

RAM

RATINGS

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

A wholly owned subsidiary of RAM Holdings Berhad

Senkadagala Finance Company Limited – Rating Review

Financial Institution**Ratings:**

Long-term: BBB+
[Downgraded]
Short-term: P2 [Reaffirmed]

Rating Outlook:

Stable

Strengths:

- Adequate capitalization
- Effective IT framework
- Strong branch network

Weaknesses:

- Rising NPLs

Principal Activities:

Finance company engaged in hire-purchase, leasing, retail lending and mobilising public deposits

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Summary

RAM Ratings Lanka has lowered the long-term rating of Senkadagala Finance Company Limited ("Senkadagala" or "the Company") from A- (with a negative outlook) to BBB+; the short-term rating has been reaffirmed at P2. Concurrently, the outlook on the long-term rating has been revised to stable from negative. The Company was placed on a negative outlook in November 2008 due to its deteriorating asset quality. The downgrade reflects the continued deterioration in Senkadagala's asset quality. The ratings are, nevertheless, supported by the Company's adequate capitalisation and good liquidity levels.

Senkadagala is currently the sixth-largest registered finance company ("RFC") in Sri Lanka, accounting for 3.60% of the industry's total assets as at end-March 2009. The Company operates 30 branches island-wide and is supported by a work force of 207 employees. Senkadagala's information technology ("IT") system ranks among the best in the industry and has enabled the Company to achieve substantial cost and operational efficiencies.

In line with the aggressive expansion of Senkadagala's loan books along with the challenging macroeconomic conditions, the Company's asset quality had weakened during the past few years. Nevertheless, the Company's gross non-performing-loan ("NPL") ratio (on a 6-month classification basis) ameliorated to 3.63% as at FYE 31 Mar 2009 ("FY Mar 2009") from 6.33% as at end-FY Mar 2008, driven mainly by loan write-offs. However, the Company's absolute NPLs (after adjusting for seized stock) increased 94.88% (or LKR 167.06 million) to reach LKR 343.14 million over the ensuing eight months to November 2009, with a rapid accumulation of seized stocks. Further, we note that the Company had been challenged to fully recover the dues on its repossessed stocks in recent times due to the slump in the vehicle market reflecting increased market risk. Concurrently, the Company's gross NPL ratio climbed back up to 7.42% as at end-November 2009. In tandem with the macro economic fundamentals, rising NPLs have been an industry wide phenomenon; nevertheless, we note that Senkadagala's NPLs have accelerated relatively faster than similar rated peers.

Moreover, the gross NPL ratio as at end-FY Mar 2009 had been achieved at the expense of Senkadagala's financial performance. In line with substantial loan write-offs, provisions and losses on repossessed stocks during the reviewed period, the Company's pre-tax profit ebbed to LKR 117.82 million as at end-FY Mar 2009 (FY Mar 2008: LKR 302.25 million). Accordingly, the Company's return on assets ("ROA") fell sharply from 5.67% as at end-FY Mar 2008 to 2.01% as at end-FY Mar 2009. Going forward, we anticipate performance to ameliorate marginally as the Company resumes lending and its cost of funding recedes in line with the falling interest rates; nevertheless, a drastic improvement is unlikely in the short term given the Company's deteriorating asset quality and challenging macroeconomic conditions.

Meanwhile, Senkadagala's funding structure continues to be dominated by collateralised borrowings, which had accounted for 43.90% of its total funding as at end-FY Mar 2009. However, we note that the Company's funding structure had tilted increasingly towards deposits, with a reduced reliance on collateralised borrowings.

On a separate note, the Company's capitalisation is adequate, despite its internal rate of capital generation falling in line with its declining performance. Accordingly, Senkadagala's Tier 1 and overall risk weighted capital adequacy ratios ("RWCAR") clocked in at 18.03% as at end-June 2009, well above the regulatory minimums of 5% and 10% respectively. However, in line with the weakened asset quality, the Company's ratio on net NPL to shareholders funds had deteriorated to 26.14% as at end-September 2009 (FY Mar 2009: 10.78%)

Outlook

The downgrade reflects the continued deterioration in asset quality. An upward revision of the ratings are unlikely in the short term; nevertheless, ratings can be revised upwards should the Company's asset quality retrace back to the pre-2007 levels while demonstrating improvement in its performance and funding structure, with capitalisation remaining intact.

Corporate Profile

Senkadagala was incorporated in 1968 in Kandy, by its founding director, Mr EW Balasuriya. The Company operates as an RFC and is regulated by the Central Bank of Sri Lanka ("Central Bank") under the Finance Companies Act No. 78 of 1988, and the Finance Leasing Act No.56 of 2000.

Senkadagala engages in the provision of hire-purchase financing ("HP"), finance leasing, retail lending and acceptance of public deposits. It is currently the sixth-largest RFC in terms of asset size, accounting for 3.60% of total industry assets as at end-March 2009. The Company has a strong presence in the Central and Western regions of the country and operates 30 branches located throughout the island; supported by 207 staff members.

Ownership

Senkadagala is a public limited company and is owned and managed by its founders, the Balasuriya family; the family holds approximately 97% of the Company. The Balasuriya family has wide-ranging business interests in jewellery retailing, gaming and hotels. As at end-FY Mar 2009, Senkadagala held a 39% stake in Hotel Casamara, while the remainder was held by the Balasuriya family.

Management & Strategies

Senkadagala's management team is led by its Managing Director ("MD") and Chief Executive officer ("CEO"), Mr Lakshman Balasuriya. He is supported by an experienced and versatile senior management team, most of who have been with the Company for over 10 years. Further, Mr Lalith de Alwis assumed duties as deputy CEO during October 2009; he has widespread experience and expertise in the domestic and international financial services sectors.

Incorporated in 1968

Sixth-largest RFC

Owned and managed by Balasuriya family

Experienced management team

Conservative lending

Amid the unfavourable economic conditions and lofty interest rates in FY Mar 2009, the Company had curtailed its lending while its loan books remained largely unchanged over the previous year. Currently, Senkadagala has reduced its loan exposures to around 50% of the asset being financed. Nevertheless, we note that this was possible only due to banks curtailing lending; once banks resume lending Senkadagala is positioned to increase its exposure to traditional levels. Looking ahead, the management intends to expand its loan books to approximately LKR 5.0 billion by end-FY Mar 2010.

IT system-among industry's best

On a positive note, Senkadagala's IT framework is among the best in the RFC industry and has enabled the Company to achieve significant cost and operational efficiencies. The Company's IT system facilitates comprehensive real-time information relating to its loan portfolio, including default rates, loan ageing, product-wise and branch-wise performance etc. Further, the system provides direct links to the Company's lenders, thereby enabling the trustees and banks to monitor the performance of the securitised contracts. The link provided to Commercial Bank of Sri Lanka ("Commercial Bank") allows customer accounts to be automatically updated whenever a rental is paid through any of the bank's branches, thereby leveraging on Commercial Bank's extensive branch network. Additionally, the Company is presently in the process of upgrading its hardware framework, which will minimise system failures and enhance the IT configuration's reliability.

Board composition

Corporate Governance

Senkadagala's board of directors is led by its non-executive chairman, Mr SK Wickremasinghe. Mr Wickremasinghe was appointed in April 2008, while the former chairman and founding director Mr EW Balasuriya remains a director. The board currently comprises 9 directors, 8 of whom are non-executive.

The board is supported by 4 sub-committees: credit, audit, strategic planning and human resources & remuneration. Additionally, the Company recently appointed an independent auditor who reports directly and solely to the chairman. Board meetings are held once every 2 months, while special meetings are convened as and when required. We note that the Company did not have any significant related-party transactions during the year. Moreover, it was also not exposed to any contingent liabilities or commitments of any material nature as at end-FY Mar 2009.

