

RAM

RATINGS

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

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

ALLIANCE FINANCE COMPANY PLC- Rating Review

Financial Institution Ratings:

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

Rating Outlook:

Stable

Strengths:

- Reputable franchise
- Better-than-average asset quality
- Adequate capitalisation

Weakness:

- Tight funding structure

Principal Activities:

Finance company engaged in hire-purchase, finance and operating leases, personal loans, share trading and acceptance of public deposits

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Summary

RAM Ratings Lanka has reaffirmed Alliance Finance Company PLC's ("AFC" or "the Company") respective long- and short-term financial institution ratings at BBB and P2; the long-term rating has a stable outlook. The reaffirmation is premised on AFC's better-than-industry asset quality, moderate financial performance and capitalisation. On the other hand its ratings are weighed down by its fragile funding structure.

AFC is a medium-scale registered finance company ("RFC") that accounted for 3.40% of the industry's assets as at end-December 2008. With a 53-year track record, it is one of the oldest finance companies in Sri Lanka. The Company has weathered many turbulent times in its history, underscored by its conservative growth strategy and prudent management.

During the reviewed period, there had been an uptick in defaults for AFC. Nonetheless, RAM Ratings Lanka still deems the Company to have adequate asset quality. Although AFC improved its asset quality until FYE 31 March 2008 ("FY Mar 2008"), the worsening macroeconomic environment had pushed up its non-performing loans ("NPLs"). As at end-December 2008, the Company's gross NPL ratio (on a 6-month classification basis) stood at 5.22% (end-March 2008: 3.33%). That said, the Company's NPL ratio was still better than the industry average, which came up to 6.70%¹ as at end-December 2008. Additionally, we note the Company's strategy to combat its rising NPLs.

Meanwhile, AFC's financial performance had moderated during the reviewed period, a result of rising interest rates, overheads and provisions. Consequently, the Company's returns on assets ("ROA") slumped from 1.64% as at end-FY Mar 2008 to 0.90% (annualised) as at end-December 2008. However, RAM Ratings Lanka notes that the Company had made additional provisions for overheads; after adjusting for these, its cost-to-income ratio eased to 65.53% as at the same date (unadjusted: 78.10%). Accordingly, its adjusted pre-tax profit ameliorated to LKR 57.43 million from LKR 32.61 million (adjusted ROA: 1.04%).

In the face of rising interest rates, the negative gap in AFC's asset-liability maturity profile had widened. The Company's loans-to-deposits ratio, although lower, remained elevated. On a more positive note, its statutory liquid-asset ratio improved from 16.59% as at end-March 2008 to 18.32% as at end-December the same year.

AFC reported an overall risk-weighted capital-adequacy ratio ("RWCAR") of 10.37% as at end-December 2008 (against the Central Bank's minimum requirement of 10%). Given the Company's consolidation strategy, RAM Ratings Lanka deems its capital cushioning to be moderate.

¹ Central Bank Annual Report 2008, page 167

Outlook

The stable outlook is premised on our expectation that AFC will be able to hold its asset quality in check, with its liquidity at least at current levels and its capital-adequacy ratios above the statutory minimums.

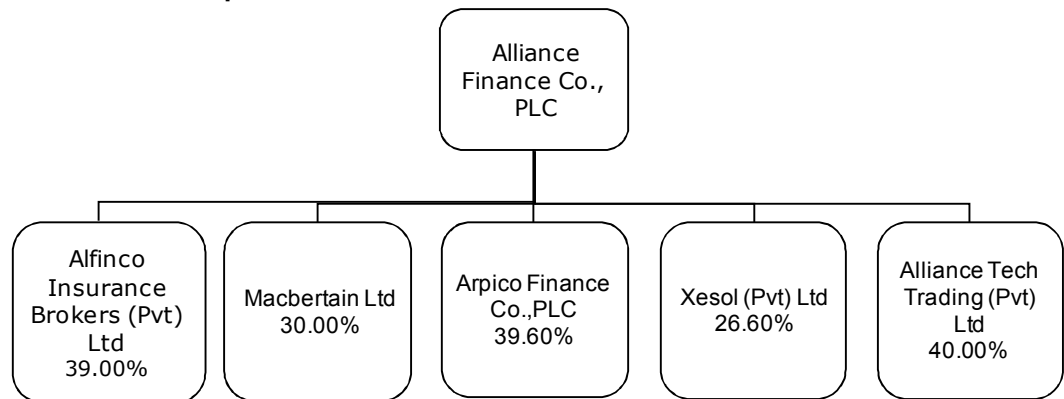
The ratings will come under pressure if the Company’s asset quality or funding structure worsens significantly. On the other hand, upward revision of its ratings is unlikely over the short to medium term, owing to the Company’s diminutive stature in relation to the industry and its weak funding structure.

Corporate Profile

AFC is the third-oldest RFC in Sri Lanka, and is regulated by the non-bank financial institutions supervision department of the Central Bank of Sri Lanka. With a 53-year track record, AFC has established itself as one of the more stable domestic finance companies. AFC also has the distinction of being the first RFC to obtain ISO9001:2000 certification.

The Company’s first branch was opened in FY Mar 2006; it presently has 3 branches, 9 collection centres, 3 business units, and 16 pawning centres. We note that as per RFC regulations, only branches are allowed to accept public deposits. Business units, collection and pawning centres cannot do so. AFC is one of only 7 finance companies listed on the Colombo Stock Exchange (“CSE”), and is the flagship of the AFC Group. The other companies within this group are engaged in finance, manufacturing, importing and trading activities (refer to Chart 1).

Chart 1: AFC’s corporate structure as at end-FY Mar 2008



As an RFC, the Company provides finance leases, hire-purchase (“HP”) facilities, operational leases, consumer credit, gold loans and collaboration finance². The latter is a unique financial product for which its Deputy Chairman, Mr Romani De Silva, won 2 bronze awards as *Entrepreneur of the Year* in 2002. The Company also supplements its income from proprietary share trading, on top of importing and trading vehicles and furniture.

