its high proportion of short-term debt often leads to negative asset-liability maturity mismatches.

Less Severe Macroeconomic Risk: The removal of the RWN reflects our view that further downside is less imminent to MIF'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 a 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 2024 (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.

Vehicle Financing Dominance: MIF's business model is dominated by vehicle financing, with leases and vehicle loans accounting for about 86% of gross loans at FYE23. The company has recently started increasing its share of non-vehicle loans amid lower demand for vehicle financing. However, we do not expect a material change in its business mix in the medium term. Vehicle-backed lending is still likely to dominate the portfolio mix, given MIF's more established franchise in this segment than in newer lending segments.

Weak Underwriting Standards: MIF's high-risk appetite stems from its weaker underwriting standards than higher-rated peers along with evolving risk controls. MIF's exposure to riskier loan types - particularly large property-backed mortgages, as well as interest-only products - has increased over past few years. That said, company plans to increase the granularity in its loan portfolio, by reducing exposure to mortgage-backed loans and increasing share of small gold-backed loans, in the medium term.

Persistent Asset-Quality Risks: MIF's gross nonperforming loans (NPL) ratio rose to 12.1% by end-March 2023, from 9.1% at FYE22, on weaker collection in its core vehicle loans segment and lumpy corporate loan delinquencies. We expect asset quality to remain stressed in the medium term, due to the weak economic environment. Nonetheless, loan collections could increase as borrower repayment capability improves, provided the economy gradually stabilises with declining inflation and interest rates.

Margin Pressure to Decrease: MIF's pretax profit/average total assets declined to 1.0% in FY23, from 4.5% in FY22, following a sharp reduction in the net interest margin (NIM; FY23: 6.6%, FY22: 11.2%) as borrowing costs rose sharply with rising interest rates. We expect the company's NIM to gradually recover in the medium term, in the declining interest-rate environment, as MIF's debt reprices faster than its mostly fixed-rate loans. This, along with a potential pick-up in loan growth, should support its earnings and profitability.

Leverage to Stay Stable: MIF's leverage is unlikely to increase significantly in the medium term, as we expect loan growth to remain modest. Leverage is moderate, with debt/tangible equity of 3.2x at FYE23 (FYE22: 3.1x), but its regulatory Tier 1 ratio of 16.5% at FYE23 (FYE22: 15.5%) is lower than the peer average. Revaluation reserves, which contributed to 20% of MIF's equity, are excluded from the calculation of regulatory Tier 1 capital.

Improved Funding and Liquidity Profile: MIF's share of unsecured debt/total debt rose significantly to 91% by FYE23, from 78% at FYE22, supported by increased focus on raising deposits. MIF's increased cash and cash equivalents from deposit raising and reduced lending in FY23 mitigated near-term liquidity pressure from negative asset-liability mismatches. Liquid assets/total assets rose to 13.5% by FYE23, from 8.9% at FYE22, as MIF increased investment in liquid assets amid lower lending opportunities.

MIF expects to increase its bank funding in the medium term, on a reduction in banks' lending rates.

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 downgrade could result from higher leverage or a substantial erosion of capital buffers due to asset-quality deterioration and weakening profitability.

Increased risk appetite, as evident in a shift of business mix towards riskier products and more vulnerable customer segments, could also lead to negative rating action.

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 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 sustained asset quality and profitability improvement, provided adequate capital buffers are maintained, 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 Watch Negative

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. 06 May 2023) (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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