Asset Quality

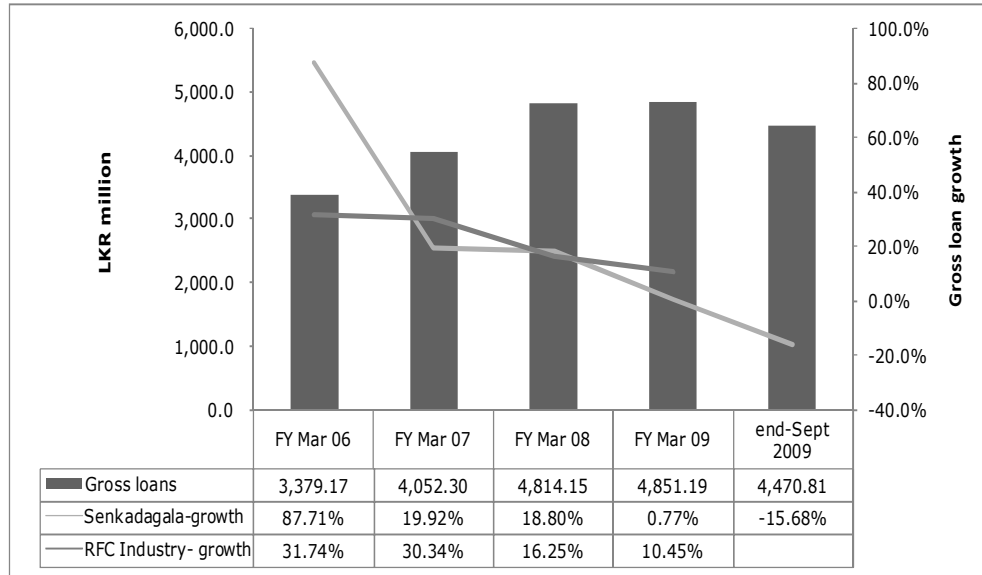
The Company's gross NPL ratio had improved as at end-March 2009, driven mainly by write-offs. Nevertheless, NPLs had accelerated in the ensuing eight months, with a rapid accumulation of seized stocks. While we acknowledge Senkadagala's recent efforts to curtail lending and beef up its monitoring procedures, our concerns hinge on the swift acceleration of NPLs.

Lending curtailed

Senkadagala's asset base remained largely unchanged at LKR 5.87 billion as at end-FY Mar 2009 against the backdrop of sluggish loan growth. Gross loans grew by a mere 0.77% during the year, compared to growth of 18.80% recorded last year. Loan growth decelerated in line with the non-conducive economic environment and elevated interest rates which prevailed during 2008, resulting in the Company adopting a conservative lending approach. We note that Senkadagala's loan growth was significantly lower than the industry's loan

growth of 10.45% during FY March 2009 (refer to Chart 1). Further, the Company’s loan books contracted considerably, down 11.08% to LKR 4.31 billion as at end-June 2009.

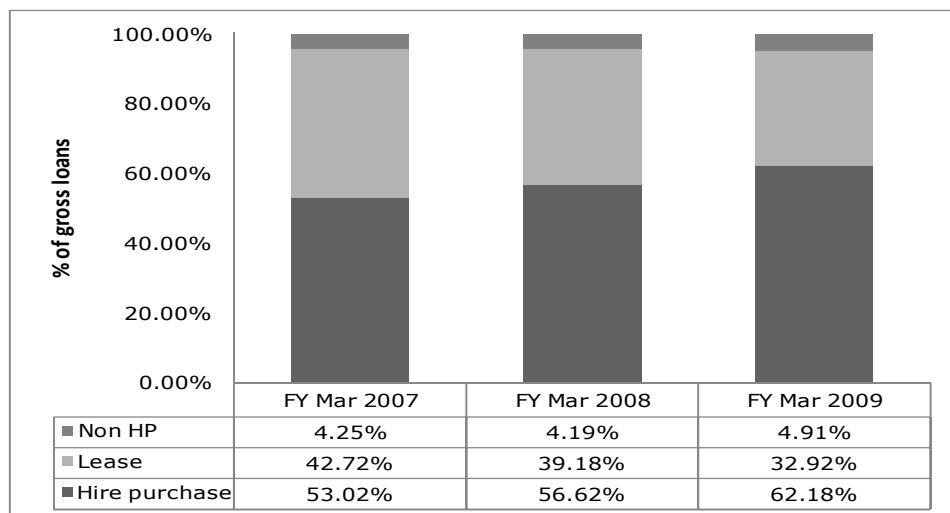
Chart 1: Senkadagala’s loan growth vs the industry



Dominated by HP

While Senkadagala’s HP portfolio expanded at a slower 9.03% during the year under review (FY Mar 2008: 28.32%), overall loan growth was thwarted by a dip in the leasing portfolio, which contracted 16.59% year on year (“y-o-y”). As such, the Company’s HP portfolio continued to increase its dominance in the loan portfolio, accounting for 62.18% of total gross loans as at FY Mar 2009. Meanwhile, contributions from leasing declined to 32.92% of the total loan portfolio (refer to Chart 2).

Chart 2: Composition of loan portfolio



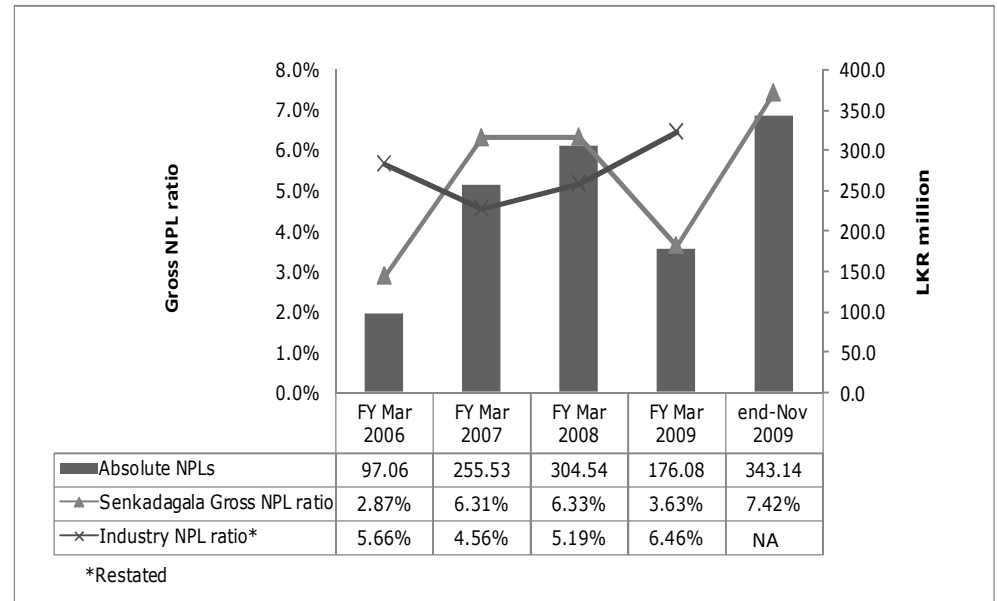
Deteriorated gross NPL ratio

Parallel to the challenging economic conditions and Senkadagala’s aggressive loan book expansion in previous years, the Company’s asset quality had weakened gradually. Accordingly, its gross NPL ratio had deteriorated to 6.33%¹ as at FY Mar 2008 (refer to Chart 3). However, the ratio had edged down to

¹ Gross NPL ratios have been restated to include seized stocks, to accommodate more stringent NPL-recognition policies recommended by the Central Bank. Accordingly, the gross NPL coverage and net NPL ratios have also been adjusted.

3.63% as at FY Mar 2009 (industry average of 6.46%), mainly due to write-offs amounting to LKR 121.62 million. However, Senkadagala’s new NPLs during the period (excluding the seized stock) increased to LKR 149.76 million (FY Mar 2008: LKR 46.66 million). Further, the Company’s absolute NPLs (after adjusting for seized stocks) increased by LKR 167.06 million (or 94.88%) to LKR 343.14 million in the ensuing eight month period to November 2009. This together with the contraction in the loan portfolio during the said period resulted in its gross NPL ratio climbing up to 7.42% by end-November 2009. RAM Ratings Lanka views this deterioration with concern. We further note that the Company does not include seized stock as NPLs; therefore seized stocks relating to contracts in arrears for more than 6 months have been added to the NPLs in line with the Central Bank regulations.

Chart 3: Senkadagala’s gross NPL ratios vs the industry



Accumulation of seized stocks

Meanwhile it is noteworthy that 45% of Senkadagala’s NPLs can be attributed to its seized stocks, underscoring the Company’s stringent monitoring and recovery procedures. Our concern lies with Senkadagala’s unsold seized stock, which receded to LKR 182.71 million as at end-FY Mar 2009, supported by 882 disposals during the year; however, the stock augmented to LKR 234.71 million by end-November 2009. We also note that 93% of these stocks fell into the “more than 6-months in arrears” category as at end-November 2009 (end-FY Mar 2009: 14%). Previously, the accumulation of seized stocks had not given rise to much concern as the second-hand vehicle market prices had recorded steady appreciation. However, given the current slump in demand for vehicles, RAM Ratings Lanka remains concerned with the increased market risk as the Company will face challenges in fully recovering dues on repossessed vehicles.