² Under collaboration finance, AFC provides working capital to other businesses. In return, AFC has custody of the inventory and also manages cash for the client company. This business yields both fee and interest income.

Third-oldest RFC in Sri Lanka

Listed on SEC

Offers various products and services

Only RFC in Sri Lanka named PCI of World Bank

Closely held, listed entity

Expansion plans on hold

New loan product

In 2007, AFC became a Participating Credit Institution (“PCI”) of the World Bank. This enables the Company to access concessional funding lines vis-a-vis expanding its micro-finance portfolio, particularly the financing of solar panels for households that do not have access to the national grid.

Ownership

Despite being listed on the CSE, AFC is a closely held entity; successive generations have held board positions within the Company. The founding members had been Messrs Eardley de Silva, Heyward Fernando, Fred Perera, Hayes Jayasundara and NM Appuhamy. Its top 20 shareholders controlled approximately 78.65% of the Company as at end-FY Mar 2008.

Management & Strategies

Mr Romani De Silva, the Joint Managing Director-cum-Deputy Chairman, continues to spearhead the management team. AFC remains true to its 2-pronged business strategy of cautiously expanding its financing business while diversifying into other areas. Its conventional business lines include HP, finance and operating leases, import loans³, gold loans and collaboration finance. However, liquidity has taken centre stage amid the rising trend in delinquencies, together with a decline in deposit renewals since December 2008. Hence, AFC’s current focus is on improving its liquidity position.

The Company’s diversification programme entails trading vehicles, furniture and tiles. The management’s ultimate aim is to achieve a more sustainable business model via its trading businesses. Hence, the Company intends to broaden the range of assets that it finances, especially since it had previously encountered high defaults while financing the products of third-party vendors. To overcome these drawbacks, the Company has been trying to gain experience in various trading products. Meanwhile, the management understands the risks inherent in the tile business; this experience had been gleaned through its collaboration business. In addition to trading, the management also seeks to leverage on its expertise in fleet management. In this respect, AFC has been offering operating leases. Given the increasing cost of vehicle ownership (i.e. the rising expenses of acquiring and maintaining a vehicle), however, AFC is positioning itself as a transport-solutions provider.

In the context of conventional financing, AFC has ventured into pawn brokering; this has become the product of choice for many RFCs, given the weaker economic fundamentals and high domestic interest rates. Pawn brokering, which the Company promotes as gold loans, are short-term advances (12 months or less) that yield broader margins. As these advances are against the physical custody of gold, recovery prospects are high in the event of default due to the pledged security (precious metal). However, there is a market risk involved in pawning; this risk is mitigated by providing only 67% to 80% of the security’s value, depending on the tenure. Moreover, this form of credit product entails a whole host of operational risks, thus necessitating adequate internal controls. Currently, internal audits are carried out weekly by the Company’s internal auditor.

³ Financing letters of credit for vehicle importers.

Increased focus on recoveries and improving liquidity

One of AFC's key strengths is its monitoring systems. The failure of 2 high-profile non-regulated financial institutions, together with the recessionary global economic climate, has prompted the management to focus on liquidity rather than profitability or expansion. In response to the uptick in defaults since March 2008, the management has redoubled its emphasis on collections and recoveries. Collection and recovery meetings are held fortnightly to review the amounts in arrears and formulate follow-up actions. Default trends are monitored geographically and by credit officer. These efforts are expected to rein in delinquencies and improve AFC's liquidity and financial performance.

Corporate Governance

AFC's board is composed of 3 non-executive directors and 4 executive directors. Board meetings are held monthly, during which the Company's performance and the industry climate are extensively discussed. Of the 3 non-executive directors, 2 are deemed independent by the Company. The board is also supported by 4 committees: audit, risk management, remuneration and asset-liability.

Going forward, the Company is expected to comply with the CSE's revised rules on corporate governance (effective 1 April 2009). In addition, AFC is also required to comply with the Finance Companies (Corporate Governance) Direction 3 and 4 of 2008.

Asset Quality

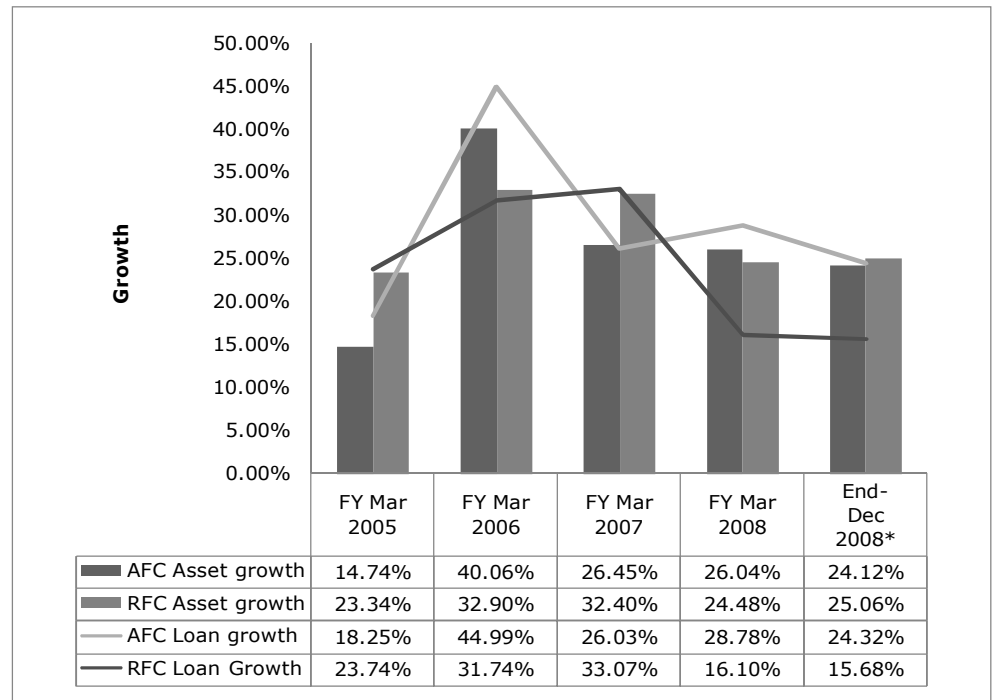
Asset quality still better than industry's

AFC's asset quality is still better than the industry average. Even though there has been an increase in defaults, AFC's stringent monitoring and strategies to counter the adverse trends are expected to keep the Company's asset quality in check.

