May 17, 2023

Mr. Ransith Karunaratne
Chief Executive Officer
UB Finance Company Limited
No.10 , Daisy Villa Avenue
Colombo, 00500
Sri Lanka

Dear Mr. Karunaratne:

Re: Initial Rating Letter for UB Finance Company Limited

Fitch (see definition below) assigns the following ratings.

UB Finance Company Limited	Natl LT	BB(lka)	New Rating

RATINGS KEY	OUTLOOK	WATCH
Positive		
Negative		
Evolving		
Stable		

You should notify your business relationship manager at Fitch if you wish to publish the rating. Fitch will then publicly disseminate the resulting rating and the rating will be monitored. Should you not request that the rating be made public, the rating will be point-in-time only or, subject to agreement with Fitch, monitored on a non-public basis.

Applicable Criteria: National Scale Rating Criteria, Non-Bank Financial Institutions Rating Criteria

Fitch Assigns UB Finance First-Time BB(lka) Rating; on RWN

Fitch Ratings has assigned UB Finance Company Limited (UBF) a first-time National Long-Term Rating of 'BB(lka)'. The rating is on Rating Watch Negative (RWN).

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UBF is a 91.8%-owned subsidiary of Sri Lanka-based Union Bank of Colombo PLC (UB, BBB-(lka)/RWN). Acquired by UB in 2011, it mainly provides asset-backed financing to SMEs, and is a small finance and leasing company (FLC) in the country with less than 1% of the sector's total assets. Another major shareholder of UBF is ShoreCap II Limited (3.2%), a social impact fund managed out of the US, although its involvement in UBF is limited relative to UB's.

For more information on UB, please refer to our rating action commentary "Fitch Maintains Union Bank of Colombo's 'BBB-(lka)' on rating Watch Negative", dated 22 September 2022.

Support-Driven Rating: UBF's National Long-Term Rating is driven by our expectation of some likelihood of extraordinary support from UB to UBF, if required. This is premised on UB's majority ownership of UBF and record of ordinary support, as well as the branding and operational integration between the two entities. Counterbalancing factors are UBF's limited role in the parent's franchise and UB's more moderate capacity to provide any required support compared to larger FLC-owning banks.

RWN Mirrors Parent's Rating: The RWN on UBF's National Long-Term Rating reflects that on its parent, and also our view that similar to other Sri Lankan non-bank financial institutions, UBF is not immune to heightened near-term downside risks due to the weak domestic economy and volatile funding and liquidity conditions. Further financial-system stress could compound UBF's already weak financial performance and constrain the parent's ability or propensity to provide timely shareholder support.

Parent's Ability to Support: We believe UB has some capacity to provide support to UBF, due to the parent bank's above-peer capital ratios and stronger credit profile relative to its subsidiary. However, any support required by UBF may be more of a burden relative to UB's modest balance-sheet size, compared with Fitch-rated FLCs owned by larger banks. This is a rating constraint as reflected in the two-notch difference between the ratings of UB and UBF.

UB has a modest franchise within the domestic banking sector, and UBF accounted for 7% and 14% of its parent bank's consolidated assets and equity, respectively, as of end-December 2022 – a larger proportion than other Fitch-rated FLCs owned by larger banks. UB's smaller absolute capital base also limits the funding that it can lend to UBF in times of need given the single borrower limit imposed by the regulator.

Limited Contribution: UBF's rating also reflects our assessment of its limited importance to the UB group. UBF is designated to offer leases and gold-backed lending within the group, but we do not consider such products as core to UB's overall banking franchise. Leases and gold-backed loans form less than 10% of UB's total gross loans and the earnings contribution from UBF has been mostly limited due to its weak and volatile profitability. While there are plans for UB to refer more customers to UBF, the synergy remains to be seen given the entities' divergent target customer profiles.

Parental Oversight: UB maintains clear oversight on UBF's strategic agenda, policies and operations. It has three directors on UBF's eight-member board, and advices UBF's management team in areas such as risk management, finance

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and technology. UB also shares its internal audit team with UBF. Three independent directors on UBF's board provide additional oversight.

Support History: UB provides regular bank loans to UBF, and has provided capital support in the form of subordinated debt in 2016, and rights issue subscriptions in 2017 and 2021. That said, the capital infusion in 2021 came at a substantial delay after UBF fell short of its capital requirements in late 2018, as the UB group hoped to source new capital from a foreign investor instead. Ultimately, UB called off the foreign investment process after prolonged delays, and injected the necessary capital to restore UBF's compliance with regulatory capital requirements.

Weak Standalone Profile: We believe that UBF's intrinsic credit profile is weaker than its support-driven rating. It carries significant borrower and depositor concentration risks due to its legacy property-backed loan portfolio and small business franchise. Its non-performing loan ratios have been consistently above the industry average for the past four years and average pretax ROAA of 1.3% over FY19-FY22 underperformed the industry average (3.5%) due to higher funding and credit costs.

We also expect its high-growth appetite to weigh on its leverage and capitalisation despite an optically high tier-1 capital ratio of 27.2% as of end-1HFY23 (industry average: 20.2%) after UB's recapitalisation.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

UBF's rating is sensitive to changes in UB's credit profile, as reflected in UB's National Long-Term Rating as well as Fitch's opinion around UB's ability and propensity to extend timely extraordinary support.

Developments that could lead to a downgrade include:

- insufficient or delayed liquidity support from UB relative to UBF's needs, which hinders UBF's ability to meet its obligations in a timely manner
- increased size relative to the parent that makes extraordinary support more onerous for the parent
- intervention by the authorities that constrain UBF's ability to service its obligations
- a perceived weakening in the parent's propensity to support its finance subsidiary due to weakening links.

Such developments could result in Fitch no longer ascribing any benefit to UBF's ratings from shareholder support, and could lead to a multi-notch rating downgrade.

The resolution of the RWN is contingent upon developments in the operating environment, the parent's credit profile, and the evolution of the finance company's funding and liquidity position, which may take more than six months.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

There is limited scope for upward rating action given the RWN.

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We are pleased to have had the opportunity to be of service to you. If we can be of further assistance, please contact Wen Jun Poh, Associate Director at +65 6796 2717.

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