On a separate note, Senkadagala’s specific provisions declined by LKR 34.68 million as at end-FY Mar 2009, supported by large write-offs during the year. However, the Company’s gross NPL coverage ratio had improved to 42.64% as at the same date from 36.04% during FY Mar 2008, in line with the dip in absolute NPLs. Senkadagala’s coverage continues to be lower than the industry average (FY Mar 2009: 55.31%) due to its relatively large quantum of seized stocks; in accordance with Central Bank Direction No. 3, RFCs are permitted to deduct collateral value when provisioning for loan losses. Nevertheless, the Company’s net NPL ratio also edged down to 2.11% as at end-FY Mar 2009 (end- FY Mar 2008: 4.14%).

Well-diversified portfolio

RAM Ratings Lanka deems Senkadagala’s loan portfolio to be fairly well diversified. The 10 largest loans accounted for less than 2% of the total loan portfolio. Further, 38.36% of the Company’s loans represent exposures of less than LKR 1 million thereby minimising concentration risk. Further, Senkadagala’s sectoral loan exposure remains moderate, with 85% of the loan base concentrated in the four main sectors of manufacturing, transport, trade and miscellaneous segment.

Limiting loan exposure

On a separate note, the Company had acted to limit its loan exposure by curbing the loan-to-value ratio on its HP portfolio to an average 59% (as at end-June 2009) from an average 65% (as at FY Mar 2009). Further, Senkadagala has cut back on the financing of Chinese vehicles, which have a weak second-hand market.

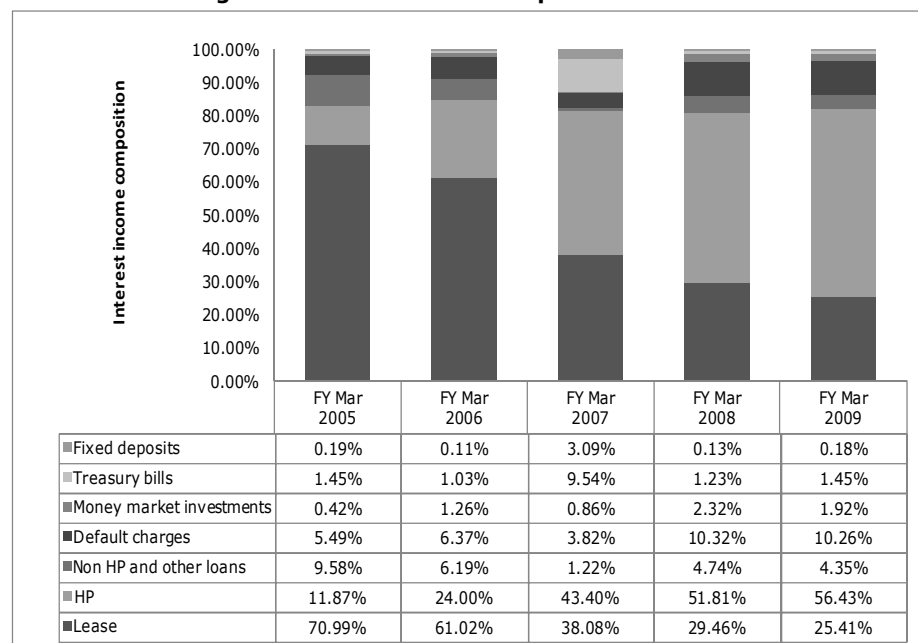
Moderate performance

Senkadagala’s performance had crimped during the reviewed period- affected by the macro economic conditions and weakened asset quality; however RAM Ratings Lanka still considers the Company’s performance to be moderate. Looking ahead, we anticipate the Company’s performance to ameliorate marginally from its current levels and remain above industry. However, a drastic improvement is unlikely in the short term given Senkadagala’s shrinking loan books and weakening asset quality.

Expanding interest income

Notwithstanding the sluggish loan base expansion, the Company’s interest income augmented 23.83% y-o-y to LKR 1.56 billion in FY Mar 2009. The expansion of interest income continued to be driven by the HP portfolio; interest from HP spiked 34.87% y-o-y to LKR 880.31 million during FY Mar 2009. Despite the contraction in its lease portfolio, interest income from leasing widened 6.80% y-o-y to reach LKR 396.45 million, supported by elevated interest rates during the reviewed period. As such, the composition of interest income continued to tilt more towards HP while the importance of the lease portfolio continued to diminish during the reviewed period (refer to Chart 4).

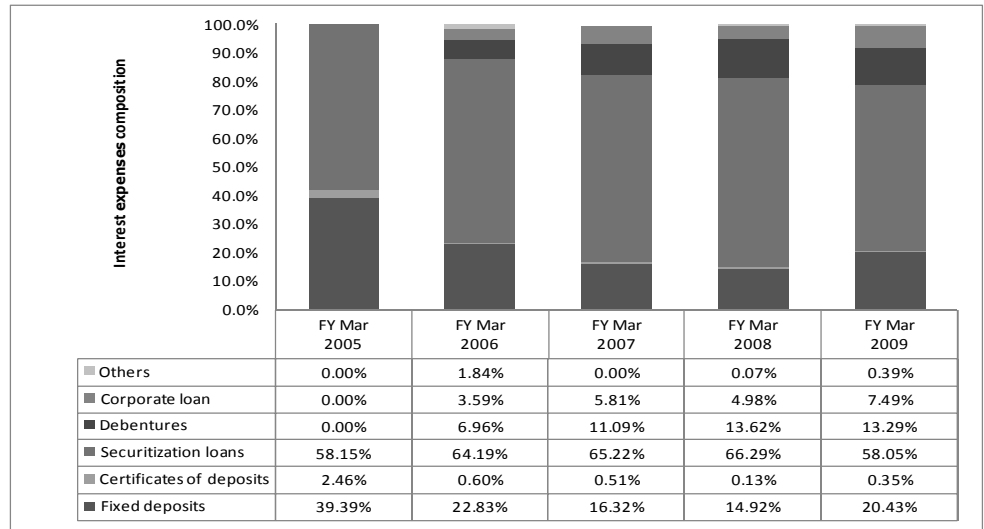
Chart 4: Senkadagala’s interest income composition



Heightened interest expenses

At the same time, Senkadagala’s interest expenses jumped 39.35% y-o-y (or LKR 263.17 million) during FY Mar 2009, mainly in view of the high interest rates that prevailed during the reviewed period, coupled with an enlarged deposit base. We note that interest on fixed deposits grew 90.77% y-o-y against a 47.77% expansion in the fixed deposit base. As a result the Company’s interest expenses had tilted towards deposit interest expenses; nevertheless, interest on securitised borrowings continued to dominate the interest expense composition (refer to Chart 5).

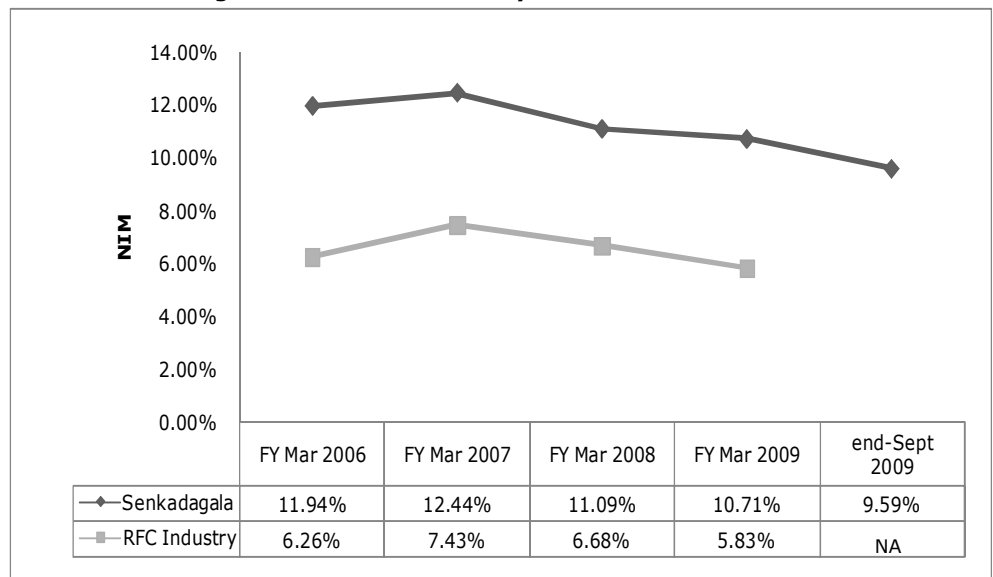
Chart 5: Senkadagala’s interest expenses composition



NIM better than industry

In line with the escalated interest expenses during the reviewed period, Senkadagala’s net interest income grew only 6.27% y-o-y, while the net interest margin (“NIM”) had edged lower to 10.71% as at end-FY Mar 2009 (end-FY Mar 2008: 11.09%) and further to 9.59% as at end-September 2009. Nevertheless, the Company’s NIM continued to compare better than the industry average of 5.83% as at end-FY Mar 2009 (refer to Chart 6).

