



RATINGS

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

A wholly owned subsidiary of RAM Holdings Berhad – an affiliate of Standard & Poor's

Merchant Bank of Sri Lanka PLC – Rating Review

Financial Institution
Ratings:

Long-term: AA- [Reaffirmed]

Short-term: P1 [Reaffirmed]

Rating Outlook:

Stable

Instruments:

i) LKR300 million unsecured unlisted private debentures (2007/2009)

ii) LKR14.60 million unsecured unlisted public debentures (April 2007/2009)

Ratings

(i) AA- [Reaffirmed]

(ii) AA- [Reaffirmed]

Last Rating Action

October 2007

Coupon Rates:

i) Weighted-average 1-year treasury bill rate, excluding withholding tax + 300 basis points, with a cap of 17% and a floor of 13%.

ii) 3-year secondary-market bond rate before withholding tax + 110 basis points, with a cap of 18% and a minimum fixed rate of 17.9% payable bi-annually and also to be revised bi-annually.

Strengths:

- State-owned parent
- Strong capitalisation
- Improving profitability

Weakness:

- Relatively high level of NPLs
- Relatively hefty borrowing costs

Principal Activities:

Provision of leasing, trade-financing and other merchant banking activities

Summary

RAM Ratings has reaffirmed Merchant Bank of Sri Lanka's ("MBSL" or "the Bank") long- and short-term financial institution ratings at AA- and P1, respectively; the long-term rating has a stable outlook. The ratings are supported by the credit strength and financial flexibility which stem from its parent – the state-owned Bank of Ceylon ("BOC"), the largest commercial bank in Sri Lanka. At the same time, both its LKR300 million Unlisted Private Debentures and LKR14.60 million Unlisted Public Debentures have also been reaffirmed at AA-, with stable outlooks.

MBSL is a 76%-owned subsidiary of BOC, the largest commercial bank in terms total assets. BOC is a sovereign-owned entity that has consistently demonstrated its commitment to MBSL via long- and short-term loans. Although the Bank had intended to raise LKR600 million through 2 debenture issues, it had only managed to raise half that amount due to a lack of investor interest as a result of treasury yields rising above the rate offered by MBSL. Hence in recent times, MBSL has been increasingly relying on short-term loans, underscoring the inherent funding risks in its business model. Short-term debts constituted 30.65% of the Bank's total interest-bearing funds as at the end of FYE 31 December 2007 ("FY Dec 2007") (FY Dec 2006: 20.85%). Nonetheless, the Bank had been able to secure other financing lines on top of the temporary overdraft facility provided by its parent. Moving forward, the Bank intends to apply for a specialised banking license in order to alleviate its funding risk.

The current high interest environment, coupled with MBSL's funding mix, has pushed up its interest costs. As a result, net interest income for FY Dec 2007 only nudged up 3.36% year-on-year ("y-o-y"). Even though MBSL had managed its overheads well, the Bank's cost-to-income ratio still increased marginally as result of provisioning vis-à-vis its portfolio of trading equities.

Meanwhile, the Bank's improving - albeit still weak - asset quality resulted in slightly lower provisions. MBSL's pre-tax profit was lifted 1.52% y-o-y to LKR273.36 million in FY Dec 2007. This translated into a respectable return on assets ("ROA") of 6.68% for the same period, although lower than its record of 7.56% a year earlier. A factor that enables MBSL to keep its ROA at an adequate level is its strong capitalisation. The Bank's shareholders' funds amounted to LKR1.56 billion as at end-FY Dec 2007, resulting in a gearing ratio of 1.59 times, which is deemed conservative.

Analysts:

Prakash Jerome ACMA
(9411) 2503551
prakash@ram.com.lk

Shivanthi Sugathadasa
ACMA, BSc
(9411) 2553089
shivanthi@ram.com.lk

Company Contact:

Priya Thamotheram
FCA, FCMA
Chief Executive Officer
(9411) 2596099
priya@ram.com.lk
Website: www.ram.com.lk

**Subsidiary of
BOC**
**Sri Lanka's first
merchant bank**
**Registered
investment
manager, margin
provider and
underwriter**
Outlook

The stable outlook reflects RAM Ratings' expectation that the Bank continues to improve its asset quality and funding mix. The outlook is also premised on the expectation that its interest coverage does not deteriorate below 1.5 times and its financial performance will remain adequate.

Nevertheless, the ratings may come under pressure should MBSL's interest coverage weaken substantially, along with deterioration in its asset quality or liquidity.

Conversely MBSL's upside rating potential is limited by its dependence on its parent, BOC.

Corporate Profile

In response to a request by the World Bank, BOC had initially established MBSL as its management-consultancy division in 1980, to cater to the advisory needs of the corporate sector. This division was later incorporated as a public limited company – Merchant Bank of Sri Lanka – in 1982; wholly owned by BOC, it was listed on the Colombo Stock Exchange in 1991.

MBSL is the pioneer merchant bank in Sri Lanka. Although its initial focus had been on fee-based merchant-banking activities, it had subsequently changed course to fund-based activities due to limited market scope.

MBSL is registered under the country's Securities and Exchange Commission ("SEC") Act No. 36 of 1987 - as an investment manager, margin provider and underwriter. Apart from the SEC, the Bank is also regulated by the Central Bank of Sri Lanka ("Central Bank") as a registered finance-leasing establishment, under the Finance Leasing Act No. 56 of 2000.

Although lease financing is the mainstay of MBSL, it also offers an assortment of products and services to its clients (refer to Table 1).

