

RAM

RATINGS

## CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

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

## Mercantile Investments Limited – Rating Review

**Financial Institution****Ratings:**

Long-term: A [Reaffirmed]

Short-term: P1 [Reaffirmed]

**Rating Outlook:**

Negative [Revised from stable]

**Instrument:**

Proposed LKR 250 million  
Commercial Paper  
Programme

**Rating:**

P1 [Assigned]

**Tenure & Repayment:**

3-month CP revolving up to  
15 months, LKR 50 million  
repayable quarterly

**Coupon Rate:**

AWPLR + 2.25% per annum

**Strengths:**

- Sturdy capitalisation
- Adequate liquidity

**Weaknesses:**

- Weaker asset quality
- Declining profitability

**Principal Activities:**

Finance company engaged in  
hire-purchase, leasing,  
loans and accepting public  
deposits

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**Summary**

RAM Ratings has reaffirmed the respective long- and short-term financial institution ratings of Mercantile Investments Limited ("MIL" or "the Company") at A and P1; concurrently, the outlook on the long-term rating has been revised from stable to negative. The negative outlook reflects the significant deterioration in the Company's profit performance, precipitated by weakening asset quality and higher funding costs. Nonetheless, the ratings are still supported by MIL's sturdy capitalisation and adequate liquidity position. Meanwhile, the Company's proposed maiden LKR 250 million Commercial Paper Programme ("CP") has been assigned a short-term rating of P1. The assigned rating is at par with MIL's short-term financial institution rating as the proposed issuance ranks *pari passu* with the Company's other senior unsecured creditors.

Established in 1964 as a financier of motor vehicles, MIL has evolved into one of the top 5 registered finance companies ("RFCs") in Sri Lanka. The Company accounts for almost 6% of the industry's assets, in a sector where the 2 largest players combined take up the lion's share of over 50%. Through the years, MIL has also built up a solid franchise vis-à-vis the import, sale and financing of motor vehicles in the country.

The Company's weakening asset quality and decelerating loan growth have taken a toll on its margins. MIL's pre-tax profit declined to LKR 231.29 million in FYE 31 March 2008 ("FY Mar 2008"), from LKR 337.31 million in FY Mar 2007, pressured by heftier funding costs (brought about by rising interest rates) and greater loan-loss provisioning. Consequently, its return on assets ("ROA") and return on equity ("ROE") eased from a respective 4.92% and 14.72% to 2.95% and 8.74% over the same period. The rise in its cost-to-income ratio, from 44.82% to 56.54%, added further pressure on MIL's bottom line.

Meanwhile, MIL's asset quality, which had previously been improving, altered its course in FY Mar 2008. The Company's gross non-performing-loan ("NPL") ratio - which had been ameliorating earlier - rose to 7.64% as at end-FY Mar 2008 (end-FY Mar 2007: 6.05%), i.e. worse off than the industry average<sup>1</sup> of 6.54%. Nevertheless, the Company's net NPL ratio remained at 2.82% as at the same date, somewhat better than the industry's 4.29% average.

All things considered, MIL's ratings are still supported by its robust capitalisation. As at end-FY Mar 2008, the Company's core capital base (shareholders' funds excluding revaluation reserves) stood at an impressive LKR 1.55 billion, translating into a strong Tier-1 risk-weighted capital-adequacy ratio ("RWCAR") of 20.06%. At the same time, its liquid assets remained at adequate levels and above the statutory minimum of 15% throughout the fiscal year.

<sup>1</sup> All industry statistics for FY Mar 2008 are based on provisional financial statements.

## Outlook

The negative outlook on MIL's ratings reflects the Company's deteriorating profit performance, precipitated by rising NPLs and the resulting effect on its profitability vis-à-vis higher loan-loss provisioning.

While an upward movement in MIL's ratings is unlikely in the medium term, its outlook may be reinstated to stable if its asset quality demonstrates sustainable improvements while revisiting historical performance levels. However, any further deterioration in MIL's performance, asset quality or capitalisation levels will exert downward pressure on its ratings.

## Corporate Profile

MIL is an RFC governed by the Central Bank of Sri Lanka ("Central Bank"), under the Finance Companies Act No. 78 of 1988. Established in 1964 as a financier of motor vehicles, the Company has evolved into one of the top 5 players in the local RFC industry. MIL's main lines of business include hire-purchase ("HP") financing, leasing, lending and accepting public deposits.

Operating from its headquarters in Colombo 03 and 2 branches in Negombo and Kohuwela, MIL is supported by 253 staff. The management intends to open another 2 branches during by end- FY Mar 2009.

## Ownership

MIL is essentially a family concern, owned and managed by the Ondaatjie family. The Company had been founded by its Chairman, Deshabandu George Ondaatjie, who is also the major shareholder. While the family directly owns 56% of the Company's shares, cross-shareholdings exist via MIL's related investments, e.g. Nilaveli Beach Hotel, Tangerine Tours Ltd and Mercantile Fortunes (Pvt) Ltd ("Mercantile Fortunes").

In addition to financing motor vehicles, MIL has also built a solid franchise in the import and sale of cars on the island, through Mercantile Fortunes. At the same time, the Company has substantial exposure to the hotels sector via its investments in the Tangerine Group of Hotels. This is of concern to RAM Ratings as the tourism sector is highly susceptible to the security situation in the country.

## Management & Strategies

MIL's management team is led by its Executive Deputy Chairman, Mr Gerard Ondaatjie. He is supported by a loyal team of executive directors and senior managers.

MIL deferred the planned opening of 2 branches in 2007, mainly due to unfavourable economic conditions. Looking forward, the Company intends to open at least 2 more branches in FY Mar 2009; the first of these is to be opened in Balangoda.