Moderating loan growth

RAM Ratings Lanka envisages the Company's asset and loan growth to ease over the medium term. AFC's asset base augmented 26.04% in FY Mar 2008 (FY Mar 2007: 26.45%). In the first nine months of FY Mar 2009, its asset base advanced a further 24.12% on an annualised basis (refer to Chart 2). As expected, loans and advances continued driving its asset expansion. Over the short to medium term, however, AFC's loan growth is expected to moderate given its focus on maintaining a healthy portfolio.

Chart 2: AFC's and the industry's asset and loan growth

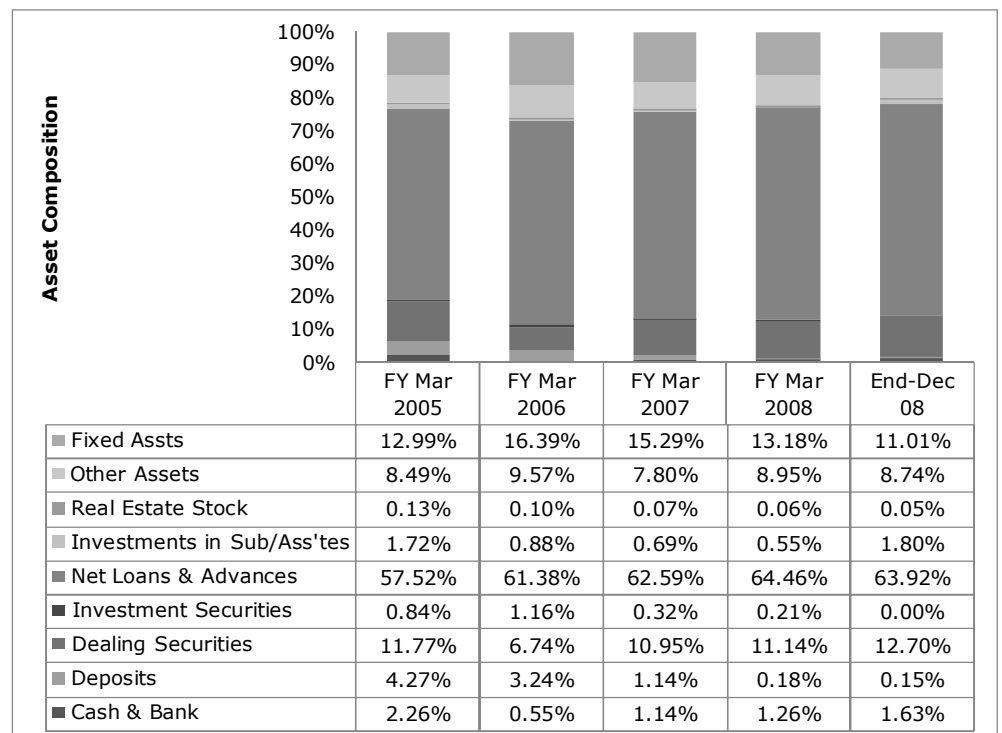


*Annualised

Asset composition still largely unchanged

The Company's gross loans and advances had risen 28.78% as end-FY Mar 2008. In the ensuing 9 months, however, the pace of its credit expansion eased to 24.32% (annualised). Correspondingly, credit assets took up a larger 64.46% of its asset base before contracting to historical levels over the same span (refer to Chart 3).

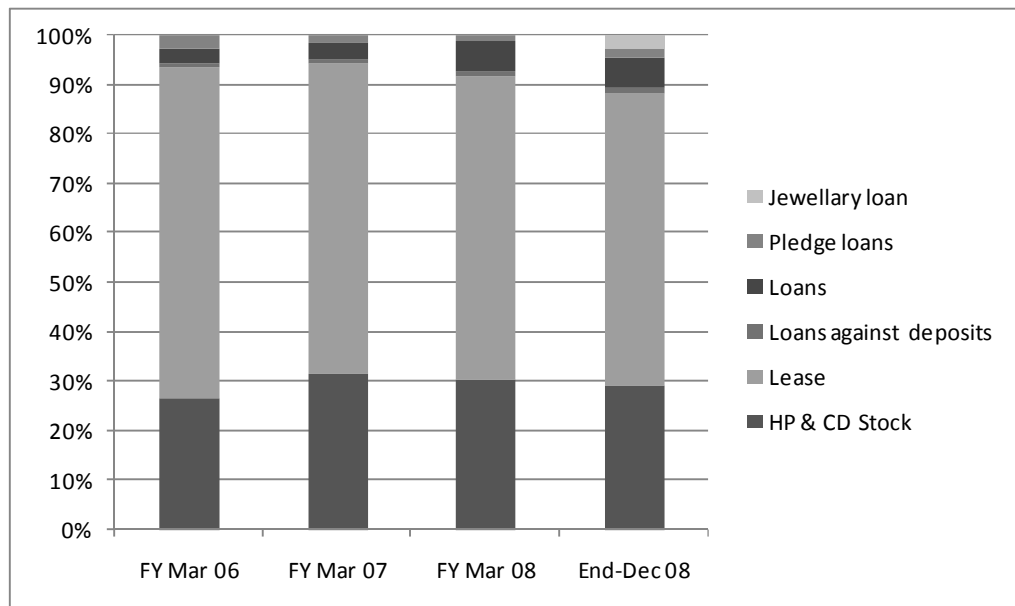
Chart 3: Trends in AFC's asset composition