Chart 6: Senkadagala’s NIM vs the industry



Losses in disposing seized vehicles

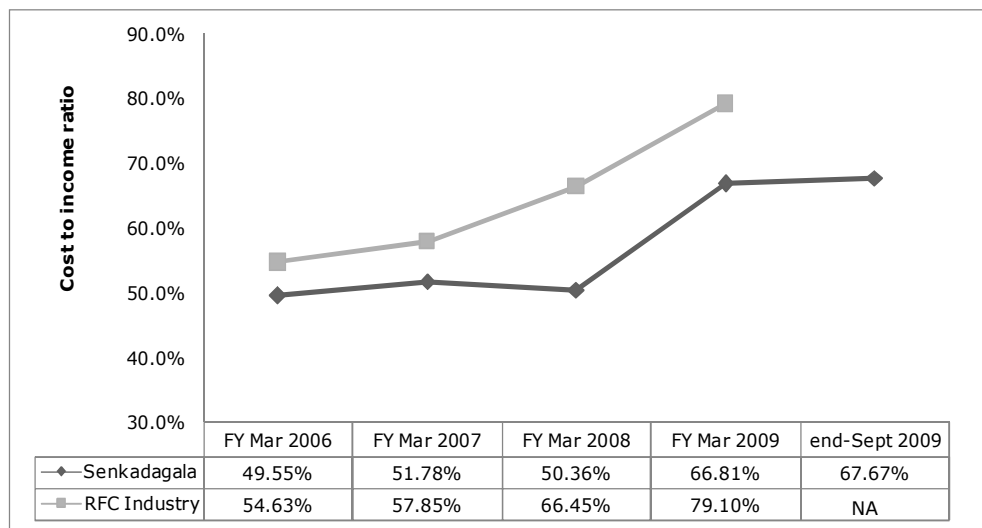
Elsewhere, non-interest-income declined by a sharp 70.11% y-o-y (or LKR 51.25 million) due to losses incurred on the sale of seized vehicles; these losses spiked to LKR 62.04 million during the reviewed period, compared to losses of LKR 8.22

Increased cost-to income ratio

million recorded in FY Mar 2008. Given the increase in seized stocks to LKR 234.71 million as at end-November 2009, RAM Ratings Lanka remains concerned with regard to the potential impact these future losses may have on the Company’s bottom line. Meanwhile, contributed by the drop in non-interest-income, the Company’s gross income dipped to LKR 650.07 million during FY Mar 2009 (FY Mar 2008: 664.26 million).

Senkadagala’s total overhead costs (excluding provisions) increased 29.82% y-o-y (or LKR 99.75 million) during FY Mar 2009. This escalation in costs was driven by increased administration and establishment expenses. In line with the escalated overhead costs and contraction in gross income, Senkadagala’s cost to income ratio advanced to 66.81% during the reviewed period, up from 50.36% the previous year. Nevertheless, it remains better than the industry average of 79.10% as at the same date (refer to Chart 7). Prospectively, RAM Ratings Lanka expects Senkadagala’s cost-to-income ratio to improve in the medium term given the Company has no immediate branch expansion plans, and contributions from the recently added branches are set to accelerate.

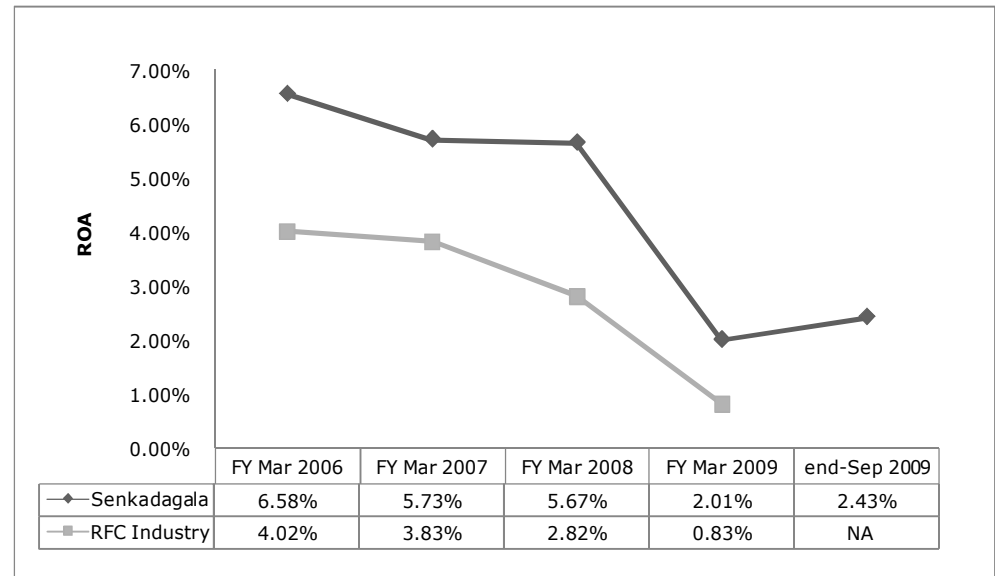
Chart 7: Senkadagala’s cost-to-income ratio vs the industry



ROA-stronger than industry

Meanwhile, in line with the escalation of new NPLs during the reviewed period, the Company’s provision charge for the year increased by LKR 70.50 million to LKR 97.96 million. As a result, Senkadagala’s pre-tax profit declined 61.02% y-o-y to LKR 117.82 million; this translated to an ROA of 2.01% as at end-FY Mar 2009 (FY Mar 2008: 5.67%). However, the Company’s ROA continues to be better than the industry average, which fell to 0.83% at the same date (refer to chart 8).

Chart 8: Senkadagala’s ROA vs the industry



Funding & Liquidity

The Company’s funding base is still dominated by collateralised borrowings; this had enabled Senkadagala to withstand the impact of sudden deposit withdrawals and liquidity pressures which had affected several industry peers. Nevertheless, we note that the reliance on securitised and bank borrowings expose Senkadagala to refinancing and liquidity risks. That said, we note an improvement in the funding structure with declining reliance on collateralised borrowings.

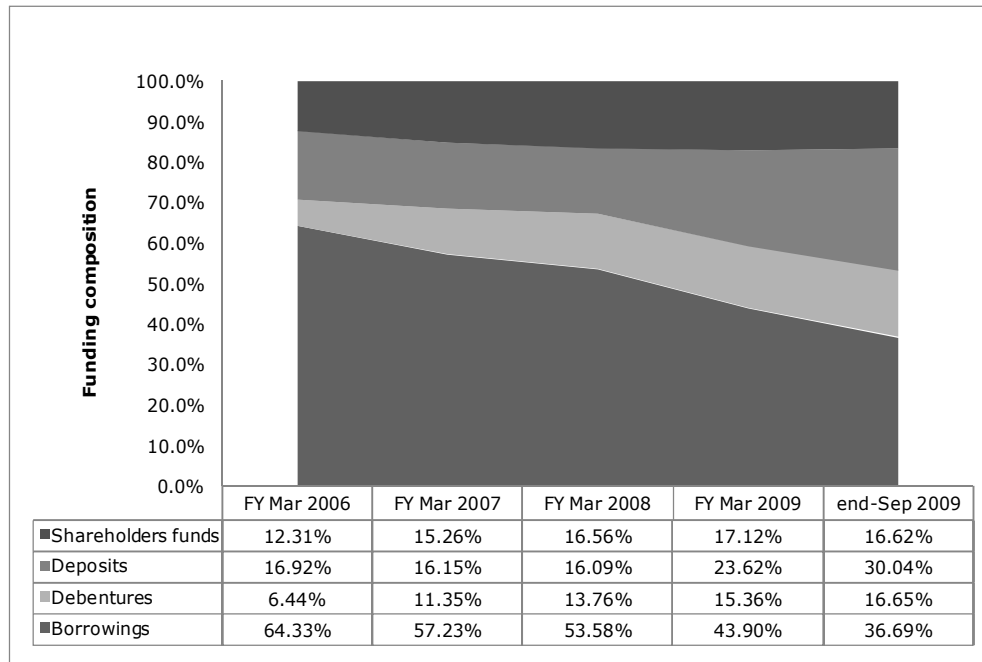
The Company’s secured borrowings dipped from LKR 2.92 billion as at end-FY Mar 2008 to to LKR 2.40 billion as at end-FY Mar 2009, while falling further to LKR 1.06 billion by end-November 2009. By the end of the reviewed period, LKR 4.91 billion of the Company’s HP and lease receivables had been pledged. While the reliance on borrowings had enabled the Company to withstand the liquidity pressures arising from sudden deposit withdrawals, we note that it also exposes Senkadagala to refinancing risks. As such, a lumpy repayment amounting to LKR 636.88 million is due in 2013. Additionally, Senkadagala’s bank borrowings amounted to LKR 940.43 million by end-November 2009 out of which 43.70% constituted borrowings from one bank. Despite the Company’s relatively good liquidity levels, these bank borrowings expose the Company to liquidity risks. The banks reserve the right to recall the loans and due to the high level of concentration in the borrowings, the Company may be faced with liquidity pressures in the event that the borrowings are recalled.