**Among top 5 RFCs in Sri Lanka**

**Owned and managed by Ondaatjie family**

**Exposure to hotels sector**

**Planned branch expansion**

**Upgrading information systems**

In the meantime, the Company has fully computerised its core business areas (i.e. lending, payments, receipts, general ledger, insurance, fixed deposits and savings modules) through software developed in-house. The upgrade is expected to offer greater security and stability. The Company has also commenced a project to re-engineer its main information systems for improved information quality.

**Board composition**

**Corporate Governance**

MIL's Board comprises 9 directors, none of whom are independent. Chaired by Deshabandu George Ondaatjie, the Board convened 4 times in FY Mar 2008. Five sub-committees have been appointed to facilitate the Board's decision-making process: credit, audit, remuneration, nominations and recoveries monitoring.

**Related-party transactions**

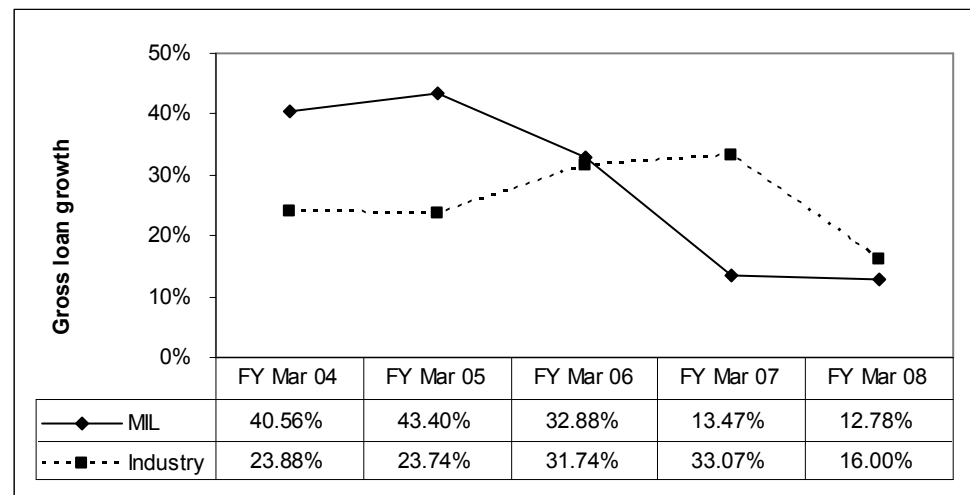
In FY Mar 2006, the Company lent LKR 125 million to 3 related companies in the hotels sector, via a special loan scheme introduced by the Central Bank for small and medium-scale enterprises affected by the 2004 Tsunami. Apart from this, related-party transactions remained minimal in the reviewed period.

**Asset Quality**

**Slowdown in loan growth**

MIL kept up its moderate pace of loan expansion in FY Mar 2008, recording a 12.78% year-on-year ("y-o-y") growth in gross loans compared to 13.47% the previous year. In the past 2 years, loan expansion has slowed down notably owing to the management's consolidation strategy amid the uncertain economic conditions (refer to Chart 1). However, this decelerating pace of loan expansion has taken a toll on the Company's margins (also refer to Performance and Funding sections).

**Chart 1: Gross loan growth of MIL vs the industry**



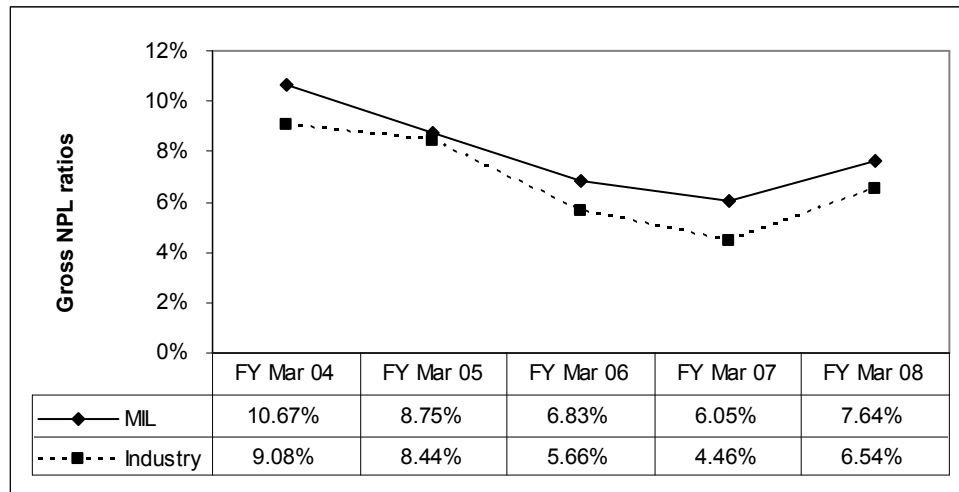
**HP dominates loan portfolio**

As at end-FY Mar 2008, HP dominated 57.12% of MIL's net loan portfolio while leases took up 37.88%. Other loans constituted only 5.00% of the Company's overall portfolio. The stronger demand for HP has been driven by the exemptions of value-added tax ("VAT") on HP rentals. True to trend, the Company's HP portfolio expanded 24.06% in FY Mar 2008; other loans rose 17.02% while leases contracted 4.92%, due to a slowdown in the disbursement of new leases.

**Rising NPLs**

MIL’s asset quality, which had been improving consistently over the past few years, reversed its trend in FY Mar 2008. Its gross NPL ratio, which had been trending downwards, altered its course in FY Mar 2008, rising to 7.64% from 6.05% a year earlier (refer to Chart 2). This was worse off than the industry average of 6.54% as at end- FY Mar 2008. In absolute terms, MIL’s gross NPLs augmented 40.46% y-o-y to LKR 432.58 million, displaying the effects of the weakening economic climate, to which the RFC sector is more vulnerable.