Portfolio growth to centre on gold loans

Alliance’s loan growth had been driven by leases and HP facilities. Accordingly, its loan composition continued to be dominated by leases (refer to Chart 4), surging 23.66% year-on-year (“y-o-y”) and 52.04% (annualised) in FY Mar 2008 and the first 9 months of FY Mar 2009, respectively. Meanwhile, HP loans and consumer durable (“CD”) loans stayed in second place. AFC’s new loan product, i.e. loans collateralised by jewellery, has also been charting buoyant growth, surpassing existing offerings such as pledge loans and loans against deposits. The new product is a type of short-term advance, lent against collateral that typically comprises jewellery. RAM Ratings Lanka expects this portfolio to expand over the short to medium term.

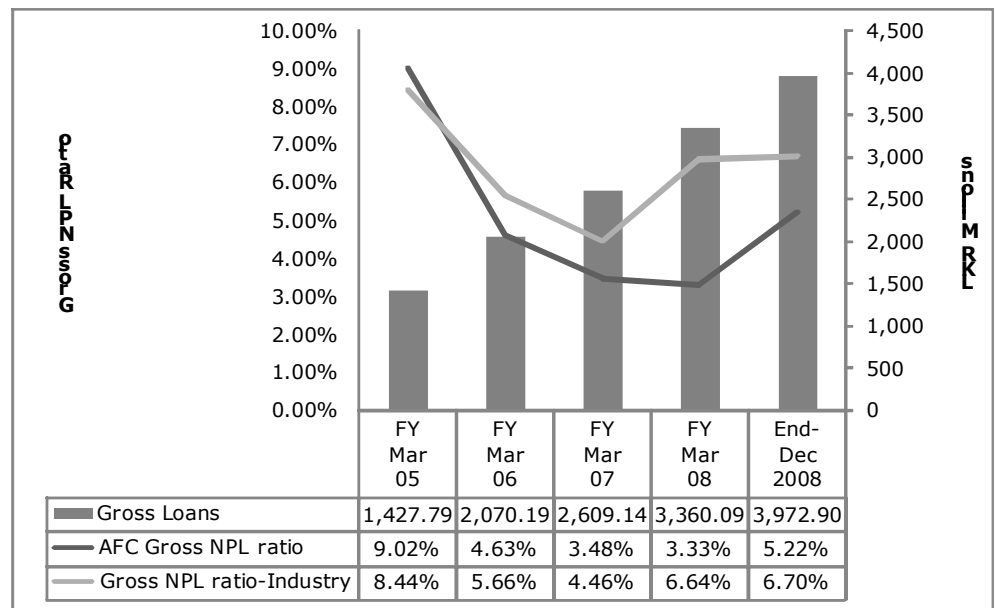
Chart 4: AFC’s absolute incremental loan mix



Rising NPLs expected to reverse trend

In tandem with its healthy loan growth, AFC has been able keep its credit quality at above the industry average. The Company’s gross NPL ratio, which stood at 3.48% as at end-FY Mar 2007, eased further to 3.33% as at end-FY Mar 2008. By end-December 2008, however, the deteriorating economic scenario had exerted considerable pressure on AFC’s lending portfolio, thus pushing up its gross NPL ratio to 5.22%. As gold loans are not classified as NPLs, its adjusted NPL ratio (ie removing gold loans from the base) stood at 5.36%. Nevertheless, this was still better than the industry average as of the same date (refer to Chart 5). RAM Ratings Lanka also notes that the Company has successfully halted further deterioration in its NPLs. AFC’s absolute NPLs reduced from LKR 228.99 million as at end-December 2008 to LKR 223.46 million as at end-February 2009.

Chart 5: Trends in the asset quality of AFC and the industry



Curbing delinquencies

About 90% of the Company’s NPLs stems from leases and HPs, of which approximately 74% is taken up by 4-wheeled vehicles (refer to Table 1). The management realises that most of these NPLs originate from outstation branches, and has frozen the financing of such vehicles. AFC has also ceased financing equipment such as solar panels due to rising default rates. Given the worsening economic fundamentals, the management has instead focused its efforts on improving collections. RAM Ratings Lanka views AFC’s current caution in a positive light.

Table 1: Analysis of NPLs within the HP and lease portfolios

Type of asset financed	NPLs	Default rate
4-wheeled vehicles	73.34%	11.33%
3-wheeled vehicles	9.88%	2.72%
2-wheeled vehicles	2.66%	5.32%
Equipment	12.86%	17.79%
Unclassified	1.27%	100.00%

Better-than-industry coverage levels

AFC adopts Direction 3 in respect of provisioning for bad and doubtful debts. This provisioning policy allows the Company to net off the collateral value of assets that have been repossessed. Accordingly, its NPL coverage weakened from 97.40% as at end-FY Mar 2007 to 65.86% as at end-December 2008. Nonetheless, AFC’s coverage level remained better than the industry average of 44.10% as at the same date. We also note that the Company makes a more conservative estimate of repossessed stock.

To minimise exposure to trading assets

Apart from loan assets, other income-generating assets include trading inventory, share/equity trading, operating leases and real-estate assets. The Company’s inventory or trading businesses include vehicles, furniture and ceramic tiles, electrical goods, pesticides and ventilators; collectively, these made up 4.45% of its total assets as at end-December 2008 (end-FY Mar 2008: 2.51%). RAM Ratings Lanka understands that these exposures will be reduced further towards the end of the current financial year.

