



LRA assigns AA₃ to Merchant Bank of Sri Lanka's Rs 600 million debentures

LRA has reaffirmed Merchant Bank of Sri Lanka's ("MBSL" or "the Bank") long-term financial institution rating of AA₃ and short-term rating of L1. The ratings are primarily based upon the credit strength and financial flexibility of MBSL, which stem from its parent – the state-owned Bank of Ceylon ("BOC"), i.e. the largest commercial bank in Sri Lanka. Meanwhile, the proposed Rs 600 million unsecured debentures of the Bank have been assigned a AA₃ rating. All the long-term ratings have a stable outlook. The rating of the proposed debt issue is similar to that of MBSL's long-term financial institution rating because the issue ranks *pari passu* with the Bank's other senior unsecured debts. The proceeds from the proposed debenture issue will be used to fund MBSL's growing loan base and to repay the Bank's debts that are falling due in 2007.

Meanwhile, the ratings are also supported by the Bank's strong capitalisation, improving performance, recovering liquidity levels and healthier asset quality.

For FYE 31 December 2006 ("FY Dec 2006"), MBSL achieved a record pre-tax profit of Rs 269.18 million, a 43.69% increase from the previous year. The growth was supported by the Bank's expanding leasing and hire-purchase ("HP") bases, coupled with healthier lending and borrowing rates. With the Bank's cost-to-income ratio at 40.46%, its return on assets improved from 5.74% to 7.56%, while its return on equity trended upwards from 16.36% to 19.19%.

MBSL's better profit performance also strengthened its shareholders' funds, which remained the prime source of financing for the Bank. As a result, the Bank's capital adequacy ratio or CAR came up to a high 41.41% as at end-FY Dec 2006. This level of capitalisation is deemed strong; LRA derives further assurance from the support of the Bank's parent. The second major source of funding for MBSL has been its long-term borrowings. However, its gearing ratio only stood at a low 1.17 times as at end-FY Dec 2006 - well below the average of 4 times for specialised leasing companies and the regulatory limit of 7 times. Nonetheless, funding remains a moderating factor against the Bank's asset growth.

Meanwhile, the Bank's gross non-performing-loan ratio on a 6-month basis improved from 16.58% as at end-FY Dec 2005 to 10.41% as at end-FY Dec 2006, supported by write-offs and recoveries. As expected, the Bank had written off Rs 117.00 million of bad debts, which stemmed from lease facilities granted prior to FY Dec 2003, during the year. These bad debts were the residual amounts subsequent to the collateral disposal and had been fully provided for. The Bank had also recovered Rs 104.58 million of bad debts, the bulk (Rs 75.62 million) of which was from the lease portfolio. Nonetheless, new bad debts surged 40.39% to Rs 90.31 million, from Rs 64.33 million the previous year. LRA therefore opines that there is ample room to improve the Bank's underwriting and monitoring standards. The high level of bad debts was, however, cushioned by adequate specific and general provisions, with a gross NPL coverage of 66.94%.

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