Table 1: Products and services offered by MBSL

Leasing and HP	Trade Financing	Corporate Advisory	Capital Market	Corporate Secretarial
Finance leases	Bank guarantees	Loan/equity syndications	Listing/IPOs of equities and debt securities	Company incorporation
Hire-purchase facilities	Cheque discounting	Mergers and acquisitions	Management of mandatory and voluntary offers	Registrar for bonus and rights issues as well as IPOs
Operating leases	Project loans	Company restructuring	Private placements	Share-ledger management
	Real estate	Portfolio management	Underwriting of IPOs	
	Term loans	Margin trading	Securitisation	
	Trade bills	Project financing	Rights/bonus issues	
		Management training and consultancy		

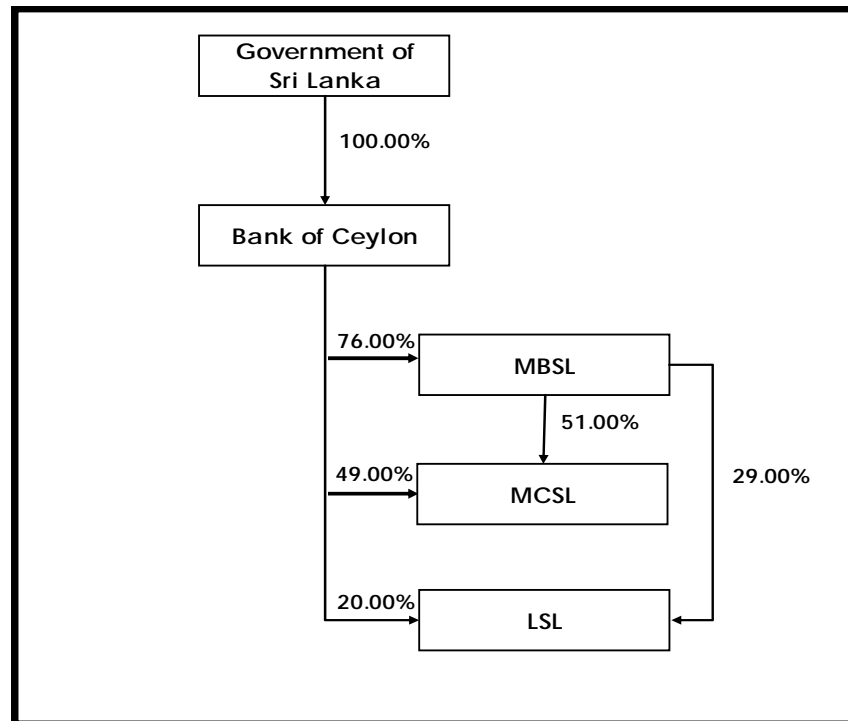
Ratings underscored by parent's strength and support

MBSL currently operates through 5 branches in Galle, Kandy, Kurunegala, Maharagama and Anuradhapura, which are linked to the central system at its head office in Colombo.

Ownership & Financial Flexibility

MBSL's ratings are anchored by the strength of its sovereign-owned parent, BOC - Sri Lanka's largest commercial bank in terms of total assets and branch network. BOC has aided MBSL on numerous occasions; after a capital reorganisation, the parent subscribed for a 1:2 rights issue in FY Dec 2005. In FY Dec 1996, BOC funded an LKR1.75 billion 3-year debenture which, at that time, had constituted 30% of the Bank's funding requirements. Additionally, MBSL enjoys an LKR500 million funding line that includes term loans, money-market loans, and temporary as well as permanent overdrafts from BOC. Further, the National Treasury has also renewed the guarantee granted on loans obtained by MBSL amounting to LKR 830 million.

Chart 1: Group structure



Owns 51% of Merchant Credit of Sri Lanka

Merchant Credit of Sri Lanka ("MCSL") a registered finance company, is a 51%-owned subsidiary of MBSL; the other 49% is held by BOC. This subsidiary is engaged in leasing, HP, loans, real estate and acceptance of public deposits. As at end-FY Dec 2007, MCSL's assets amounted to LKR2.41 billion; it reported a pre-tax profit of LKR50.99 million for the year (FY Dec 2006: LKR40.19 million).

Holds 29% of Lanka Securities Limited

Lanka Securities Limited ("LSL"), a registered stockbroker, is an associate of MBSL. The Bank owns 29% of LSL's equity while another 20% is held by BOC and 51% is controlled by First Capital Securities Corporation Limited of Pakistan. In FY Dec 2007, MBSL subscribed for LSL's rights issue, thus maintaining its equity stake. As at end-FY Dec 2007, LSL's total assets came up to LKR312.20 million, with a pre-tax profit of LKR26.70 million for the year (FY Dec 2006: LKR38.05 million).

Management & Strategies

MBSL's management team continues to be led by Mr Gamini Karunathilake. He had previously been the Bank's Chief Operating Officer, before being designated Chief Executive Officer in 2007.

In pursuit of a specialized banking license

In view of the high interest rate environment and keener competition in the financial-services sector, MBSL is forging ahead with its plans to transform its business model; accordingly, it intends to apply to become a specialised bank. Nonetheless, the expansion of its branch network has slowed down; the Bank intends to open only 1 mini branch in Colombo over the next 3 months.

Focused on business expansion while tightening monitoring

At the same time, the management team is focusing on expanding the Bank's loan portfolio, with added emphasis on tightening monitoring and collections. The management is in the process of developing its management information system ("MIS"), for early identification of possible delinquencies. Hence, loan monitoring is expected to be more stringent. To complement early-warning signals, the management has increased the accountability of front-line staff. Following from this, the Bank's loan portfolio has now been segregated and its performance is linked to the staff that originated it. Although RAM Ratings has a positive view of these initiatives, credit will only be accorded when they yield sustainable results that are reflected in the Bank's financials.

Fee-based revenue on the cards

We note that the general economic and security situations of Sri Lanka have been dampening business sentiments. In spite of this, MBSL has been mandated for 4 initial public offerings ("IPOs"). Nonetheless, these mandates may not be finalised in 2008 if investor sentiments remain dull. Mindful of the subdued operating environment, the management has adopted a conservative short-term strategy for its trading portfolio, to minimise possible gains and losses.