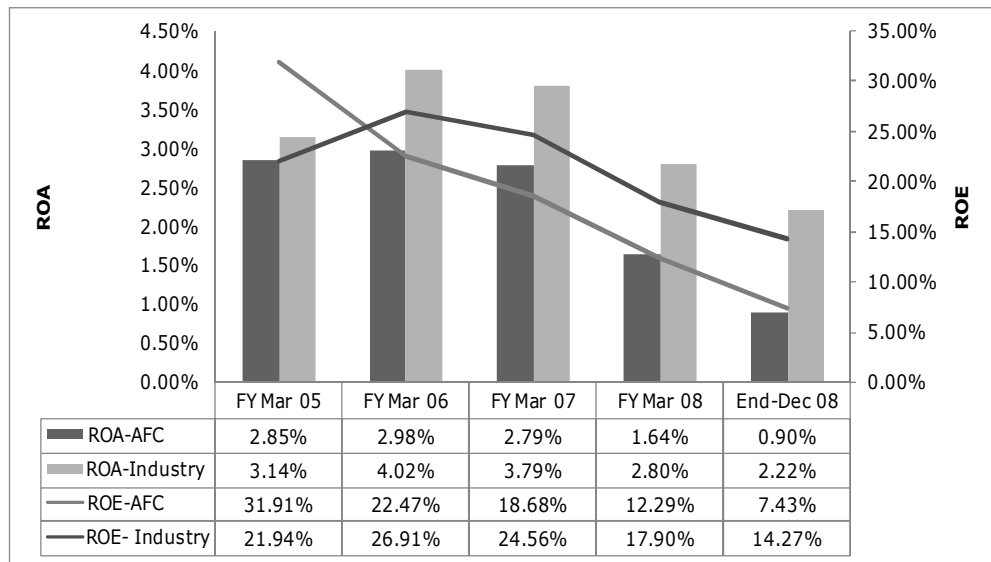
Overheads and margin squeeze affected performance

In the context of share trading, the Company’s exposure remained moderate at 4.45% of its total assets as at end-December 2008. These investments are quoted at the lower of cost or market value on an aggregate basis. AFC’s exposure to equity trading is also envisaged to be trimmed in future.

Performance

Despite maintaining a better-than-industry asset quality, AFC’s financial performance is still rather modest owing to margin compression and hefty overheads. Consequently, its ROA and ROE have remained below the industry average (refer to Chart 6). However, RAM Ratings Lanka notes that the Company makes discretionary operational provisions; after adjusting for these, its ROA and ROE stood at 1.04% and 8.62% as at end-December 2008.

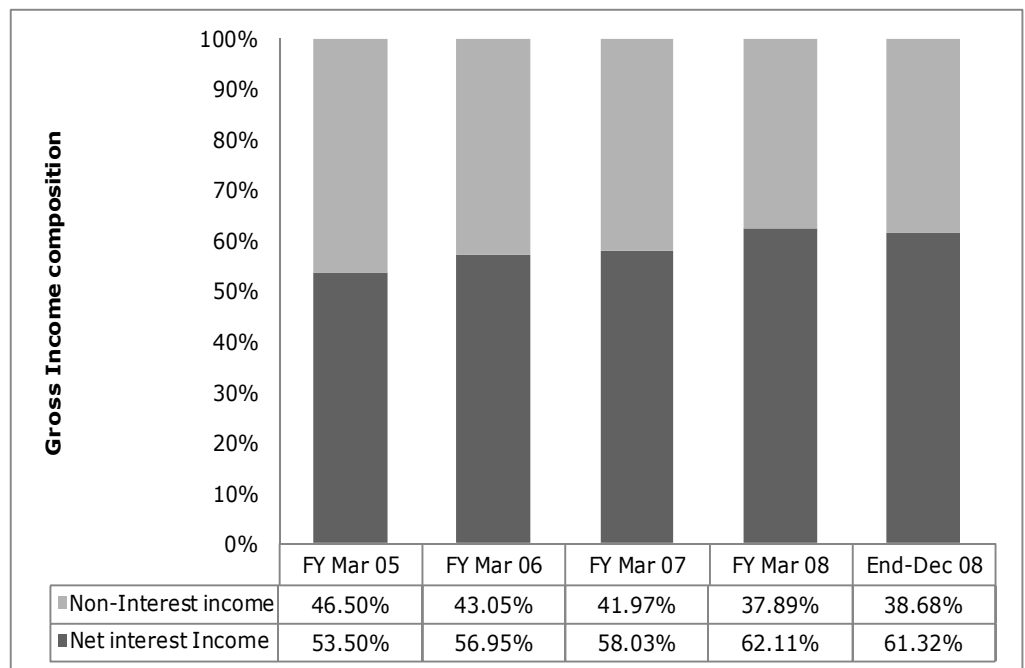
Chart 6: Profitability trends of AFC and the industry



Interest income still dominates revenue

Gross income of AFC eased somewhat in FY Mar 2008, slipping 1.57% y-o-y as non-interest income receded. As a result, its gross income composition tilted more in favour of interest income (refer to Chart 7). Non-interest income declined 11.16% y-o-y in FY Mar 2008, due to depressed share-trading profits and losses from AFC’s trading businesses. Consequently, its non-interest margin narrowed from 5.09% in FY Mar 2007 to 3.58% in FY Mar 2008. RAM Ratings Lanka notes that the management has taken measures to reduce the overheads of the Company’s trading businesses and to improve its financial performance. On a more positive note, operating-lease income, commissions and documentation fees constitute the bulk of AFC’s non-interest income – a recurring source of income.

Chart 7: Trends in AFC’s gross income composition



Contracting margins

Meanwhile, AFC’s net interest margin (“NIM”) had also come under pressure, as the Company had been unable to benefit from the healthy growth in advances as interest expenses had escalated much faster than interest income. As a result, its NIM narrowed from 7.04% to 5.88% between FY Mar 2007 and FY Mar 2008.