Meanwhile, Senkadagala’s deposit base expanded 47.26% y-o-y to reach LKR 1.29 billion as at end-FY Mar 2009 (vs industry deposit growth of 14.30%) and grew further to LKR 1.73 billion as at end-September 2009. As a result, Senkadagala’s funding structure has tilted increasingly towards deposits, which account for a near 23.62% of total funding, while the proportion of collateralised borrowings to total funding reduced to 43.90% as at end-FY Mar 2009 (refer to Chart 9). RAM Ratings Lanka notes that Senkadagala’s deposit concentration is moderate; the top 20 depositors accounted for 13.67% of its total deposit liabilities as at end-FY Mar 2009. Further, the Company’s geographical deposit concentration remains somewhat high, with 55.10% of deposits clustered in the Kandy district.

Dominated by borrowings

Increased focus on deposits

Chart 9: Senkadagala’s funding mix



Debenture issue

At the same time, the Company had issued LKR 240.00 million of unlisted unsecured redeemable debentures during FY Mar 2009. These debentures have a 5-year tenure and a fixed interest rate of 16.00% per annum. During the reviewed period, the Company also repaid LKR 150.00 million of outstanding listed debentures. Consequently, Senkadagala’s total outstanding debentures amounted to LKR 840.00 million as at end-FY Mar 2009.

Improved ALMM

Meanwhile, we note an improvement in Senkadagala’s asset liability maturity mismatch (“ALMM”), particularly in the ‘up to 3 months’ bucket. This has been supported by the settlement of secured borrowings during the reviewed period (refer to Table 2). The Company’s statutory liquidity ratio fell to 28.34% as at end-FY Mar 2009 (FY Mar 2008: 57.03%) due to the augmentation of its deposit base; nevertheless the ratio remains well above the regulated minimum of 10% and the industry average of 19.99% as at the same date.

Table 2: Senkadagala’s asset liability maturity mismatch

	FY 2008				FY 2009			
	< 3 months	3-12 months	1-3 years	Over 3 years	< 3 months	3-12 months	1-3 years	Over 3 years
Interest earning assets	429	1,703	1,403	1,138	589	1,395	1,979	774
Interest bearing liabilities	(629)	(1,608)	(1,645)	(727)	(391)	(1,801)	(1,946)	(501)
Gap	(199)	95	(242)	410	198	(406)	32	273
Gap as a % of interest earning assets	-46.46%	5.60%	-17.25%	36.08%	33.65%	-29.10%	1.64%	35.29%

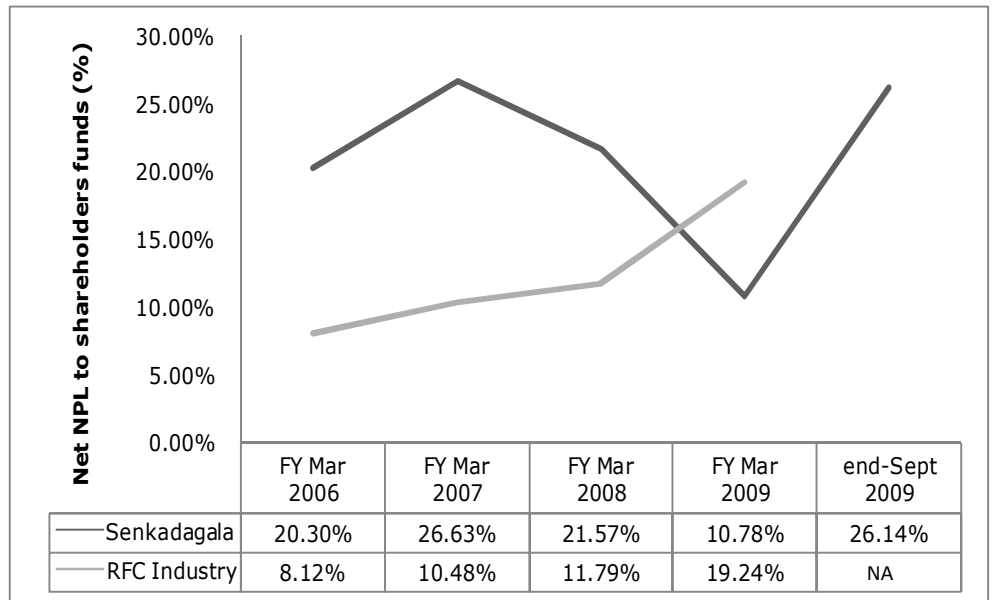
Adequate capitalization

Capital Adequacy

RAM Ratings Lanka deems Senkadagala’s capitalisation to be adequate. The Company’s Tier 1 and overall RWCAR clocked in at 16.82% as at end-FY Mar 2009 (FY Mar 2008: 16.84%), well above the regulated minimums of 5% and 10% respectively. The Company’s healthy internal capital generation had fortified its capitalisation in the previous years; however, in line with its deteriorated performance during FY Mar 2009, Senkadagala’s internal rate of capital generation decelerated to 3.65% during the reviewed period (FY Mar 2008: 27.40%).

Parallel to the loan write-offs during the reviewed period , the Company’s net NPL to shareholders funds ratio declined from 21.57% last year to 10.78% as at FY Mar 2009 (refer to Chart 10). However, the influx of NPLs in the ensuing 6 months had resulted in the ratio worsening to 26.14% as at end-September 2009.

Chart 10: Senkadagala’s net NPL to shareholders funds vs the industry



Industry Overview

Sri Lanka’s Gross Domestic Product (“GDP”) expanded 1.5% in the first quarter of 2009. Although this pales in comparison to the 6.2% of the previous corresponding period, the slower growth must be seen in the context of the global financial downturn. Not surprisingly, all 3 major sectors of the domestic economy have been hit by the global turmoil.

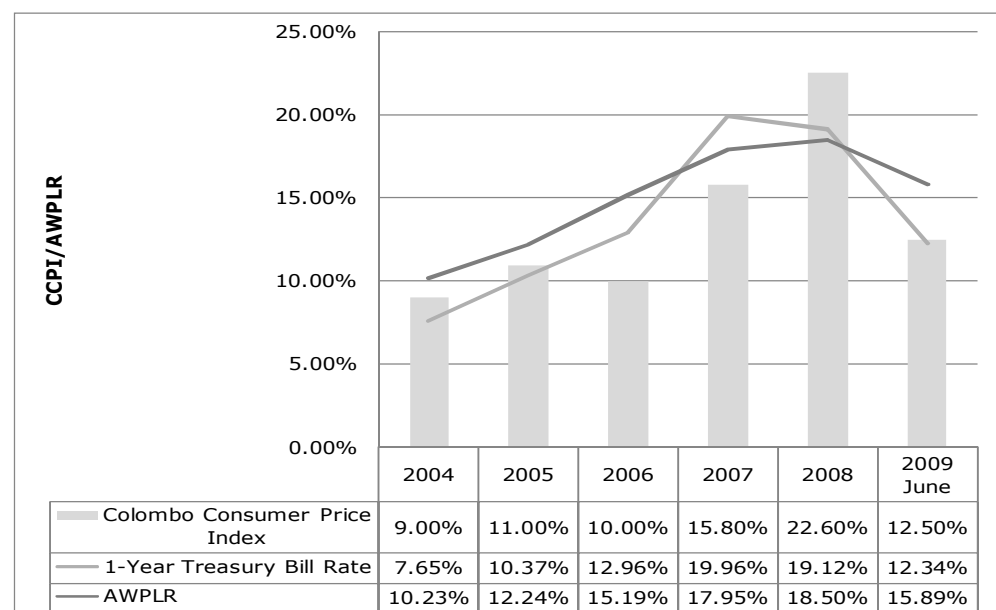
The performance of the primary sectors (agriculture, forestry and fishing) had been dented by the steep fall in tea prices, drought and slumping demand. Although value addition in tea declined 40.9%, this was partially cushioned by the expansion of other food items, including fishing. However, virtually all sub-segments within the industrial and services sectors advanced at a slower pace last year, principally due to weaker export demand (refer to Table 3).