**Chart 2: MIL’s gross NPL ratios vs the industry**



**Slip in collections**

RAM Ratings also notes a slip in the Company’s collections in the “0-3 months in arrears” bucket, from 76.56% to 70.44% as at end-FY Mar 2008. The “0-6 months in arrears” category has also slackened from 93.75% to 92.01%. We anticipate the Company to retain its focus on collections and recoveries to maintain the health of its portfolio. Meanwhile, leases accounted for the majority of its NPLs as at end- FY Mar 2008, taking up 54.59% of NPLs carried forward; HP accounted for the balance.

**Thinner but still adequate NPL coverage**

Despite an additional LKR 52.05 million of provisions for bad debts during the year, MIL’s gross NPL coverage weakened from 77.16% to 64.90% as at end-FY Mar 2008. Nonetheless, this was still in line with the industry average of 49.30% as at the same date. The Company has adopted the Central Bank’s new Direction 3<sup>2</sup> on loan-loss provisioning; hence, bad-debt provisioning requirements are now less stringent. Meanwhile, MIL’s net NPL ratio also climbed up to 2.82% as at end-FY Mar 2008, from 1.45% a year earlier; this was still better than the industry average of 4.29%.

**Equity investments within regulatory threshold**

On a separate note, MIL’s gross investments in equity (apart from investments in associate companies) amounted to LKR 447.59 million as at end-FY Mar 2008 (end-FY Mar 2007: LKR 438.14 million). Share investments against capital funds stood at 16.50% as at the same date, and below the regulatory minimum of 25%<sup>2</sup>; hence not a concern to RAM Ratings. Elsewhere, investments in related companies amounted to LKR 749.46 million, with significant exposure to the hotels sector, which is highly susceptible to the domestic security situation. As the Company has reserved LKR 546.28 million against a fall in the value of these investments<sup>3</sup>, however, RAM Ratings’ concerns are somewhat moderated.

<sup>2</sup> Refer to page 10 for relevant Central Bank regulations.

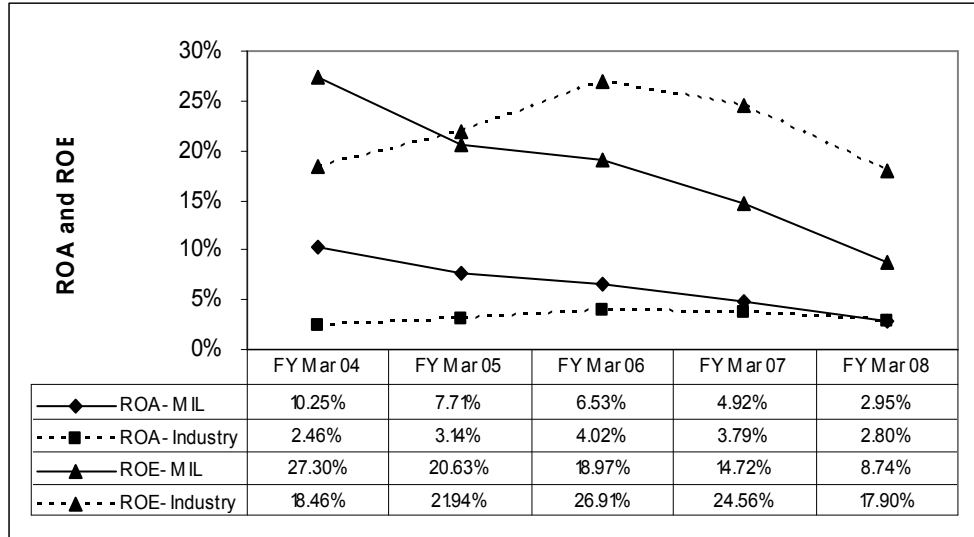
<sup>3</sup> MIL revalues its investments in long-term quoted shares based on the market values of such investments as at the end of the financial year. Any appreciation/depreciation is recognised in the long-term investments revaluation reserve.

**Waning performance**

**Performance**

MIL's performance has been persistently sliding over the past few years (refer to Chart 3) . Pre-tax profit receded 31.43% to LKR 231.29 million in FY Mar 2008, from LKR 337.31 million the previous year. Correspondingly, both ROA and ROE almost halved from a respective 4.92% and 14.72% to 2.95% and 8.74% over the same period.

**Chart 3: MIL's ROA and ROE vs the industry**



**Contracting margins**

MIL's gross income composition remained healthy as at end-FY Mar 2008, with 90% stemming from interest-earning activities. As a result of heightened interest rates, however, the Company's funding costs have risen disproportionately relative to its interest income, leading to margin compression. The ratio of interest expenses to interest-bearing liabilities jumped from 10.96% as at end-FY Mar 2007 to 15.68% as at end-FY Mar 2008, in contrast to the rather nominal increase in interest income to interest-earning assets, from 19.24% to 21.97% over the same period. This phenomenon has been squeezing margins over the past few years, as reflected in Table 1.