Corporate Governance

Despite frequent Board changes, MBSL has maintained its business focus. Dr Gamini Wickremasinghe, appointed Chairman in 2007, has resigned to in favour of Mr Janaka Ratnayake. However, Dr Wickremasinghe is still the Chairman of BOC.

New Chairman

Meanwhile, the new Chairman assumes executive duties. Mr Ratnayake is also the Chairman and Managing Director of Computer Island (Pvt) Ltd, a computer-hardware vendor and maintenance provider. Mr Ratnayake was named *Entrepreneur of the Year 2000*, conducted under the aegis of the Federation of Chambers of Commerce and Industry of Sri Lanka.

The 7-member Board convened 10 times in 2007. The Board comprises 3 nominees of BOC and 4 independent directors. These directors are assisted by 6 committees: Audit, Credit, Purchasing, Incentive, Training and Investment.

In the meantime, RAM Ratings does not have any concerns about related-party transactions as the disclosed dealings are deemed to be at arm's length by its auditors.

Asset Quality

Efforts to improve asset quality will be tested by lofty interest rates

RAM Ratings opines that MBSL's asset quality is improving, albeit still weak as its NPLs are still higher than the industry's. Although we acknowledge the management's initiatives to further enhance the Bank's asset quality, we also note that MBSL will be challenged by the currently lofty high interest rates. As such, any deterioration in its asset quality may exert downward pressure on its ratings.

Change in balance sheet

The Bank's asset base augmented 22.15% y-o-y to LKR4.42 billion as at end-FY Dec 2007. Following this, its balance sheet composition has changed as investment properties - consisting of land and buildings for the purpose of trading - increased from 3.00% of its total assets as at end-FY Dec 2006 to 7.69% a year later. Meanwhile, gross loans, which had previously constituted 95.69% of the Bank's balance sheet, contracted to 90.34% over the same period. Even though other current assets decreased by LKR17.69 million, MBSL's portfolio of treasury bills appreciated by LKR41.74 million.

Elsewhere, MBSL's equity trading portfolio also contracted from LKR73.83 million to LKR65.30 million over the same period. Although the Bank may increase its exposure to up to LKR100 million, RAM Ratings expects any gains or losses to be minimal due to the management's trading strategy. Moreover, its current portfolio contains fairly liquid stocks.

Disposal of investment property

RAM Ratings has a cautious view of MBSL's property business, as the liquidity of these assets is strained by legal processes. The Bank acquires properties on foreclosures, and timely disposal is hindered by legal and commercial issues. During the period under review, the Bank purchased an LKR225 million property by paying LKR150 million and setting-off a receivable of LKR75 million. As a result, MBSL's exposure to real estate swelled from LKR106.78 million to LKR340.16 million; these properties had an aggregate fair value of LKR515.41 million. MBSL intends to sell off 3 properties in 2008 – RAM Ratings opines that this move is critical to improving the Bank's asset quality.

Loan assets still take up lion's share of balance sheet

In spite of its larger base of real-estate assets, the bulk of MBSL's assets are still made up of loans. Leasing and HP dominate the Bank's lending portfolio (84.80%) while bill discounting and other advances constitute the balance.

Focused on enhancing monitoring process

RAM Ratings deems the loan-origination and monitoring procedures of MBSL to be still weak, albeit improving. During the year under review, the Bank implemented a new online credit-approval system. As most of MBSL's clients are small and medium-scale enterprises, they lack proper documentation; this renders cashflow-based evaluation unfeasible. As such, the Bank relies on collateral and its own qualitative assessment of clients. Therefore, loan-origination procedures are largely dependent on the experience of its credit officers. To raise its credit-assessment standards, MBSL conducts continuous training and performance reviews for its employees. Final loan approval is under the purview of the members of the credit committee.

Efforts to increase accountability

In light of the segment MBSL serves, monitoring is vital towards maintaining the Bank's asset quality. The management is implementing an MIS that would provide early-warning signals that will minimise defaults. The Bank's loan portfolio is also segregated, to encourage its credit officers to be more accountable for the performance of their clients. An additional unit is also being set up to expedite recoveries. Even though these efforts are likely to improve the Bank's asset quality, RAM Ratings is still concerned about the weakened

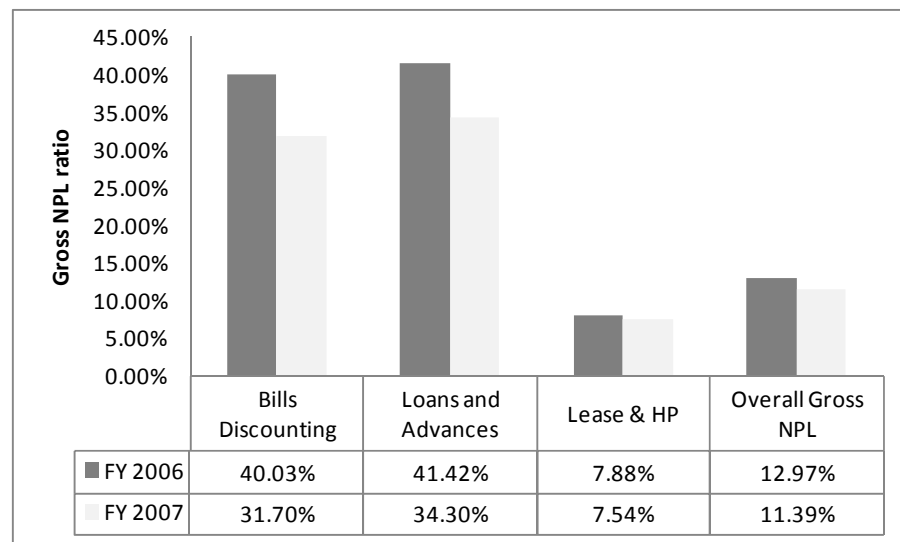
Asset quality expected to improve

economic outlook of Sri Lanka. The environment of lofty interest rates will exert an adverse impact on asset quality, as borrowers find it difficult to service the hefty interest rate on their loans.