Table 3: Overall and sectoral GDP growth in 1Q 2008 and 1Q 2009

Sector	1Q 2008	1Q 2009
Agriculture, forestry and fishing	5.9%	3.0%
Industry	6.0%	1.9%
Services	6.4%	1.0%
GDP	6.2%	1.5%

On a more positive note, the end of the 25-year war against the separatist Tamil Tigers has spawned renewed hope for the country. Additionally, the country’s long-awaited USD 2.5 billion stand-by facility from the International Monetary Fund (“IMF”) is expected to elevate the nation’s sorely depleted foreign-exchange reserves. Moreover, both inflation (as measured by the Colombo Consumer Price Index) and interest rates, which peaked in 2008, have been easing consistently since early 2009 (refer to Chart 11). While this augurs well for the domestic economy, sluggish export demand is still a concern. The tapering interest rates follow the Central Bank’s reversal of its tight monetary policy.

Chart 11: Inflation and interest rates



In the context of the financial-services industry, the collapse of 2 unregulated financial institutions relatively recently had triggered a crisis of confidence among depositors. However, the contagion effects of the collapse had been halted by the Central Bank. The regulator’s timely move of vesting the vulnerable Ceylinco-related institutions to state-owned or state-linked enterprises had helped avert a full-blown crisis. Concurrently, there have been changes in ownership, which RAM Ratings Lanka considers positive on the whole.

On a broader note, RFCs’ main revenue spinner is vehicle financing, where they compete with commercial banks. Although commercial banks have a cost advantage as their cost of funds is much lower, RFCs cater to small and medium-scale businesses as well as micro-businesses that fall outside the banks’ risk appetite. Hence, this segment is considered sub-prime. Although RFCs have been encouraged to finance machinery and equipment, most of them still focus entirely on vehicle financing due to lack of expertise and difficulties in legally seizing these assets.

Meanwhile, RAM Ratings Lanka observes that RFCs’ lack of extensive branch networks presents a challenge when trying to expand their portfolios while maintaining asset quality. RFCs are generally hindered by asset-quality issues as geographical concentration and intense competition result in financing a more risky segment. In view of the expected improvement in the economic climate and enhanced regional growth, however, we expect some RFCs to take advantage of these opportunities. Although this would entail heightened operational risk, we note that some financial institutions have already gained experience in managing such risks.

Despite easing inflation and interest rates, RFCs are still reeling from the effects of a weakened economy. With the resumption of economic activity, however, the industry’s asset quality is expected to chart a healthy recovery. RAM Ratings Lanka’s interaction with industry players reveals that recoveries and collections are still high on the agenda. Although we anticipate asset quality to weaken in the short term, the industry’s asset-quality indicators are envisaged to improve over the medium term.

Elsewhere, RFCs that extensively deal in real estate still face liquidity issues arising from subdued demand. Going forward, RAM Ratings Lanka expects these companies to revisit their business models and craft strategies that will provide greater agility.

In the interim, RAM Ratings Lanka expects the industry’s overall profit performance to come under pressure from slower loan growth. Nonetheless, this is expected to be a short-term phenomenon; the sector’s profitability is expected to bottom out in 2009. This view is anchored by our expectations vis-à-vis interest-rate trends and economic recovery.

At present, the country’s leading RFCs are flushed with liquidity due to slower loan growth and augmenting deposits. Public confidence, which had ebbed in the first quarter of this year, is now staging a comeback. Apart from improving liquidity, the industry’s funding structure - although improving - is still fragile. RFCs continue to rely on bank funding, which poses an additional liquidity risk. Over the medium and long term, however, RAM Ratings Lanka expects the industry’s funding structure to weaken further as RFCs resort to bank borrowings to expand their loan books.

From a regulatory perspective, the industry's capital-adequacy levels are deemed adequate as they are able to support about a 40% asset growth. However, RAM Ratings Lanka notes that the current capital-adequacy framework does not capture the entire spectrum of risks inherent in RFCs.

On a more positive note, RAM Ratings Lanka welcomes the regulator's emphasis on risk management and improved transparency. In this regard, the Central Bank has set a direction on corporate governance. Moreover, the regulator has also proposed that all RFCs be listed by June 2011 (pending formal regulation). Although these directions will be disconcerting to some market participants, RAM Ratings Lanka believes that the industry as a whole will benefit over the long haul.

Relevant Central Bank Directions Applicable to Registered Finance Companies

<p><i>Liquid assets</i></p>	<p>Every finance company must have a minimum holding of liquid assets at any given time. Liquid assets mean:</p> <ol style="list-style-type: none"> a) Cash in hand. b) Balances in a current or deposit account in a commercial bank, free from any banker’s lien or charge. c) Sri Lankan Government Treasury Bills, free from any charge or lien. d) Sri Lankan Government Securities maturing within 1 year and free from any charge or lien. e) Central Bank securities maturing within 1 year and free from any charge or lien. f) Cash balance, if any, maintained with the Central Bank. <p>The minimum limits are as follows:</p> <ol style="list-style-type: none"> 1. For time deposits, 15% of outstanding deposits. 2. For certificates of deposits, 15% of the face value of the certificates. 3. For savings deposits, 20% of the outstanding deposits. <p>The companies should maintain the liquid assets in the form of (c), (d) and (e) above, equivalent to 10% of its average month-end deposit liabilities of the preceding financial year.</p>
<p><i>Provision of bad and doubtful debts</i></p>	<p>Every finance company had been required to follow either one of the following directions on provisioning for bad and doubtful debts until 1 April 2007:</p> <p><u>Direction No. 1 of 1991</u></p> <p>Bad and doubtful debts provided for under this direction are subject to a minimum of:</p> <ol style="list-style-type: none"> a) 50% of all advances in arrears for a period of 7 to 12 months. b) 100% of all advances in arrears for 13 months or more. <p>A company may deduct the value of land and buildings held as collateral for a particular advance, in arriving at the provision figure under both (a) and (b) above, subject to the following conditions:</p> <ol style="list-style-type: none"> 1. The value so deducted should not exceed the value decided by a professional valuer at the time of granting the advance. 2. In the case of residential properties occupied by the borrower or a tenant, there should be an agreement to grant vacant possession in the event of the sale of such property. <p><u>Direction No. 2 of 1991</u></p> <p>Bad and doubtful debts provided for under this direction are subject to a minimum of:</p> <ol style="list-style-type: none"> a) 50% of all advances in arrears for a period of 12 to 24 months. b) 100% of all advances in arrears for more than 24 months. <p>A new directive came into effect on 1 April 2007 (Direction No. 3 of 2006); this is very similar to Direction 1. However, Direction 3 requires all finance companies to follow a more stringent formula in the calculation of collateral value that is deductible for provisioning purposes.</p>