**Table 1: MIL's interest income and expense yields**

	FY Mar 04	FY Mar 05	FY Mar 06	FY Mar 07	FY Mar 08
Interest Income/ Interest Earning Assets	25.85%	22.42%	20.38%	19.24%	21.97%
Interest Expense/ Interest Bearing Funding	11.21%	10.44%	10.13%	10.96%	15.68%
Interest differential	14.64%	11.99%	10.25%	8.28%	6.29%

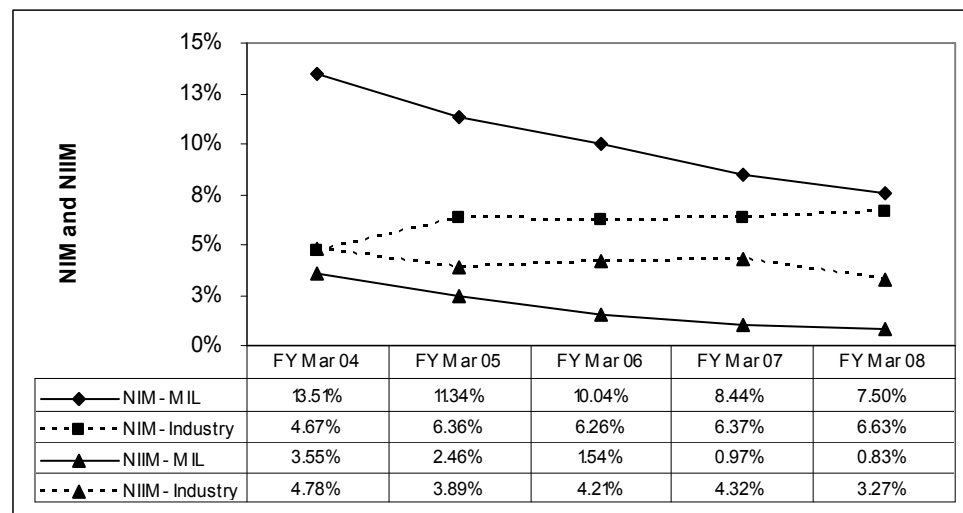
**Maturity mismatches affect margins**

The maturity profile of MIL's assets and liabilities has also negatively affected the Company's margins, While over 60% of MIL's borrowings (including deposit liabilities) bear tenures of less than 1 year, almost all its lending facilities have 3- to 4-year tenures at fixed interest rates. As such, the Company's borrowings would re-price faster at higher rates of interest during a period of rising interest rates, thus preventing it from effectively passing on its heftier borrowing costs to its customers. This situation would be further aggravated by a slowdown in new loan disbursements, as is the case with MIL.

**Lower NIM**

Hence, MIL’s net interest margin (“NIM”) shrank further to 7.50% in FY Mar 2008, from 8.44% the previous year (refer to Chart 4). Though still above the industry average for the same periods (the industry’s NIMs for FY Mar 2007 and FY Mar 2008 stood at 6.37% and 6.63%, respectively), the steep downtrend in the Company’s margins in the last few years is of concern to RAM Ratings. MIL’s non-interest-income margin (“NIIM”) has also been declining, from 0.97% in FY Mar 2007 to 0.83% in FY Mar 2008.

**Chart 4: MIL’s NIM and NIIM vs the industry**



**Cost-to-income ratio lower than industry’s**

That said, MIL’s efficient cost structure is still a positive rating factor. Although the Company’s cost-to-income ratio ascended from 44.82% to 56.54% as at end-FY Mar 2008, it remained below the industry average of 66.33% (end-FY Mar 2007: 57.85%). The rising overheads can be partly attributable to inflationary pressures, as reflected by the rise in the industry’s average ratios.

**Weak asset quality affects bottom line**

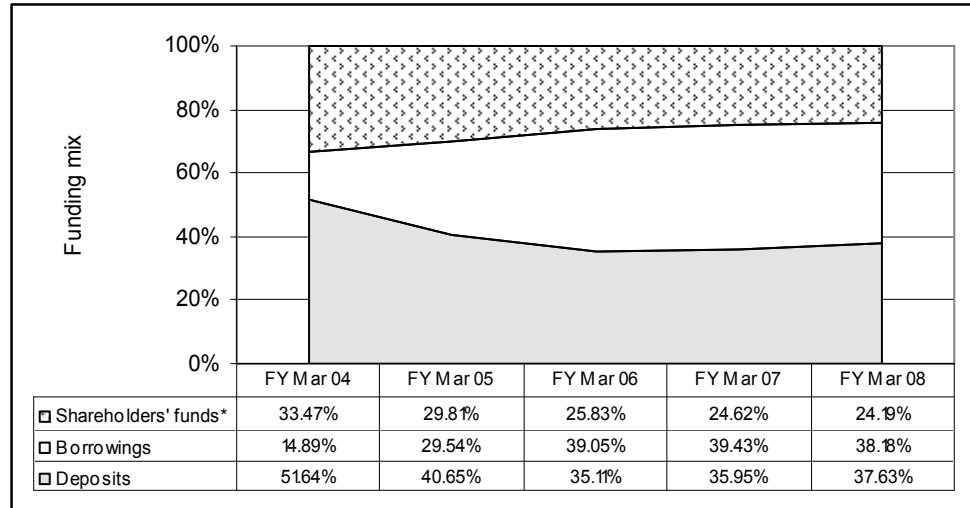
Meanwhile MIL’s ROA and ROE have been suffering rather badly over the past few years; while its ROA has tumbled from its peak of 10.25% as at end-FY Mar 2003 to a meagre 2.95% as at end-FY Mar 2008, its ROE has plunged from 27.30% to 8.74% over the same period. Increasing funding costs, coupled with heftier loan-loss provisioning necessitated by its weakening asset quality, have had ripple effects on MIL’s profitability. We note that MIL’s superior (above-average) performance had historically been one of its key rating drivers. On the other hand, the Company’s more recent waning profit performance has been exerting downward pressure on its ratings.

**Funding & Liquidity**

**Adequate liquidity levels**

MIL’s liquidity position remained adequate as at end-FY Mar 2008. Its liquid-asset ratio stood at 17.28% as at the same date, comfortably above the statutory minimum of 15%. The Company’s deposit base, meanwhile, expanded 16.63% y-o-y to LKR 2.41 billion as end-FY Mar 2008. A bulk of MIL’s funding had originated from borrowings (38.18%) while deposits and shareholders’ funds (excluding revaluation reserves) constituted a respective 37.63% and 24.19% (refer to Chart 5). However, bank borrowings are not perceived as a favourable source of funding for an RFC, as they lack the diversity offered by a pool of deposits.