Provisions envisaged to decrease

Apart from margin compression, AFC also bears hefty overheads. The Company’s elevated overheads are reflected in its cost-to-income ratio, which climbed up to 78.90% as at end-December 2008. That said, RAM Ratings Lanka notes that AFC’s overheads had been affected by the management’s discretionary provisions; after adjusting for these, its cost-to-income ratio improved to 65.53% as at end-December 2008.

The Company’s performance in the first 9 months of FY 2009 had also been affected by increased provisions for bad debts, which amounted to LKR 38.23 million. However, RAM Ratings Lanka expects the Company’s ROA to inch up as at end-FY Mar 2009, as provisions are reversed on account of recoveries.

Funding & Liquidity

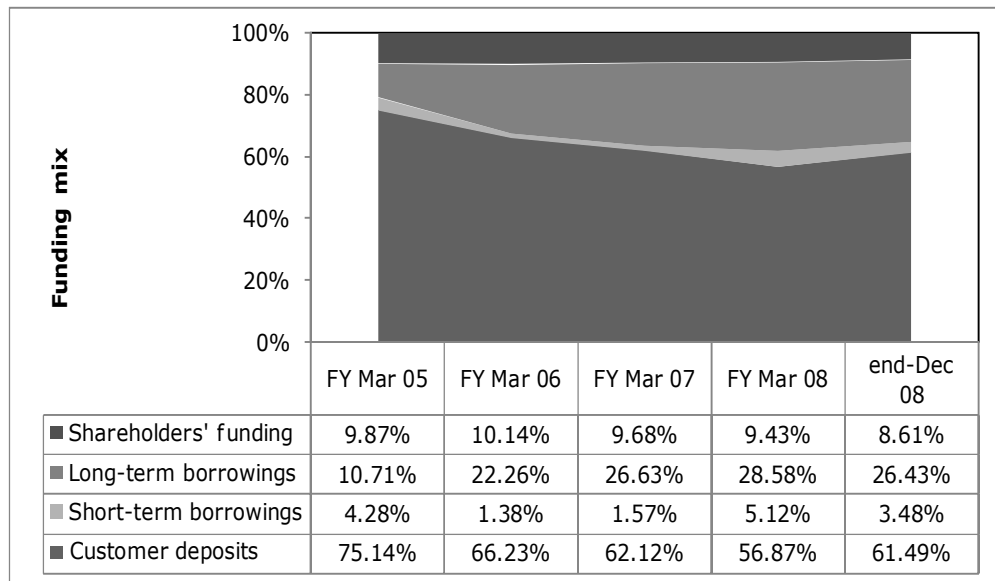
Moderate liquidity and funding levels

Owing to macroeconomic factors AFC’s funding and liquidity risks had heightened over the period under review. To partially alleviate liquidity risk, the Company had improved its liquidity position, as reflected in its statutory liquid-asset ratios of 16.59% as at end-FY Mar 2008 and 18.32% as at end-December 2008.

Trending towards public deposits

On a brighter note, AFC’s deposit franchise continued to bolster its funding; public deposits made up 56.87% of its total funding (refer to Chart 8) as at end-FY Mar 2008. Meanwhile, long-term borrowings came in second, accounting for 28.58% of its funding base. As a result of the Company’s reliance on secured funding lines, its loans-to-deposits ratio, though easing, remained above prudential limits. That said, we note that this is an industry-wide phenomenon.

Chart 8: Funding mix of AFC



Increased interest-rate and liquidity risks

Amid the prevailing environment of high interest rates, the negative gap in AFC's asset-liability maturity profile widened to LKR 692.93 million as at end-FY Mar 2008 in the "less than 1 year" bucket (refer to Table 2). To manage the higher liquidity and interest-rate risks, AFC has secured LKR 51 million of unutilised banking lines. Furthermore, the Company has managed to negotiate an interest-rate swap agreement worth LKR 200 million.

Table 2: AFC's asset-liability maturity profile

Maturity Bucket	FY Mar 2008			FY Mar 2007		
	Interest earning assets	Interest bearing liabilities	Gap	Interest earning assets	Interest bearing liabilities	Gap
Less than 1 Year	1,712.75	2,405.67	(692.93)	1,405.96	1,518.42	(112.46)
1 to 3 Years	1,654.79	1,294.99	359.80	1,283.27	1,250.88	32.39
More than 3 Years	361.87	454.44	(92.57)	357.55	385.08	(27.53)
Total	3,729.40	4,155.10		3,046.78	3,154.38	

Mitigating heightened liquidity and interest-rate risks

RAM Ratings Lanka notes that AFC has a healthy deposit-renewal rate of about 90%. The Company's deposit renewals dipped as much as 75.58% in January 2009, amid a crisis vis-a-vis depositor confidence in the finance-companies sector, arising from the collapse of errant (unregulated) finance companies. By February 2009, however, AFC's renewal rates had improved to 84.77%. We note that the management is also considering investing its short-tenured deposits in short-term instruments such as commercial papers.

Capital Adequacy

Capital cushioning still adequate

AFC reported an overall capital-adequacy ratio of 10.37% as at end-December 2008. Even though this ratio had been trending down over the last 3 years, RAM Ratings Lanka expects an improvement as the management reduces its exposure to risk-weighted assets such as inventories. AFC's ratio on net NPLs to shareholders' funds ratio, which stood at 10.39% as at end-December 2008, is also envisaged to ease due to its focus on improving the Company's asset quality. All these efforts are expected to keep the Company's capital cushioning at moderate levels over the short to medium term.

Improved capital adequacy

Industry Overview

Sri Lanka's gross domestic product ("GDP") is estimated to have expanded by 6.0% in 2008, compared to 6.8% the previous year. While the growth of the agriculture sector had accelerated during this span, the industrial and services sector's pace had slowed down (refer to Table 3).

