



Media Release

RAM Ratings Lanka downgrades Mercantile Investments PLC's ratings to BBB+/P2 with a stable outlook

RAM Ratings Lanka has downgraded Mercantile Investments PLC's ("MIL" or "the Company") long- and short-term financial institution ratings from A and P1 to BBB+ and P2, respectively. Meanwhile, the outlook on the long-term rating has been revised from negative to stable. Simultaneously, a short-term issue rating of P2 has been assigned to MIL's LKR 100 million Commercial Paper Issue (2011/2012). The downgrade reflects MIL's weak asset quality as a result of its high exposure to equity investments as well as the deterioration in its core performance. On the other hand, MIL's ratings are upheld by its strong capitalisation, although this is likely to be eroded amid the planned aggressive expansion of credit assets. Meanwhile, the ratings are pressured by MIL's small-size, and its weak credit quality owing to its relatively high gross non-performing-loans ("NPL") ratio as well as the lack of a seasoned loan portfolio.

MIL's long-term ratings were placed on a negative outlook in July 2008, following a steep decline in MIL's financial performance and its weakening asset quality. Although its credit quality improved in FYE March 2010 ("end-FY Mar 2010"), the negative outlook had been maintained, premised on the change in MIL's risk profile due to its heightened exposure to equity investments, which had exceeded the level allowed by the Central Bank of Sri Lanka ("CBSL").

RAM Ratings Lanka opines that MIL's overall asset quality is weak owing to its substantial exposure to equity investments, weak credit quality as reflected in its high NPL ratio as well as the lack of seasoning in its loan book amid the aggressive loan growth. The Company had increased its equity trading portfolio by LKR 1.45 billion (or 140%) and LKR 442.58 million (or 23%) respectively during fiscal 2011 and 7M FY Mar 2012. MIL's total equity investments accounted for 28.65% of its total assets and 78.93% of its shareholders' funds as at end-October 2011; its trading portfolio took up a respective 18.77% and 51.70% of its total assets and shareholders' funds. We note that MIL exceeds CBSL's stipulated limit of 25% of shareholders' funds under Investment Direction No. 7 of 2006. The management's high risk appetite with regards to equity investments is viewed with concern as it exacerbates MIL's vulnerability to market risk.

On a separate note, the Company's loan book expanded robustly, growing by 32.86% year-on-year ("y-o-y") in fiscal 2011; this further augmented 54.69% (annualised) in 7M FY Mar 2012 to LKR 8.30 billion as at end-October 2011. Meanwhile, MIL's gross NPL ratio had improved supported by enlarged credit assets as well as the fall in absolute NPLs; it improved from 9.69% as at end-

March 2010 to 4.11% as at end-October 2011, albeit weaker than those of its similar rated peers. RAM Ratings Lanka's concerns also hinge on the lack of seasoning in the Company's loan portfolio, given the Company's aggressive growth as of late.

In fiscal 2011, MIL's profitability surged mainly supported by stronger non-interest income which grew 2-fold to reach LKR 716.41 million. This uptick was triggered by capital gains from its equity trading portfolio amid the stock-market boom. Although the Company's performance had improved, our concerns hinge on its high dependence on capital gains from its equity portfolio (two-third of its gross income is made up of non-interest income) which are volatile in nature and are unlikely to be sustained given the declining stock market. Moreover, MIL does not mark-to-market its equity investments; as a result, its pre-tax profit of LKR 762.39 million is overstated as unrealized losses in the Company's equity portfolio was LKR 209.83 million in 7M FY Mar 2012. Furthermore, we view the Company's weak core performance with concern; its net interest margin ("NIM") thinned to 4.60% in 7M FY Mar 2012 (fiscal 2010: 9.42%) and is deemed to be one of the weakest relative to its similar rated peers. This is reflective of the Company channelling a considerable portion of its funds towards increasing its equity exposure. Further, MIL's loan portfolio has relatively low yields compared to its peers due to its focus on the relatively low-yielding 4-wheeler segment. Meanwhile, the Company's cost-to-income ratio which clocked in at 37.12% by end-fiscal 2011, is envisaged to deteriorate over the short to medium term on - the back of its aggressive branch expansion plans and the Company's profitability is likely to be hampered until these new branches break even.

Meanwhile, RAM Ratings Lanka views MIL's funding and liquidity levels to be moderate. However, the robust growth of its credit assets had trimmed its statutory liquid-asset ratio to 12.64% as at end-October 2011 (fiscal 2010: 13.90%). Meanwhile, the Company's funding position had moderated due to its increasing reliance on short-term borrowings, which in turn had weakened MIL's near-term maturity mismatches. Moreover, its loans-to-deposits ("LD") ratio had also deteriorated, from the previous year's 127.80% to 153.20% as at end-FY Mar 2011. This is higher than its peers', reflecting the sluggish accretion in deposits, owing to MIL's limited geographical presence and high debt component.

MIL's superior capital cushioning remains its key rating strength which upholds its ratings at current levels. Following the inclusion of audited profit in fiscal 2011, the Company's tier-1 and overall risk weighted capital adequacy ratios ("RWCAR") had improved to a respective 27.41% and 32.44% as at end-October 2011.

Media contact

Kuleesha Gamage
(9411) 2553089
kuleesha@ram.com.lk

Date of release: 03 February 2012



Media Release

The credit rating is not a recommendation to purchase, sell or hold a security, inasmuch as it does not comment on the security's market price or its suitability for a particular investor, nor does it involve any audit by RAM Ratings Lanka. The credit rating also does not reflect the legality and enforceability of financial obligations, transfer and convertibility risks, repatriation risk, currency risk or any other risk apart from credit risk.

RAM Ratings Lanka receives compensation for its rating services, normally paid by the issuers of such securities or the rated entity, and sometimes third parties participating in marketing the securities, insurers, guarantors, other obligors, underwriters, etc. The receipt of this compensation has no influence on RAM Ratings Lanka's credit opinions or other analytical processes. In all instances, RAM Ratings Lanka is committed to preserving the objectivity, integrity and independence of its ratings. Rating fees are communicated to clients prior to the issuance of rating opinions. While RAM Ratings Lanka reserves the right to disseminate the ratings, it receives no payment for doing so, except for subscriptions to its publications.

Similarly, the disclaimers above also apply to RAM Ratings Lanka's credit-related analyses and commentaries, where relevant.

Published by RAM Ratings (Lanka) Ltd
© Copyright 2011 by RAM Ratings Lanka