**Chart 5: MIL's funding mix**



\*Excluding revaluation reserves

Moreover, RAM Ratings notes a widening of maturity mismatches in MIL's asset-liability profile. The maturity gap in the "less than 3 months" maturity bucket had widened to minus LKR 733.64 million as at end- FY Mar 2008, compared to minus LKR 246.49 million a year earlier. Nonetheless, it should be noted that the cumulative gap in MIL's "less than 1 year" maturity bucket, although worsening, was still positive; thus comparing favourably with most of its industry peers. Moreover, RAM Ratings derives comfort from the satisfactory deposit renewal rates enjoyed by the Company and the availability of unused stand-by credit facilities.

**Capital Adequacy**

MIL's sturdy capitalisation is still one of the driving forces supporting its current ratings. The Company's core capital base stood at LKR 1.55 billion as at end- FY Mar 2008, translating into a strong Tier-1 RWCAR of 20.06% - far superior to its peers' and the regulatory minimum of 5%. Its overall RWCAR also came up to a healthy 27.59% as at the same date. We note that the Company's strong capitalisation is underpinned by the management's prudent retention policies.

Meanwhile, the ratio of MIL's net NPLs to shareholders' funds stood at 5.60% as at end-FY Mar 2008. Although significantly higher than the 2.72% of a year earlier, it was still much lower than the industry average of 18.08%.

**Robust capitalisation**

## Industry Overview

Sri Lanka's gross domestic product ("GDP") is estimated to have expanded by 6.8% in 2007 (2006: +7.7%). Growth had slowed down for all sectors, with agriculture and services recording the most acute deceleration (refer to Table 2). All sub-segments within the services sector had lost momentum, with the hotel industry reporting the steepest drop. However, the financial services, insurance and real estate sub-sectors bucked the trend, advancing by 8.7% in 2007 (2006: +8.5%).

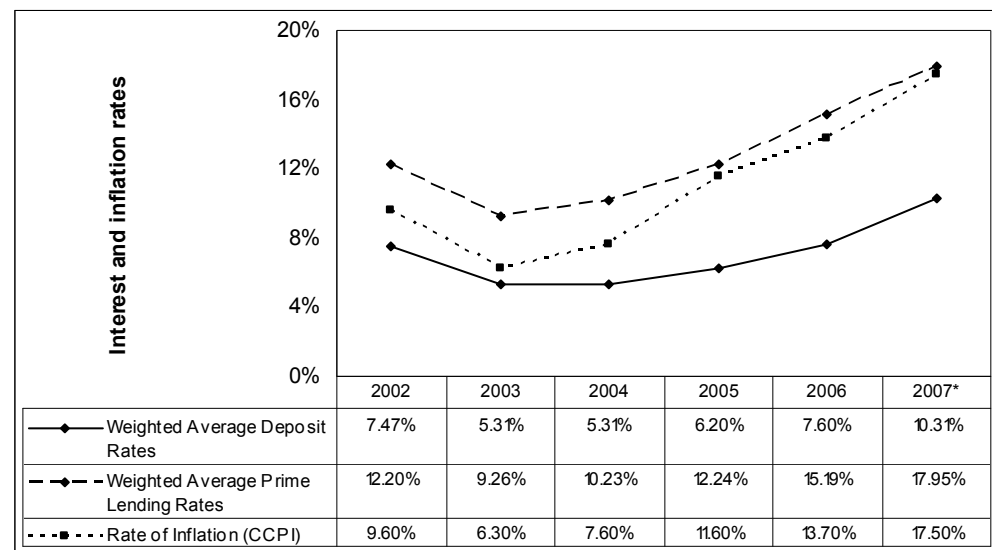
**Table 2: Overall and sectoral GDP growth**

GDP at Constant 2002 Prices	2006	2007*
Agriculture	6.3%	3.3%
Industry	8.1%	7.6%
Services	7.7%	7.1%
<b>Total</b>	<b>7.7%</b>	<b>6.8%</b>

\*Provisional

The domestic banking sector, meanwhile, had progressed despite rising interest rates driven by housing and consumption loans. Greater inflation is likely to have driven borrowing for consumption while easy access to credit may also have been a contributory factor. The Colombo Consumer Price Index ("CCPI") has been trending upwards since 2003, indicating that monetary measures have not yielded the desired results. Furthermore, the steeper incline of the index since 2005 may be a reflection of the escalating hostilities in the northern and eastern parts of the country (refer to Chart 6). Against this backdrop, the weighted-average deposit rate<sup>4</sup> has been lower than the inflation rate, resulting in negative real returns for depositors.

**Chart 6: Trends in interest and inflation rates**



\*Provisional

Looking ahead, interest rates are expected to remain elevated, driven by mounting inflationary pressures - likely to continue at current levels due to escalating global commodity prices, growth in government credit and the nation's expanding budget deficit.

<sup>4</sup> The Central Bank calculates the weighted average deposit rate monthly, based on the weighted average of all outstanding interest-bearing deposits of commercial banks and the corresponding interest rates.

Against this backdrop, the RFC industry's asset quality is likely to weaken as a whole. RFCs predominantly deal in vehicle financing, where lending rates are fixed and tenures usually extend from 36 to 48 months. Therefore, in an environment where interest rates are lofty, the borrower is locked in at a higher rate for a longer period. Meanwhile, rising inflation erodes the borrower's repayment capacity, resulting in more defaults. Given this, RFCs that cater to the sub-prime segment need to be cautious when expanding their portfolios. It is therefore vital for RFCs to become more stringent in their underwriting, and emphasise collection and recoveries.