MBSL's weak asset quality is reflected in its gross non-performing-loan ("NPL") ratio. The Bank's overall delinquency rate came up to 11.39% as at end-FY Dec 2007 (end-FY Dec 2006: 12.97%). This is considered rather high; the chief reasons for its poor showing are the high delinquency rates in bill discounting and loans, which accounted for 43.88% of the Bank's NPLs, despite only making up 15.92% of its lending portfolio. Elsewhere, RAM Ratings also notes an increase in new NPLs from the leasing and HP segments as at end-FY Dec 2007.

On a more positive note, MBSL's gross NPL ratio declined during the review period (refer to Chart 2); the improvement in bill discounting and loans and advances was underpinned by recoveries. In the leasing and HP segments, the ratio had eased as portfolio expansion had exceeded the pace of delinquencies. RAM Ratings expects the Bank to chart further progress in its asset-quality indicators as a result of more stringent monitoring efforts.

Chart 2: Gross NPL ratios by segment



On the whole, MBSL's provisions remain adequate. The Bank adopts the Central Bank's Direction 1 of 1991, issued to registered finance companies ("RFCs") vis-à-vis provisions for bad debts; this is more stringent than the direction applicable to leasing companies, i.e. Finance Leasing (Provisions for Bad & Doubtful Debts) Direction 2 of 2005. Although Direction 1 allows the netting off of immovable properties, MBSL applies its own hair-cut rule on provisions, which we consider to be more stringent. Apart from specific provisions, the Bank also makes a general provision of a minimum 0.5% of the aggregate value of its net portfolio (after specific provisions), subject to cumulative general provisions not exceeding 2.5% of its net portfolio. As a result, the Bank's gross NPL coverage stood at an adequate 57.19% as at end-FY Dec 2007.

Meanwhile, MBSL also had LKR190.92 million of contingent liabilities in the form of guarantees and cases under litigation as at end-FY Dec 2007. As this only represented 4.43% of the Bank's assets as of the same date, RAM Ratings is not unduly concerned.

Performance

Adequate financial performance

MBSL's financial performance is deemed adequate; the Bank reported a respectable pre-tax ROA of 6.67% as at end-FY Dec 2007, despite narrower interest margins. The previous year, the Bank had chalked up a record ROA of 7.56%, underpinned by a surge in net interest income and a one-off gain on disposal of unquoted shares. MBSL was unable to maintain its performance in FY Dec 2007 because of heftier interest expenses. Looking ahead, RAM Ratings expects the Bank's performance to moderate further due to elevated interest rates.

Hike in interest expenses

The Bank's net interest income remained somewhat flat at LKR434.64 million in FY Dec 2007 (FY Dec 2006: LKR420.50 million). Even though its interest income had surged 26.38% to LKR770.34 million, this was overshadowed by LKR335.07 million of interest expenses - 77.60% higher than the previous year's LKR189.02 million. The heavier interest expense was also reflected in the Bank's interest coverage, which declined to 1.88 times. Consequently, its net interest income only edged up 3.36% y-o-y in FY Dec 2007.

Adequately controlled overheads

MBSL's overheads, however, have been well managed. As a result, its cost-to-income ratio only rose slightly to 42.05% as at end-FY Dec 2007 (end-FY Dec 2006: 40.62%). Overheads had gone up 30.12% y-o-y, the main reason being provisions vis-à-vis its portfolio for equity trading.

MBSL's loan-loss provisions - albeit better than the year before - remained high in FY Dec 2007 owing to its frail, although improving, asset quality. MBSL's total provisions in respect of loan assets amounted to LKR37.36 million in FY Dec 2007 (FY Dec 2006: LKR42.91 million). This level of provisioning translated into 4.85% of its interest income for year (FY Dec 2006: 6.38%).

Despite a stronger top line, the Bank's pre-tax profit only nudged up 3.09% to LKR266.13 million in FY Dec 2007, constrained by its heftier interest expense and provisions in respect of its trading portfolio.

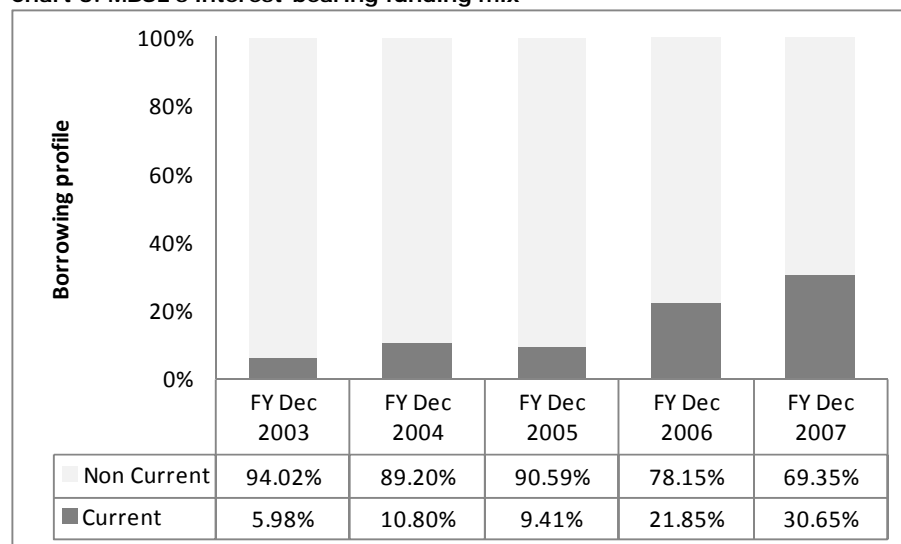
Funding & Liquidity

Marginal funding and liquidity levels

RAM Ratings considers MBSL to have marginal liquidity and funding levels; the Bank has been able to manage its liquidity and funding risks due to its treasury management and its parent, BOC. The Bank, however, faces constraints in raising long-term funds. Nonetheless, RAM Ratings notes that this is not an unusual situation given the high interest rate environment. MBSL intends to navigate through this period by raising funding lines with 2- to 3-year tenures, rather than via longer-dated instruments, so as to avoid locking in such facilities at lofty interest rates over a longer period. At the same time, investors' demand for long-term instruments is also limited.