The better performance of the agriculture sector had been driven by increased production levels, supported by favourable weather conditions and prices as well as more land for cultivation. The deceleration of the industrial sector, on the other hand, had been mainly due to the slowdown in the manufacturing sub-sector, particularly within the textile, garment and leather industries. Meanwhile, the services sector decelerated with a contraction in the hotels and restaurant sub-sectors while banking, insurance and real estate had lost momentum. Looking ahead, however, global recession is expected to take its toll on all sectors.

Table 3: Overall and sectoral GDP growth

At constant 2002 prices	2007	2008
Agriculture	3.4%	7.5%
Industry	7.6%	5.9%
Services	7.1%	5.6%
Total	6.8%	6.0%

Meanwhile, the rate of inflation, which has been rising since 2H 2007, is now slowing down. The Colombo Consumer Price Index ("CCPI"), which hit an all-time high of 28.2% in June 2008, has been declining significantly since the latter part of last year (December 2008: 14.4%). Favourable domestic supply factors, as well as easing international commodity prices - especially crude oil - have supported the deceleration in inflation. Furthermore, the tight monetary policies adopted by the Central Bank in 1H 2008 complemented the results achieved. With easing inflation the Central Bank has relaxed its monetary policy by cutting base interest rates. If the expected favourable trend in inflation continues, the Central Bank may ease its monetary policy further, thereby encouraging lower interest rates. A fall in market rates could help boost economic activity and galvanise the system; however, the effectiveness of these measures remains to be seen in the face of global recessionary pressures.

Even though falling interest rates may be a positive development, RAM Ratings Lanka does not envisage the RFC industry's asset quality to improve over the medium term. This is because RFCs are more vulnerable to economic vagaries given their exposure to the sub-prime sector. Although inflationary pressure is easing, economic fundamentals have yet to strengthen. Hence, maintaining asset quality will remain a challenge. On this note, rising loan delinquencies have weakened the industry's average gross NPL ratio, which deteriorated from 4.5% as at end-March 2007 to 6.7% as at end-December 2008. In an attempt to curb rising NPLs, RFCs have curtailed lending and adopted consolidation strategies, which have resulted in an industry-wide deceleration in portfolio growth. Consequently, the industry's y-o-y loan growth almost halved from 33.07% in end-March 2007 to 15.64% as at end-December 2008. To minimise exposure to credit risks, RFCs are introducing short-term, small-denomination loans while minimising their exposures by increasing borrowers' contributions. These strategies are expected to curtail RFCs' exposures to interest-rate and credit risks.

In tandem with the above, monitoring and recovery efforts have become more stringent. Most RFCs now take action to repossess collateral (mostly vehicles) as soon as debt servicing exceeds 3 months in arrears. Therefore, RAM Ratings Lanka notes an accumulation in the number of seized vehicles. In this respect, the quality of collateral takes centre stage vis-à-vis recouping outstanding advances.

Furthermore, competition from commercial banks has also increased as they too have ventured into the vehicle-financing business - the key business segment of RFCs. This highlights the inherent product-concentration risk in the RFC business model.

Against this backdrop, RAM Ratings Lanka observes a shift in RFCs' asset mix, from lending to other non-interest-earning business pursuits such as trading in real estate. However, our concerns hinge on the weakened property market; the high yields offered on financial assets are diverting investments from real assets, hence subduing demand for real estate and heightening market risk. Moreover, investments in real estate expose RFCs to liquidity risk; this is because real-estate stocks are less liquid, render cashflow unpredictable and incur holding costs. As such, real-estate assets introduce myriad risks to financial institutions.

On the funding side, the deposit structure has tilted towards shorter tenures as depositors seek to take advantage of volatile interest rates. Many RFCs consequently face widening negative liquidity gaps in the short term. As such, deposit franchise and asset-liability management become crucial. Although RFCs are now allowed 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. Moreover, following the collapse of 2 unregulated finance companies, liquidity levels in the RFC sector have been pressured. Nonetheless, the Central Bank's easing monetary policy is expected to provide some respite to the industry.

In the meantime, the weakened economic climate is weighing down on the financial performance of the RFC sector as a whole. The industry's ROA declined from 3.79% as at end-March 2007 to 1.95% as at end-December 2008; this trend is expected to persist over the medium term. The industry's performance has also been hampered by margin squeezes and rising overheads. Moreover, rising delinquencies have been narrowing portfolio yields and increasing pressure on bottom lines via heftier provisioning. RAM Ratings Lanka further notes that RFCs involved in housing and real-estate development tend to recognise trading profits upfront; this clouds profit comparisons with other RFCs that only offer financing products.

Although the RFC industry's overall risk-weighted capital adequacy has improved slightly, rising defaults have weakened the industry's ratio on net NPLs to shareholders' funds, from 10.48% (end-March 2007) to 18.51% (end-December 2008).

On a separate note, the Central Bank has introduced its *Direction on Corporate Governance of Finance Companies*, which took effect on 1 January 2009. As per transitional provision, however, a 3-year extension has been granted for full compliance. These guidelines are envisaged to instil more discipline on RFCs vis-à-vis board responsibility and overall risk management. Nonetheless, RAM Ratings Lanka notes that meeting these requirements will be a challenge.