RFCs are also likely to face heftier funding costs and a tilt in the funding structure towards the shorter end, as they are largely dependent on deposits. Commercial banks - their main competitors - enjoy lighter funding costs because of their large volumes of current and savings accounts, which bear low interest rates. In contrast, RFCs are expected to offer higher rates of interest on their deposit products. Even though the Central Bank has allowed RFCs to offer savings accounts, they are still at a disadvantage as they lack the infrastructure vis-à-vis branches and automated teller machines to effectively compete against commercial banks. To compound this, the current interest-rate environment is likely to further skew the funding structure towards the short end as depositors move their funds from long- to short-term facilities, in an effort to maximise their returns.

In addition, RAM Ratings notes RFCs' increasing tendency to pledge their portfolios with banks, in a bid to minimise mismatches between funding and lending. Even though RFCs could attain a better maturity structure from this strategy, it could also bring about concentration risk in relation to their funding structure. As these funding lines are based on floating interest rates, RFCs' capacity to manage their funding costs would be limited. While a large and diversified public deposit base reduces concentration risk, it also means greater leeway in managing funding costs.

The tendency of RFCs to chase short-term profits through trading activities, especially in real estate, is likely to expose them to a vast spectrum of risks, e.g. market, liquidity, counterparty and credit. Finance companies that are involved in housing and real-estate development tend to recognise trading profits upfront; this clouds comparison with other RFCs that offer financing products. Furthermore, trading activities also expose the RFCs' cashflows to volatility. Moreover, aggressive profit recognition could also deplete capital through excessive dividend payouts. Market risk arises due to inflated property prices, location risk, infrastructure facilities and extraneous social factors. On the other hand, counterparty risk would materialise should contractors fail to meet their obligations.

In terms of capitalisation, the RFC industry is anticipated to expand its capital base due to regulatory requirements. The Central Bank issued a directive in 2006, under which RFCs are required to have a minimum core capital of LKR 100 million by February 2007, and LKR 200 million by July 2008.

On the whole, the industry's profit performance - which is affected by all the abovementioned issues - is likely to be adversely affected. Nonetheless, RFCs with thin margins and high overheads are expected to feel the pinch much more than those with leaner structures and broader margins. Finally, resource allocation is also likely to be influenced by credit ratings as the public becomes more aware of such ratings and divert their funds towards better-managed RFCs.

## Relevant Central Bank Directions Applicable to Registered Finance Companies

<p><b>Liquid assets</b></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"> <li>a) Cash in hand.</li> <li>b) Balances in a current or deposit account in a commercial bank, free from any banker's lien or charge.</li> <li>c) Sri Lankan Government Treasury Bills, free from any charge or lien.</li> <li>d) Sri Lankan Government Securities maturing within 1 year and free from any charge or lien.</li> <li>e) Central Bank securities maturing within 1 year and free from any charge or lien.</li> <li>f) Cash balance, if any, maintained with the Central Bank.</li> </ol> <p>The minimum limits are as follows:</p> <ol style="list-style-type: none"> <li>1. For time deposits, 15% of outstanding deposits.</li> <li>2. For certificates of deposits, 15% of the face value of the certificates.</li> <li>3. For savings deposits, 20% of the outstanding deposits.</li> </ol> <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><b>Provision of bad and doubtful debts</b></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"> <li>(a) 50% of all advances in arrears for a period of 7 to 12 months.</li> <li>(b) 100% of all advances in arrears for 13 months or more.</li> </ol> <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"> <li>1. The value so deducted should not exceed the value decided by a professional valuer at the time of granting the advance.</li> <li>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.</li> </ol> <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"> <li>(a) 50% of all advances in arrears for a period of 12 to 24 months.</li> <li>(b) 100% of all advances in arrears for more than 24 months.</li> </ol> <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> <p>(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> <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"> <li>1. Sri Lankan Government securities, free from any lien or charge.</li> <li>2. Central Bank securities, free from any lien or charge.</li> <li>3. Time deposits in a licensed commercial bank, specialised bank or RFC, free from any lien or charge.</li> <li>4. Bank guarantees.</li> <li>5. With regard to repossessed vehicles and machinery, 80% of the valuation obtained in the preceding 6 months and by an approved valuer.</li> <li>6. With regard to mortgaged land and buildings that are held as collateral, if the accommodation has been in arrears for a period of: <ol style="list-style-type: none"> <li>a) 6-36 months, 100% of the value is deductible</li> <li>b) 37-60 months, 80% of the value is deductible</li> <li>c) 61-120 months, 50% of the value is deductible</li> <li>d) more than 120 months, 0% of the value is deductible</li> </ol> </li> </ol>
<p><b>Capital adequacy</b></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> <p>(a) Tier I - Core Capital</p> <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> <p>(b) Tier II - Supplementary Capital</p> <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><b>Single-borrower limit</b></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><b>Minimum core-capital requirement</b></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> <ul style="list-style-type: none"> <li>(a) A finance company with a core capital of less than LKR 100 million must: <ul style="list-style-type: none"> <li>1. enhance its core capital to at least LKR 100 million by February 2007; and</li> <li>2. bring the remaining LKR 100 million or the deficit up to the core-capital requirement of LKR 200 million by July 2008.</li> </ul> </li> <li>(b) A finance company with a core capital of between LKR 100 million and LKR 200 million must bring in: <ul style="list-style-type: none"> <li>1. at least 50% of the deficient amount to meet the core-capital requirement of LKR 200 million by February 2007; and</li> <li>2. the balance of the deficient amount up to the core capital requirement of LKR 200 million by July 2008.</li> </ul> </li> </ul>
<p><b>Investments</b></p>	<p>A finance company must not invest in the shares of any company</p> <ul style="list-style-type: none"> <li>(a) In excess of 5% of its capital funds, provided that such investment does not exceed 40% of the issued share capital of the investee company</li> <li>(b) In aggregate, in excess of 25% of the capital funds of the finance company</li> </ul> <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>