Increase in short-term funding

In light of the above, short-term financing has been a prominent feature of MBSL's funding mix. In FY Dec 2007, the Bank relied more on commercial papers and overdraft facilities. These short-term lines, together with debentures renewed at current interest rates, had heightened MBSL's interest expenses. Realising the need to contain the lofty interest rates on its short-term borrowings, MBSL intends to raise LKR300 million via another debenture issue. RAM Ratings' projections indicate that the Bank's gearing levels should not breach 2 times over the next year, which is considered conservative by industry standards.

Chart 3: MBSL's interest-bearing funding mix

Funding risks

MBSL faces funding risks, however, through its treasury management and parental support the bank expanded its portfolio whilst repaying its financial obligations. The Bank's funding risks had already been highlighted after it failed to raise sufficient funds via debentures. As mentioned earlier, MBSL had intended to raise LKR600 million via 2 debenture issues. As yields of treasury bills had risen, there had been a lack of investor appetite and MBSL could only raise about half of what it had aimed for. Nonetheless, the Bank had been able to secure other banking lines on top of the temporary overdraft facility from its parent. MBSL also renewed its LKR475.79 million of debentures with the Employee Trust Fund ("ETF") (refer to Table 2). On the other hand, the Bank repaid LKR247.25 million of debentures that had matured in FY Dec 2007, apart from renewing LKR830 million of debentures that had become due in December 2007 and 2008.

Table 2: Borrowing movements

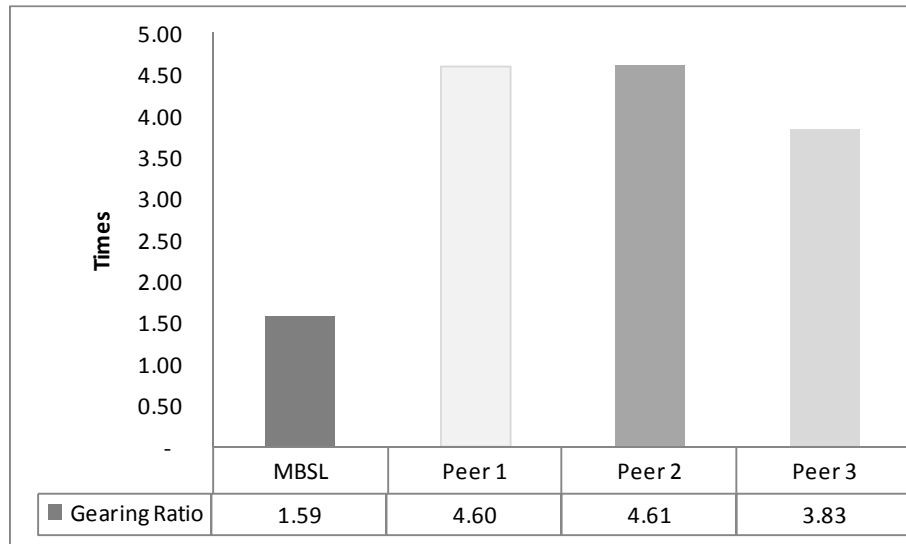
	LKR million
Borrowings as at end-FY Dec 2006	1,660.97
Add: Additional borrowings	
Debenture issues	314.16
Secured borrowings	475.79
Overdrafts	188.13
Commercial papers	19.76
Less: Repayments/Reduction in borrowings	
Repayment of ETF debenture	125.00
Repayments NSB debenture	15.00
Repayment of unsecured debentures	107.25
Money-market borrowings	6.57
Borrowings as at end-FY Dec 2007	2,404.99

Adequate capitalisation

Capital Adequacy

RAM Ratings opines that MBSL is adequately capitalised, with LKR1.54 billion of shareholders’ funds as at end-FY Dec 2007. Even though the Bank has a gearing ratio of 1.59 times, this compares well against those of its peers (refer to Chart 4). Taking into consideration MBSL’s asset quality, RAM Ratings opines that the Bank has an acceptable gearing ratio. This ratio is expected to remain below 2 times over the short term, even under a stressed scenario. Due to prudent provisions and moderate profit generation, the Bank’s net NPLs as a percentage of shareholders’ funds eased from 19.25% as at end-FY Dec 2006 to 9.64% as at end-FY Dec 2007.