	<p>With effect from 1 April 2007, Direction No. 3 of 2006 will be applicable to every RFC and will replace Directions 1 and 2.</p> <p><u>Direction No. 3 of 2006</u></p> <p>Bad and doubtful debts provided for under this direction are subject to a minimum of:</p> <ul style="list-style-type: none"> (a) 50% of all advances in arrears for a period of 6 to 12 months. (b) 100% of all advances in arrears for 13 months or more. <p>A finance company may deduct the value of the following items held as collateral in arriving at the amount of provisioning;</p> <ol style="list-style-type: none"> 1. Sri Lankan Government securities, free from any lien or charge. 2. Central Bank securities, free from any lien or charge. 3. Time deposits in a licensed commercial bank, specialised bank or RFC, free from any lien or charge. 4. Bank guarantees. 5. With regard to repossessed vehicles and machinery, 80% of the valuation obtained in the preceding 6 months and by an approved valuer. 6. With regard to mortgaged land and buildings that are held as collateral, if the accommodation has been in arrears for a period of: <ul style="list-style-type: none"> a) 6-36 months, 100% of the value is deductible b) 37-60 months, 80% of the value is deductible c) 61-120 months, 50% of the value is deductible d) more than 120 months, 0% of the value is deductible
<p>Capital adequacy</p>	<p>Every finance company must maintain a minimum total risk-weighted capital-adequacy ratio of 10% in relation to its risk-weighted assets. The constituents of the capital are divided into:</p> <ul style="list-style-type: none"> (a) Tier I - Core Capital <p>This represents permanent shareholders' equity and reserves created or increased by appropriation of retained earnings or other surpluses, including share premiums, retained profits and other reserves. The core-capital ratio should constitute not less than 50%, i.e. this has to be at least half, of the total risk-weighted capital-adequacy ratio.</p> <ul style="list-style-type: none"> (b) Tier II - Supplementary Capital <p>Represents revaluation reserves, general provisions and other capital instruments which combine certain characteristics of equity and debt, such as hybrid capital instruments and unsecured subordinated debts. Supplementary capital should not exceed 100% of the core capital.</p> <p>The Central Bank also issues guidelines from time to time, to be used in computing total risk-weighted assets.</p>
<p>Single-borrower limit</p>	<p>In the case of an individual borrower, the maximum of a single advance or the aggregate of advances granted to, and the aggregate outstanding at any time on advances granted to, should not exceed 10% of the capital funds of the finance company.</p> <p>This limit stands at 15% for any group of corporate or unincorporated borrowers with common directors or common partners or common proprietors.</p> <p>Capital funds generally mean paid-up capital and permanent free reserves, and may include unsecured debentures and other loan stocks if approved by the Monetary Board.</p>

<p>Minimum core-capital requirement</p>	<p>Every finance company must at all times maintain an unimpaired core capital of LKR 200 million. However, companies that could not meet this requirement by February 2006 had been granted a 30-month extension, subject to the following:</p> <p>(c) A finance company with a core capital of less than LKR 100 million must:</p> <p>enhance its core capital to at least LKR 100 million by February 2007; and bring the remaining LKR 100 million or the deficit up to the core-capital requirement of LKR 200 million by July 2008.</p> <p>(d) A finance company with a core capital of between LKR 100 million and LKR 200 million must bring in:</p> <p>at least 50% of the deficient amount to meet the core-capital requirement of LKR 200 million by February 2007; and the balance of the deficient amount up to the core capital requirement of LKR 200 million by July 2008.</p>
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Corporate Information

Date of Incorporation: 29 December 1968

Commencement of Business: 1968

Major Shareholders:

EW Balasuriya & Co (Pvt) Ltd	58.9%
Mr EW Balasuriya	0.08%
Mr L Balasuriya	6.56%
Dr A Balasuriya	6.56%
Mr R Balasuriya	6.56%
Dr M Balasuriya	6.56%
Dr Gayatri Madan Mohan	6.56%
Mrs L Fernando	5.47%

Directors:

Mr SK Wickremasinghe	Chairman
Mr L Balasuriya	Chief Executive Officer/Director
Mr EW Balasuriya	Director
Dr A Balasuriya	Director
Mr R Balasuriya	Director
Dr M Balasuriya	Director
Dr Gayatri Madan Mohan	Director
Mrs L Fernando	Director
Mr LGC Herath	Director

Auditor: KPMG Ford, Rhodes, Thornton & Co

Listing: Not listed

Key Management:

Mr L Balasuriya	Chief Executive Officer
Mr Lalith de Alwis	Deputy Chief Executive Officer
Mr P Ikiriwatte	General Manager
Mr JK Jayatileke	Assistant General Manager - Operations
Mr K Aturupana	Assistant General Manager - Accounts
Mr Timothy de Silva	Assistant General Manager - IT
Mr S Supramaniam	Manager, Treasury

Major Subsidiaries and Associates: Hotel Casamara (associate company)

Capital History:

Year	Remarks	Amount (LKR million)	Cumulative Total (LKR million)
1969	Ordinary share capital	0.23	0.23
1976	Share issue	0.001	0.23
1981	Share issue	0.03	0.26
1984	Share issue	0.12	0.38
1990	Rights issue	3.05	3.43
1990	Bonus issue	1.91	5.34
1994	Bonus issue	5.33	10.67
1998	Bonus issue	21.35	32.02
2004	Bonus issue	21.35	53.37
2005	Bonus issue	160.10	213.47

Financial Summary - Company

BALANCE SHEET (LKR Million)	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	30-Sep-09
ASSETS					
Cash & Money At Call	381.26	307.21	417.43	234.52	177.06
Deposits & Placements With Financial Institutions	0.00	0.00	0.00	0.00	499.21
Securities Purchased Under Resale Agreements	0.00	0.00	0.00	0.00	0.00
Securities					
Dealing Securities	73.94	92.32	110.18	159.58	186.08
Investment Securities	0.21	0.21	0.21	0.21	0.00
Gross Loans & Advances	3,379.17	4,052.30	4,814.15	4,851.19	4,470.81
Interest-In-Suspense	0.00	0.00	0.00	0.00	0.00
General Loan Loss Reserves	4.41	0.00	0.00	0.00	0.00
Specific Loan Loss Reserves	0.00	73.26	109.77	75.08	83.90
Net Loans & Advances	3,374.76	3,979.04	4,704.39	4,776.10	4,386.91
Investments in Subsidiaries/Associates	13.96	13.96	13.96	13.96	0.00
Investment Land and Properties	0.00	0.00	0.00	0.00	0.00
Other Assets	215.48	194.40	260.03	280.93	448.03
Property, Plant and Equipment	139.76	206.85	359.63	401.97	384.14
TOTAL ASSETS	4,199.36	4,794.00	5,865.81	5,867.27	6,081.42
LIABILITIES					
Customer Deposits					
Savings	0.00	0.00	19.32	41.18	46.53
Fixed	639.56	699.65	864.90	1,278.10	1,682.84
NIDs	17.33	24.69	12.47	13.91	2.16
Interbank Deposits	0.00	0.00	0.00	0.00	0.00
Bills & Acceptances Payable	0.00	0.00	0.00	0.00	0.00
Securities Sold Under Repurchase Agreements	0.00	0.00	0.00	0.00	0.00
Other Borrowing	2,497.59	2,566.48	2,921.21	2,401.08	2,114.80
Subordinated Debt & Hybrid Capital	250.00	509.00	750.00	840.00	960.00
Other Liabilities	316.84	309.68	394.90	356.40	316.78
TOTAL LIABILITIES	3,721.32	4,109.50	4,962.80	4,930.67	5,123.11
Paid-up Capital	213.47	213.47	213.47	213.47	213.47
Minority Interest	0.00	0.00	0.00	0.00	0.00
Share Premium & Other Reserves	275.70	405.70	603.02	638.02	638.02
Statutory General Reserve	43.59	61.03	79.54	83.54	83.54
Retained Profits/(Loss)	(54.73)	4.31	6.99	1.57	23.28
Total Shareholders' Funds	478.03	684.50	903.02	936.60	958.31
TOTAL LIABILITIES & SHAREHOLDERS' FUNDS	4,199.36	4,794.00	5,865.81	5,867.27	6,081.42
COMMITMENTS & CONTINGENCIES	0.00	0.00	0.00	0.00	0.00
TIER 1 CAPITAL	478.04	684.50	900.56	900.56	936.56
CAPITAL BASE	478.04	684.50	900.56	900.56	936.56

Financial Summary - Company

INCOME STATEMENT (LKR Million)	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	30-Sep-09
Interest Income	645.33	1,058.87	1,259.89	1,560.12	727.41
Less: Amortisation Of Premium/(Accretion Of Discount)	0.00	0.00	0.00	0.00	0.00
Less: Net Interest Suspended	0.00	0.00	0.00	0.00	0.00
Less: Interest Expense	268.69	499.47	668.74	931.90	440.90
Net Interest Income	376.64	559.40	591.16	628.22	286.51
Non-Interest Income	60.23	92.02	73.11	21.85	40.97
Gross Income	436.87	651.42	664.26	650.07	327.48
Personnel Expenses	49.98	81.10	100.20	110.84	57.74
Other Non-Interest Expenses	166.48	256.20	234.34	323.45	163.85
Loan Loss Provisions	13.04	56.37	27.47	97.96	33.35
Share of results of Associated Companies	0.00	0.00	0.00	0.00	0.00
Pre-Tax Profit	207.37	257.75	302.25	117.82	72.53
Taxation	(6.52)	(31.12)	15.04	52.22	33.74
Profit After Tax	213.89	288.87	287.21	65.60	38.79
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Prior Year Adjustments	(64.25)	0.00	0.00	0.00	0.00
Minority Interests	0.00	0.00	0.00	0.00	0.00
Transfer To Statutory Reserves	16.52	17.43	18.51	4.00	0.00
Transfer To Other Reserves	163.80	130.00	197.32	35.00	0.00
Dividend	37.89	82.40	69.70	32.02	0.00
Retained Profit For The Year	(68.57)	59.03	1.68	(5.42)	38.79