## Corporate Information

**Date of Incorporation:** 1964

**Commencement of Business:** 1964

**Major Shareholders:**

Mr G L A Ondaatjie	51.07%
Nilaveli Beach Hotels Ltd	20.83%
Mercantile Fortunes (Pvt) Ltd	13.67%
Tangerine Tours Ltd	6.67 %
Mr G G Ondaatjie	1.67 %
Ms A M Ondaatjie	1.67 %
Mr T J Ondaatjie	1.67 %
Mr G V Divititawela	0.83 %
Mr J S Dominic	0.50 %
Mr R M D Abeygunawardena	0.33 %

**Directors:**

Deshabandu G L Andrew Ondaajie	Chairman & Managing Director
Mr Gerard George Ondaatjie	Executive Deputy Chairman
Mr Shermal Hemaka Jayasuriya	Finance Director
Mrs Mignonne Bernadette Assuaw	Director Deposits
Mr Pathirana Mahes Amarasekera	Director Recoveries
Mr Saman Kumara Abraham Galappaththi	Director Legal
Mrs Angeline Myrese Ondaatjie	Director
Mr Travis John Ondaatjie	Director
Mr Justin Severimuttu Dominic	Director

**Auditor:** Cecil Arsecularatne & Co. (External Auditors)  
SJMS Associates (Internal Auditors)

**Listing:** Not listed

**Key Management:**

Mr Gerard George Ondaatjie	Executive Deputy Chairman
Mr Shermal Hemaka Jayasuriya	Finance Director
Mrs Mignonne Bernadette Assuaw	Director Deposits
Mr Pathirana Mahes Amarasekera	Recoveries Director

**Related Companies:** Tangerine Beach Hotels Ltd, Nuwara Eliya Hotels Co Ltd, Royal Palms Beach Hotels Ltd, Nilaveli Beach Hotels Ltd, Tangerine Tours Ltd, Mercantile Fortunes (Pvt) Ltd

<b>Capital History:</b>	Year	Remarks	Amount (LKR million)	Cumulative Total (LKR million)
	1964	First allotment	0.07	0.07
	1965	Issue of shares	0.07	0.14
	1966	Issue of shares	0.07	0.21
	1966	Issue of shares	0.03	0.24
	1967	Issue of shares	0.01	0.25
	1967	Issue of shares	0.24	0.49
	1967	Issue of shares	0.01	0.50
	1982	Issue of shares	0.50	1.00
	1988	Bonus Issue	1.00	2.00
	1989	Bonus Issue	1.00	3.00
	1989	Bonus Issue	2.00	5.00
	1993	Issue of shares	5.00	10.00
	1995	Bonus Issue	10.00	20.00
	1997	Issue of shares	5.00	25.00
	2004	Issue of shares	5.00	30.00

**Financial Summary - Company**

<b>BALANCE SHEET (LKR Million)</b>	<b>31-Mar-04</b>	<b>31-Mar-05</b>	<b>31-Mar-06</b>	<b>31-Mar-07</b>	<b>31-Mar-08</b>
<b>ASSETS</b>					
Cash & Money At Call	28.82	38.96	90.40	71.63	71.81
Deposits & Placements With Financial Institutions	0.00	0.00	51.42	100.00	104.10
Securities Purchased Under Resale Agreements	0.00	0.00	0.00	0.00	0.00
Securities					
Dealing Securities	357.82	516.30	570.51	628.38	688.02
Investment Securities	5.93	5.22	3.27	3.27	2.46
Gross Loans & Advances	2,498.56	3,582.98	4,761.22	5,402.40	6,093.08
Interest-In-Suspense	178.42	201.33	245.04	312.83	430.43
General Loan Loss Reserves	0.00	0.00	0.00	0.00	0.00
Specific Loan Loss Reserves	193.94	216.94	227.53	237.65	280.75
Net Loans & Advances	2,126.20	3,164.70	4,288.65	4,851.93	5,381.90
Investments in Subsidiaries/Associates	310.30	623.86	671.77	751.63	749.16
Investment Land and Properties	0.00	0.00	0.00	0.00	0.00
Other Assets	77.03	116.83	156.59	242.19	263.99
Property, Plant and Equipment	344.17	376.76	367.23	859.20	888.38
<b>TOTAL ASSETS</b>	<b>3,250.26</b>	<b>4,842.63</b>	<b>6,199.81</b>	<b>7,508.23</b>	<b>8,149.80</b>
<b>LIABILITIES</b>					
Customer Deposits					
Savings	0.00	0.00	0.00	0.00	7.57
Fixed	1,322.17	1,533.10	1,701.15	1,959.14	2,246.69
NIDs	96.80	85.90	109.90	106.50	155.00
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	409.20	1,176.61	2,014.35	2,265.37	2,444.54
Subordinated Debt & Hybrid Capital	0.00	0.00	0.00	0.00	0.00
Other Liabilities	200.59	244.17	373.08	593.99	583.95
<b>TOTAL LIABILITIES</b>	<b>2,028.76</b>	<b>3,039.77</b>	<b>4,198.48</b>	<b>4,925.00</b>	<b>5,437.74</b>
Paid-up Capital	25.00	30.00	30.00	30.00	30.00
Minority Interest	0.00	0.00	0.00	0.00	0.00
Share Premium & Other Reserves	1,036.38	1,564.97	1,713.21	2,273.33	2,380.64
Statutory General Reserve	156.40	206.40	256.40	276.40	296.40
Retained Profits/(Loss)	3.73	1.49	1.72	3.50	5.02
<b>Total Shareholders' Funds</b>	<b>1,221.51</b>	<b>1,802.86</b>	<b>2,001.33</b>	<b>2,583.22</b>	<b>2,712.06</b>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS' FUNDS</b>	<b>3,250.26</b>	<b>4,842.63</b>	<b>6,199.81</b>	<b>7,508.23</b>	<b>8,149.80</b>
<b>COMMITMENTS &amp; CONTINGENCIES</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>TIER 1 CAPITAL</b>	<b>919.54</b>	<b>1,187.30</b>	<b>1,332.50</b>	<b>1,414.33</b>	<b>1,548.85</b>
<b>CAPITAL BASE</b>	<b>1,070.52</b>	<b>1,495.08</b>	<b>1,666.89</b>	<b>1,998.77</b>	<b>2,130.45</b>