Chart 4: Gearing of MBSL and selected peers



Industry Overview

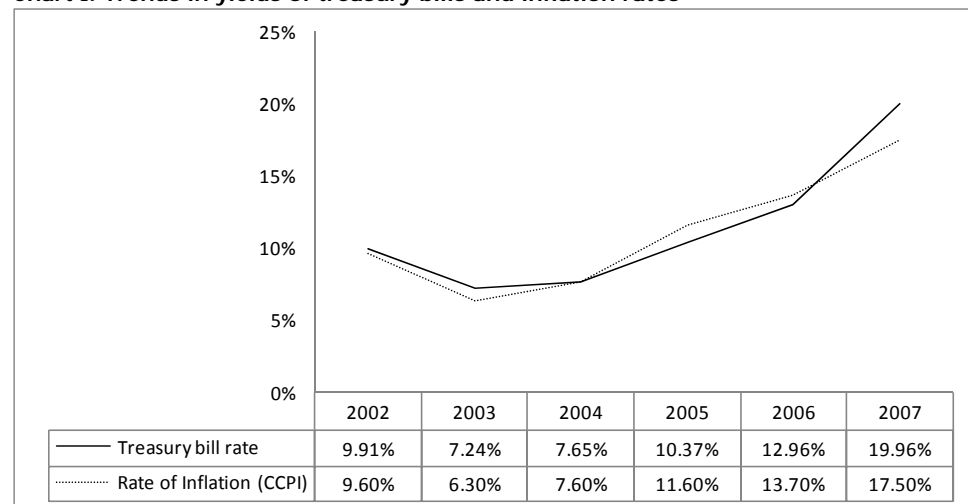
The country's gross domestic product ("GDP") is estimated to have grown by 6.8% during 2007 down from 7.7% recorded the previous year. Growth decelerated in all sectors with agriculture and services recording the highest slow-down (refer to table I). All sub-segments within the services sector decelerated with the hotel industry recording the highest drop. However, financial services, insurance and real estate sub sectors bucked the trend, growing by 8.7% during 2007, compared to 8.5% in 2006.

Table I: Total and sector-wise GDP growth

GDP at Constant 2002 Prices	2006	2007
Agriculture	6.3%	3.3%
Industry	8.1%	7.6%
Services	7.7%	7.1%
Total	7.7%	6.8%

The banking sector, meanwhile, had expanded despite loftier interest rates, driven by housing and consumption loans. Greater inflationary pressure is likely to have encouraged borrowing for consumption purposes while easy access to credit could also have been a contributing factor. The Colombo Consumer Price Index (or CCPI) has been trending upwards since 2003, indicating that monetary policies have not yielded the desired results. Furthermore, the steeper incline of the index since 2005 could be a reflection of the escalating hostilities in the northern and eastern parts of the country (refer to Chart I). In tandem with this, the yield of the benchmark 1-year treasury bill rate has been trending upwards, thereby elevating interest rates. By March 2008, however, treasury-bill rates had eased somewhat, albeit still high at 18.99%.

Chart I: Trends in yields of treasury bills and inflation rates



Against this backdrop, domestic interest rates are expected to remain elevated, driven by mounting inflation. This scenario is likely to continue due to the uptrend in international commodity prices, growth in government credit and the nation's persistent budget deficit.

In the meantime, the environment of high interest rates continues to dampen long-term investments and the merchant-banking sector. In a bid for survival, many merchant banks have transformed into fund-based institutions,

undertaking leasing and HP financing. These institutions are regulated by the Central Bank under Finance Leasing Act No. 56 of 2000. However, the country's weak economic fundamentals pose a challenge to many leasing establishments.

Leasing companies face a dilemma as they were precluded from obtaining public funds, and have to depend on bank funding to finance their lending activities. Even though the Finance Leasing ACT was amended to raise funds from the public by issuing debt instruments, RAM Ratings does not expect the benefits to materialise in the near term. In the present environment, cost of funds has risen as banking lines are based on floating rates. Therefore, the funding costs of leasing companies are very sensitive to interest-rate movements; these institutions are vulnerable when interest rates are on a rising trend - highlighting the importance of strong treasury management for such establishments.

On the income side, SLC's lending rates are fixed for 2-5 years and are not re-priced, as opposed to funding. Thus, when interest rates are trending upwards, interest expenses rise even faster, thereby squeezing margins (i.e. interest-rate risk). In an effort to overcome margin compression, these institutions raise their lending rates for new facilities, despite heightened default risk for these facilities. This is because the borrower has to pay a higher monthly rental and in the event of a delay, penalty interest will be accrued, further burdening the already-beleaguered debtor. Rising inflation erodes purchasing power, exerting even more strain on the borrower's repayment capacity.

Under the circumstances, if leasing companies are not selective in their lending and if they allow collections to fall behind, there could be serious asset-quality issues. Increased defaults can impair cashflow (i.e. liquidity risk) and have a "double-whammy" effect on the income statement, as provisioning typically rises while income contracts. Therefore, a weaker top line and heftier provisioning will deplete profitability.

The situation is exacerbated by competition from commercial banks, which has become keener as they have also ventured into the leasing arena, i.e. the key business segment of leasing companies. In this respect, leasing companies compete against banks by providing customised and swift service. Moving forward, the prospects of leasing companies will be dictated by franchise, service quality and innovative business strategies.

Corporate Information

Date of Incorporation:	1982			
Commencement of Business:	1982			
Major Shareholders:	Bank of Ceylon	76.00%		
	Bank of Ceylon A/C Ceybank Unit Trust	2.92%		
	Distilleries Company of Sri Lanka Ltd	1.07%		
	JB Cocoshell (Pvt) Ltd	0.95%		
	Waldock Mackenzie Ltd/Mr Lalith Prabash	0.84%		
	Employee Trust Fund Board	0.71%		
	Mr DS Tennakoon	0.56%		
Directors:	Mr Janaka Ratnayake	Chairman		
	Ms WA Nalani	Director		
	Dr Ranjith Bandara	Director		
	Mr BAC Fernando	Director		
	Mr Mervyn Paramananda	Director		
	Mr Lakshman Perera	Director		
	Mr JGBP Tissera	Director		
Auditor:	SJMS Associates Chartered Accountants			
Listing:	1991			
Key Management:	Mr Gamini Karunathilake	Chief Executive Officer		
	Mr Ranjith Siriwardena	Deputy Director – Strategic Planning & Risk		
	Mr Lakshman Kaluarachchi	Deputy Director – Leasing		
	Ms Shyamalie Amaratunga	Deputy Director – Trade Finance		
	Mr MA Cader	Deputy Director – Corporate Advisory & Capital Markets		
	Mr Priyantha Herath	Assistant Director – Finance & Treasury		
	Mrs Marina Phillips	Company Secretary		
Major Subsidiaries and Associates:	Merchant Credit of Sri Lanka	51.0%		
	Lanka Securities Limited	29.0%		
	GTB Colombo Corporation Ltd	20.3%		
	Mega Containers Ltd	18.3%		
Capital History:	Year	Remarks	Amount (LKR million)	Cumulative Total (LKR million)
	1989	Ordinary share capital	25.0	25.0
	1990	Share issue	65.0	90.0
	1991	Rights issue	60.0	150.0
	1993	Rights issue	130.0	280.0
	1994	Bonus issue	220.0	500.0
	2004	Write off of losses	(270.0)	230.0
	2004	Conversion of preference shares to ordinary shares	370.0	600.0
	2005	Rights issue	300.0	900.0