Financial Ratios - Company

KEY RATIOS (%)	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	30-Sep-09
Profitability					
Net Interest Margin	11.94%	12.44%	11.09%	10.71%	9.59%
Non-Interest Income Margin	1.91%	2.05%	1.37%	0.37%	1.37%
Cost To Income	49.55%	51.78%	50.36%	66.81%	67.67%
Return On Assets	6.58%	5.73%	5.67%	2.01%	2.43%
Return On Equity	49.12%	44.34%	38.08%	12.81%	15.00%
Dividend Payout	17.72%	28.53%	24.27%	48.81%	0.00%
Asset Quality					
Gross NPL Ratio ^R	2.87%	6.31%	6.33%	3.63%	8.03%
Net NPL Ratio ^R	2.87%	4.58%	4.14%	2.11%	6.27%
Gross NPL Coverage ^R	4.55%	28.67%	36.04%	42.64%	23.38%
Loan Loss Reserve Coverage	0.13%	1.81%	2.28%	1.55%	1.88%
General Loan Loss Reserve Coverage	0.13%	0.00%	0.00%	0.00%	0.00%
Liquidity & Funding					
Liquid Asset Ratio	53.88%	55.16%	58.84%	29.56%	49.80%
Statutory Liquid Asset Ratio	68.97%	53.46%	57.03%	28.34%	47.98%
Customer Deposits To Total Interest Bearing Funds	19.29%	19.06%	19.63%	29.15%	36.03%
Loans To Deposits Ratio	513.75%	549.34%	524.64%	358.25%	253.35%
Loans To Stable Funds Ratio	90.40%	93.33%	92.29%	93.74%	81.53%
Capital Adequacy					
Shareholders' Funds To Total Assets	11.38%	14.28%	15.39%	15.96%	15.76%
Tier 1 Risk Weighted Capital Adequacy Ratio	12.78%	15.56%	16.84%	16.82%	18.01%
Overall Risk Weighted Capital Adequacy Ratio	12.78%	15.56%	16.84%	16.82%	18.01%
Internal Rate Of Capital Generation	41.69%	35.52%	27.40%	3.65%	8.02%

Note :

* annualised

NA = Not available / Not applicable

R = Restated (refer Asset Quality)

Financial Ratios - Company

Ratio Definition:-	
Net Interest Margin	Net Interest Income/Total Average Assets
Non-Interest Income Margin	Non-Interest Income/Total Average Assets
Cost To Income	Personnel & Other Non-Interest Expenses/Net Interest Income & Non-Interest Income
Return On Assets	Pre-Tax Profits/Total Average Assets
Return On Equity	Pre-Tax Profits/Average Shareholders' Funds
Dividend Payout	Dividends/Profit After Tax
Gross NPL Ratio	(Total Non-Performing Loans - Interest-In-Suspense)/(Gross Loans - Interest-In-Suspense)
Net NPL Ratio	(Total Non-Performing Loans - Specific Loan Loss Reserves - Interest-In-Suspense)/(Gross Loans - Specific Loan Loss Reserves - Interest-In-Suspense)
3-months Past Due	3-months Past Due Loans/(Gross Loans - Interest-in-Suspense)
Specific Loan Loss Provisions For Current Year	Specific Loan Loss Provisions(P&L)/Average Gross Loans
Gross NPL Coverage	General & Specific Loan Loss Reserves (B/S)/(Total Non-Performing Loans - Interest-In-Suspense)
Loan Loss Reserve Coverage	General & Specific Loan Loss Reserves (B/S)/(Gross Loans - Interest-In-Suspense)
General Loan Loss Reserve Coverage	General Loan Loss Reserves/(Gross Loans - Interest-In-Suspense - Specific Loan Loss Reserves)
Liquid Asset Ratio	Liquid Assets/Customer Deposits & Short-Term Funds
Statutory Liquid Asset Ratio	Statutory Liquid Assets/Customer Deposits
Loans To Deposits	Net Loans/Customer Deposits
Loans To Stable Funds	Net Loans/(Shareholders' Funds + Total Interest Bearing Funds + General Loan Loss Reserves - Interbank Funding - Fixed Assets - Investments in Subsidiaries/Associates)
Short-Term Funds	Interbank Deposits + Bills & Acceptances + Securities Sold Under Repos
Liquid Assets	Cash & Short-Term Funds + Securities Purchased Under Repos + Deposits & Placements With Financial Institutions + Quoted Securities
Statutory Liquid Assets	Cash & Short-Term Funds + Securities Purchased Under Repos + Deposits & Placements With Financial Institutions + Government Securities and Treasury Bills
Total Interest Bearing Funding	Customer Deposits + Interbank + Bills & Acceptances + Securities Sold Under Repos + Borrowing + Supplementary Capital
Internal Rate Of Capital Generation	Profit After Tax + Extraordinary Income - Dividend + General Loan Loss Provision/Average Shareholders' Funds

CREDIT RATING DEFINITIONS (Financial Institution Ratings)

A Financial Institution Rating ("FIR") is RAM Ratings Lanka's current opinion on the overall capacity of a financial institution to meet its financial obligations. The opinion is not specific to any particular financial obligation, as it does not take in to account the expressed terms and conditions of any specific financial obligation.

Long-Term Ratings

- AAA** A financial institution rated AAA has a superior capacity to meet its financial obligations. This is the highest long-term FIR assigned by RAM Ratings.
- AA** A financial institution rated AA has a strong capacity to meet its financial obligations. The financial institution is resilient against adverse changes in circumstances, economic conditions and/or operating environments.
- A** A financial institution rated A has an adequate capacity to meet its financial obligations. The financial institution is more susceptible to adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories.
- BBB** A financial institution rated BBB has a moderate capacity to meet its financial obligations. The financial institution is more likely to be weakened by adverse changes in circumstances, economic conditions and/or operating environments than those in higher-rated categories. This is the lowest investment-grade category.
- BB** A financial institution rated BB has a weak capacity to meet its financial obligations. The financial institution is highly vulnerable to adverse changes in circumstances, economic conditions and/or operating environments.
- B** A financial institution rated B has a very weak capacity to meet its financial obligations. The financial institution has a limited ability to withstand adverse changes in circumstances, economic conditions and/or operating environments.
- C** A financial institution rated C has a high likelihood of defaulting on its financial obligations. The financial institution is highly dependent on favourable changes in circumstances, economic conditions and/or operating environments, the lack of which would likely result in it defaulting on its financial obligations.
- D** A financial institution rated D is currently in default on either all or a substantial portion of its financial obligations, whether or not formally declared. The D rating may also reflect the filing of bankruptcy and/or other actions pertaining to the financial institution that could jeopardise the payment of the financial obligations.

For long-term ratings, RAM Ratings applies signs plus (+), flat or minus (-) in each category from AA to C. The sign plus (+) indicates that the financial institution ranks at the higher end of its generic rating category; the sign flat indicates a mid-ranking; and the sign minus (-) indicates that the financial institution ranks at the lower end of its generic rating category.

Short-Term Ratings

- P1** A financial institution rated P1 has a strong capacity to meet its short-term financial obligations. This is the highest short-term FIR assigned by RAM Ratings.
- P2** A financial institution rated P2 has an adequate capacity to meet its short-term financial obligations. The financial institution is more susceptible to the effect of deteriorating circumstances than those in the highest-rated category.
- P3** A financial institution rated P3 has a moderate capacity to meet its short-term financial obligations. The financial institution is more likely to be weakened by the effects of deteriorating circumstances than those in the higher-rated category. This is the lowest investment-grade category.
- NP** A financial institution rated NP has a doubtful capacity to meet its short-term financial obligations. The financial institution faces major uncertainties that could compromise its capacity for payment of financial obligations.
- D** A financial institution rated D is currently in default on either all or he D rating may also reflect the filing of bankruptcy and/or other actions pertaining to the financial institution that could jeopardise the payment of the financial obligations.

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