## Financial Summary - Company

INCOME STATEMENT (LKR Million)	31-Mar-04	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08
Interest Income	547.50	700.04	889.69	1,025.59	1,307.42
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	172.33	241.25	335.39	447.07	720.13
Net Interest Income	375.17	458.79	554.30	578.52	587.29
Non-Interest Income	98.54	99.45	84.81	66.74	64.72
<b>Gross Income</b>	<b>473.71</b>	<b>558.24</b>	<b>639.10</b>	<b>645.27</b>	<b>652.01</b>
Personnel Expenses	60.91	80.99	95.20	111.68	134.48
Other Non-Interest Expenses	102.50	142.27	170.08	177.50	234.19
Loan Loss Provisions	25.86	23.00	13.04	18.77	52.05
Share of results of Associated Companies	0.00	0.00	0.00	0.00	0.00
<b>Pre-Tax Profit</b>	<b>284.45</b>	<b>311.98</b>	<b>360.78</b>	<b>337.31</b>	<b>231.29</b>
Taxation	19.53	7.03	77.10	100.33	82.72
<b>Profit After Tax</b>	<b>264.92</b>	<b>304.95</b>	<b>283.69</b>	<b>236.99</b>	<b>148.57</b>
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Prior Year Adjustments	0.00	0.00	0.00	(95.13)	0.00
Minority Interests	0.00	0.00	0.00	0.00	0.00
Transfer To Statutory Reserves	30.00	0.00	0.00	0.00	0.00
Transfer To Other Reserves	220.00	265.00	254.14	80.00	133.00
Dividend	12.50	42.19	29.32	60.08	14.05
<b>Retained Profit For The Year</b>	<b>2.42</b>	<b>(2.24)</b>	<b>0.23</b>	<b>1.78</b>	<b>1.52</b>

## Financial Ratios - Company

KEY RATIOS (%)	31-Mar-04	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08
<b>Profitability</b>					
Net Interest Margin	13.51%	11.34%	10.04%	8.44%	7.50%
Non-Interest Income Margin	3.55%	2.46%	1.54%	0.97%	0.83%
Cost To Income	34.49%	39.99%	41.51%	44.82%	56.54%
Return On Assets	10.25%	7.71%	6.53%	4.92%	2.95%
Return On Equity	27.30%	20.63%	18.97%	14.72%	8.74%
Dividend Payout	4.72%	13.83%	10.34%	25.35%	9.46%
<b>Asset Quality</b>					
Gross NPL Ratio	10.67%	8.75%	6.83%	6.05%	7.64%
Net NPL Ratio	2.52%	2.49%	1.88%	1.45%	2.82%
Specific Loan Loss Provisions For Current Year	1.21%	0.76%	0.31%	0.37%	0.91%
Gross NPL Coverage	78.33%	73.34%	73.82%	77.16%	64.90%
Loan Loss Reserve Coverage	8.36%	6.42%	5.04%	4.67%	4.96%
General Loan Loss Reserve Coverage	0.00%	0.00%	0.00%	0.00%	0.00%
<b>Liquidity &amp; Funding</b>					
Liquid Asset Ratio	21.15%	28.08%	31.87%	27.56%	24.40%
Statutory Liquid Asset Ratio	15.71%	17.86%	19.63%	17.52%	17.28%
Customer Deposits To Total Interest Bearing Funds	77.62%	57.91%	47.34%	47.69%	49.64%
Loans To Deposits Ratio	149.84%	195.47%	236.80%	234.89%	223.38%
Loans To Stable Funds Ratio	88.77%	87.96%	89.58%	91.49%	90.78%
<b>Capital Adequacy</b>					
Shareholders' Funds To Total Assets	37.58%	37.23%	32.28%	34.41%	33.28%
Tier 1 Risk Weighted Capital Adequacy Ratio	30.46%	26.22%	22.81%	19.79%	20.06%
Overall Risk Weighted Capital Adequacy Ratio	35.47%	33.02%	28.53%	27.96%	27.59%
Internal Rate Of Capital Generation	24.22%	17.38%	13.37%	7.72%	5.08%

**Note :**

\* annualised

NA = Not available / Not applicable

## 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

## 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

<b>AAA</b>	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.
<b>AA+</b> <b>AA</b> <b>AA-</b>	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.
<b>A+</b> <b>A</b> <b>A-</b>	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.
<b>BBB+</b> <b>BBB</b> <b>BBB-</b>	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.
<b>BB+</b> <b>BB</b> <b>BB-</b>	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> <b>B</b> <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.
<b>C+</b> <b>C</b> <b>C-</b>	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.
<b>D</b>	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.

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## **SHORT-TERM RATINGS**

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- 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.

## **RAM RATINGS' CREDIT RATING DEFINITIONS (CORPORATE DEBT SECURITIES)**

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### **SHORT-TERM RATINGS**

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- P1** Very strong safety with regard to timely payment on the instrument.
- P2** Strong ability with regard to timely payment of obligations.
- P3** Adequate safety with regard to timely payment of obligations. Instrument is more vulnerable to the effects of changing circumstances than those rated in the P1 and P2 categories.
- NP** High investment risk, with doubtful capacity for timely payment of short-term obligations.

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