Financial Summary

BALANCE SHEET (LKR million)	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07
Property, Plant and Equipment	25.12	31.36	29.23	27.15	25.53
Investment in Associates/Subsidiaries	44.46	40.21	55.37	56.93	95.53
Other Investments	88.63	76.63	121.91	106.79	340.16
Gross Debtors	2362.67	2345.35	2927.35	3324.82	3,991.44
Leasing & Hire Purchase	1668.24	1764.90	2389.84	2815.57	3,387.71
Others	694.43	580.45	537.51	509.25	603.73
Estimated Residual Values	0.00	0.00	0.00	0.00	0.00
Less : Deposits	(50.13)	0.00	(62.73)	0.00	0.00
Less : Loan Loss Reserves	(431.71)	(119.00)	(313.97)	(210.66)	(260.34)
Net Debtors	1880.83	2226.35	2550.65	3114.16	3731.10
Amounts due from Holding/Related Companies	0.00	0.00	0.00	0.00	0.00
Other Loans & Advances	0.00	0.00	0.00	0.00	0.00
Cash and Bank Balances	3.82	4.31	12.78	1.42	0.31
Other Current Assets	85.35	96.58	502.96	197.24	217.73
TOTAL ASSETS	2128.21	2475.44	3272.90	3503.69	4410.36
Long Term Deferred Liabilities	14.71	22.05	23.82	127.27	101.32
Redeemable Hybrid Capital	800.00	0.00	0.00	0.00	0.00
Long Term Private Debt Securities	0.00	0.00	0.00	0.00	0.00
Less : Sinking Fund	0.00	0.00	0.00	0.00	0.00
Other Long Term Loans	1173.63	1303.35	1488.10	1298.10	1667.86
Total Long Term Debt	1973.63	1303.35	1488.10	1298.10	1667.86
Short Term Private Debt Securities	0.00	157.74	154.50	362.87	0.00
Amounts due to Holding/Related Companies	0.00	0.00	0.00	0.00	0.00
Other Short Term Loans	85.99	7.27	17.65	73.91	813.31
Total Short Term Debt	85.99	165.01	172.15	436.78	813.31
Trade Creditors	0.00	0.00	0.00	0.00	0.00
Provision for Dividend	0.00	0.00	0.00	0.00	0.00
Provision for Taxation	0.00	0.00	0.00	0.00	0.00
Other Current Liabilities	237.69	244.07	314.63	225.29	263.16
TOTAL LIABILITIES	2312.02	1734.48	1998.70	2087.44	2845.65
Equity Share Capital/Stated Capital	500.00	600.00	900.00	900.00	1067.00
Irredeemable Hybrid Capital	0.00	0.00	0.00	0.00	0.00
Reserves	770.00	17.00	167.00	181.67	31.46
Less : Intangible Assets	0.00	0.00	0.00	0.00	0.00
Retained Profit/(Loss)	(1453.81)	123.96	207.20	334.58	466.25
Minority Interests (MI)	0.00	0.00	0.00	0.00	0.00
TOTAL SHAREHOLDERS' FUNDS + MI	(183.81)	740.96	1274.20	1416.25	1564.71
TOTAL LIABILITIES + SHAREHOLDERS' FUNDS + MI	2128.21	2475.44	3272.90	3503.69	4410.36

Financial Summary

INCOME STATEMENT (LKR million)	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07
Interest Income	361.62	398.60	474.90	609.52	770.34
Less : Interest Expense	(150.57)	(148.97)	(185.91)	(189.02)	(335.70)
Net Interest Income	211.05	249.63	288.99	420.50	434.64
Non-interest Income	25.03	36.37	64.10	94.84	102.26
Gross Income	236.08	286.00	353.09	515.34	536.90
Less : Non-interest Expenses	(109.77)	(137.10)	(162.91)	(208.49)	(225.75)
Less : Bad & Doubtful Debt Provisions	(58.12)	0.00	0.00	(38.91)	(37.36)
Less : Depreciation & Amortisation	(8.59)	(9.09)	(9.18)	(9.79)	(7.66)
Operating Profit/(Loss) Before Tax	59.60	139.81	181.00	258.15	266.13
Share in Results of Associated Companies	16.27	5.34	22.45	11.03	7.13
Prior Year Adjustments	0.00	0.00	0.00	0.00	0.00
Exceptional Items	0.00	0.00	0.00	0.00	0.00
Adjusted Profit/(Loss) Before Tax	75.87	145.15	203.45	269.18	273.26
Less : Tax	(4.38)	(3.20)	(28.90)	(59.64)	(34.80)
Adjusted Profit/(Loss) After Tax	71.49	141.95	174.55	209.54	238.46
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Less : Transferred to Statutory Reserve	0.00	0.00	0.00	0.00	0.00
Less : Dividends	0.00	0.00	0.00	(67.50)	(90.00)
Retained Profit/(Loss) For The Year	71.49	141.95	174.55	142.04	148.46
CASH FLOW STATEMENT (LKR million)	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07
Cash Flow From Operating Activities	(8.50)	(136.12)	(228.71)	(181.33)	(331.96)
Cash Flow From Investing Activities	11.54	10.97	0.31	(26.26)	(268.25)
Cash Flow From Financing Activities	(75.00)	129.72	604.75	(226.25)	452.70
Net Increase/(Decrease) in Cash During The Year	(71.96)	4.57	376.35	(433.84)	(147.51)
Cash Balance at Beginning of the Year	64.43	(60.46)	(60.46)	(60.46)	(60.46)
Cash Balance at End of the Year	(7.53)	(55.89)	315.89	(494.30)	(207.97)

n.a. - not available

Financial Ratios

KEY RATIOS	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07
Profitability (%)					
Net Interest Margin	9.83%	10.84%	10.05%	12.41%	10.98%
Cost/Income Ratio	46.50%	47.94%	46.14%	40.46%	42.05%
Return on Average Assets	2.78%	6.07%	6.30%	7.62%	6.73%
Return on Average Equity	(27.15%)	50.19%	17.96%	19.19%	17.86%
Capitalisation (times)					
Gearing Ratio	(11.21)	1.98	1.30	1.22	1.59
Long Term Gearing Ratio	(10.74)	1.76	1.17	0.92	1.07
Short Term Gearing Ratio	(0.47)	0.22	0.14	0.31	0.52
Capital Adequacy Ratio (%)	(4.94%)	29.09%	40.29%	39.82%	35.00%
Coverage (times)					
Interest Coverage Ratio	1.45	2.00	2.02	2.42	1.82
Asset Quality (%)					
Gross NPL	33.22%	19.41%	15.55%	13.69% #	11.41%
Loan Loss Reserve Coverage	18.27%	5.07%	10.73%	6.34%	6.52%
General Loan Loss Reserve Coverage	5.03%	0.00%	2.50%	0.00%	0.00%
Loan Loss Reserve Coverage (Gross NPL)	55.01%	26.14%	68.97%	46.28% #	57.19%

NOTES:

* annualised

* Negative ratios are due to negative net asset prevailed during the respective financial years.

Restated

Financial Ratios

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

RAM RATINGS' CREDIT RATING DEFINITIONS (FINANCIAL INSTITUTIONS)

RAM Ratings' rating of a financial institution is an assessment and current opinion on the strength and performance of the rated institution.

LONG-TERM RATINGS

AAA	Financial institutions rated in this category are adjudged to offer the highest safety for timely payments of financial obligations. This level of rating indicates entities with strong balance sheets, favourable credit profiles and consistent records of above-average profitability. Their capacities for timely payments of contractual financial obligations are unlikely to be impacted seriously by any foreseeable changes in economic conditions.
AA+ AA AA-	Financial institutions rated in this category are adjudged to offer high safety for timely payments of financial obligations. This level of rating indicates entities with sound credit profiles and without significant problems. Entities rated in this category are, however, considered to be somewhat more vulnerable to adverse changes in economic conditions than those entities rated in the highest category. The signs plus (+), flat and minus (-) indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.
A+ A A-	Financial institutions rated in this category are adjudged to offer adequate safety for timely payments of financial obligations. This level of rating indicates entities with adequate credit profiles, but which possess one or more problem areas, giving rise to the possibility of future riskiness. Entities rated in this category have generally performed at industry average and are considered to be more vulnerable to changes in economic conditions than those rated in the higher categories. The signs plus (+), flat and minus (-) indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.
BBB+ BBB BBB-	Financial institutions rated in this category are adjudged to offer only a moderate degree of safety for timely payments of financial obligations. This level of rating indicates entities which have been significantly under-performing in some areas. These entities are, however, considered to have the capability to overcome such problems in the short term, though adverse changes in economic conditions could impair their ability to make timely payments of financial obligations. The signs plus (+), flat and minus (-) indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.
BB+ BB BB-	Financial institutions rated in this category are adjudged to lack key protection factors, which could result in inadequate safety for timely payments of financial obligations. This level of rating indicates that the entities may need certain favourable economic changes in order to meet financial obligations in a timely fashion. The signs plus (+), flat and minus (-) indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.
B+ B B-	Financial institutions rated in this category are adjudged to be of high risk. Timely payments of financial obligations are impaired by serious problems which the entities face. Whilst entities rated in this category might be currently meeting obligations on time, continuance of this would depend upon favourable economic conditions or some degree of external support. The signs plus (+), flat and minus (-) indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.
C+ C C-	Financial institutions rated in this category are adjudged to be of very high risk in relation to timely payments of financial obligations. This level of rating indicates entities with very serious problems and, unless external support is provided, they would be unable to meet their financial obligations in a timely fashion. The signs plus (+), flat and minus (-) indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.
D	Financial institutions rated in this category are either currently in default or expected to be in default, whether or not formally declared. This level of rating indicates that the entities are unlikely to meet maturing financial obligations, which calls for immediate external support of a high order.

SHORT-TERM RATINGS

- P1** Financial institutions in this category have superior capacities for timely payments of obligations.
- P2** Financial institutions in this category have strong capacities for timely payments of obligations.
- P3** Financial institutions in this category have adequate capacities for timely payments of obligations. The ability to honour the obligations is more vulnerable to adverse changes in business, economic or financial conditions.
- NP** Financial institutions in this category have doubtful capacities for timely payments of obligations.

This page has been left blank intentionally

Published by RAM Ratings.
Reproduction or transmission in any form is prohibited
except by permission from RAM Ratings.

RAM Ratings (Lanka) Limited
No. 9 Arthur's Place
Colombo 4
Sri Lanka

Tel: (9411) 2553089 Fax: (9411) 2553090

E-mail: ram@ram.com.lk
Website: <http://www.ram.com.lk>