Relevant Central Bank Directions Applicable to Registered Finance Companies

<p><i>Liquid Assets</i></p>	<p>Every finance company should have a minimum holding of liquid assets at any given time. Liquid assets mean:</p> <ul 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 Lanka Government Treasury Bills, free from any charge or lien. (d) Sri Lanka 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 limit applicable is as follows:</p> <ul 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 was 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> <ul 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> <ul 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 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> <ul 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 will come into effect on 1 April 2007 (Direction No. 3 of 2006) which 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 become applicable to every RFC and will replace Direction 1 and 2 above.</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>(c) 50% of all advances in arrears for a period of 6 to 12 months. (d) 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"> 1) Sri Lankan Government securities, free from any lien or charge 2) Central Bank of Sri Lanka securities, free from any lien or charge 3) Time deposit in a licensed commercial bank, specialised bank or an RFC, free from any lien or charge 4) Bank guarantees 5) With regard to vehicles and machinery re-possessed- 80% of valuation obtained during preceding 6 months and by approved valuer 6) With regard to land and buildings mortgaged and held as collateral - if the accommodation in arrears for a period of <ol style="list-style-type: none"> a. 06-36 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. Over 120 months, 0% of the value is deductible
<p>Capital Adequacy</p>	<p>Every finance company has to 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>(i) 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 5%, i.e. this has to be at least half of the total risk-weighted capital-adequacy ratio.</p> <p>(ii) 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>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 is 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 has to maintain, at all times, an unimpaired core capital of LKR 200 million. However, companies that cannot meet this requirement by February 2006 are granted a 30-month extension, subject to the following:</p> <ul style="list-style-type: none"> (i) A finance company with a core capital of less than LKR 100 million shall: <ul style="list-style-type: none"> (a) enhance its core capital to at least LKR 100 million by February 2007; and (b) Bring the remaining LKR 100 million or the deficient amount up to the core capital requirement of LKR 200 million by July 2008. (ii) A finance company with a core capital of between LKR 100 million and LKR 200 million shall bring in: <ul style="list-style-type: none"> (a) at least 50% of the deficient amount to meet the core capital requirement of LKR 200 million by February 2007; and (b) the balance of the deficient amount up to the core capital requirement of LKR 200 million by July 2008.
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Corporate Information

Date of Incorporation:	18 July 1956			
Commencement of Business:	1956			
Major Shareholders:	Mr RKEP de Silva	18.21%		
	Motor Services Station Ltd	12.15%		
	Ms DMEP Perera	10.62%		
	Mr JEPA de Silva	6.24%		
	Mr DFWSK Perera	4.10%		
	Orient Hotels Ltd	4.03%		
Directors:	Mr Pratapkumar de Silva	Chairman & Joint Managing Director		
	Mr R Romani de Silva	Deputy Chairman & Joint Managing		
	Mr DLSR Perera	Director Finance Director		
	Mr JFR De Saram	Director		
	Mr RM Canekeratne	Director		
	Mr B Ponnambalam	Director		
	Mrs KSK de Silva	Director		
Auditor:	M/s HLB Edirisinghe & Co			
Listing:	Listed on the Colombo Stock Exchange			
Key Management:	Mr Romani de Silva	Deputy Chairman/Joint Managing		
	Mr Rohan Perera	Director/Finance Director		
	Mr J F R de Saram	Executive Director		
	Mr Viville Perera	General Manager/Operations		
Major Subsidiaries and Associates:	Arpico Finance Co Ltd	39.60%		
	Alfinco Insurance Brokers (Pvt) Ltd	39.00%		
	Xesol (Pvt) Ltd	26.60%		
	Macbertan Ltd	30.00%		
	Alliance Tech Trading (Pvt) Ltd	40.00%		
Capital History:	Year	Remarks	Amount (LKR million)	Cumulative Total (LKR million)
	1956	Issue of ordinary shares	0.15	0.15
	1957	Issue of ordinary shares	0.03	0.18
		Issue of preference shares	0.10	0.28
	1959	Issue of preference shares	0.06	0.35
	1966	Redemption of ordinary shares	(0.05)	0.30
	1967	Redemption of ordinary shares	(0.05)	0.25
	1968	Issue of ordinary shares	0.10	0.35
	1969	Issue of ordinary shares	0.10	0.45
	1970	Issue of ordinary shares	0.90	1.35
	1990	Issue of ordinary shares	4.05	5.40
	1994	Issue of ordinary shares	10.80	16.20

Financial Summary - Company

BALANCE SHEET (LKR Million)	31-Mar-05	31-Mar-06	Restated		Unaudited
			31-Mar-07	31-Mar-08	31-Dec-08
ASSETS					
Cash & Money At Call	51.20	17.37	45.64	63.85	97.00
Deposits & Placements With Financial Inst	96.72	102.67	45.67	9.18	9.24
Securities Purchased Under Resale Agreeer	0.00	0.00	0.00	0.00	0.00
Securities					
Dealing Securities	266.34	213.64	439.22	562.82	758.06
Investment Securities	19.00	36.85	12.78	10.86	0.00
Gross Loans & Advances	1,427.79	2,070.19	2,609.14	3,360.09	3,972.90
Interest-In-Suspense	16.56	15.00	11.74	12.59	22.73
General Loan Loss Reserves	0.00	0.00	0.00	0.00	0.00
Specific Loan Loss Reserves	109.09	109.09	87.99	89.83	135.84
Net Loans & Advances	1,302.14	1,946.10	2,509.41	3,257.68	3,814.34
Investments in Subsidiaries/Associates	38.95	27.84	27.84	27.84	107.70
Investment Land and Properties	3.04	3.04	2.95	2.95	2.95
Other Assets	192.24	303.41	312.85	452.52	521.46
Property, Plant and Equipment	294.09	519.66	612.96	665.81	656.89
TOTAL ASSETS	2,263.70	3,170.58	4,009.32	5,053.50	5,967.63
LIABILITIES					
Customer Deposits					
Savings	0.00	0.00	0.00	0.00	0.00
Fixed	1,631.10	1,783.89	2,134.45	2,486.77	3,177.30
NIDs	0.00	0.00	0.00	0.00	0.00
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 Agreeer	0.00	0.00	0.00	0.00	0.00
Other Borrowing	325.42	636.66	969.06	1,473.48	1,545.37
Subordinated Debt & Hybrid Capital	0.00	0.00	0.00	0.00	0.00
Other Liabilities	92.97	243.87	340.23	447.88	566.99
TOTAL LIABILITIES	2,049.49	2,664.42	3,443.74	4,408.13	5,289.66
Paid-up Capital	16.20	16.20	16.20	16.20	16.20
Minority Interest	0.00	0.00	0.00	0.00	0.00
Share Premium & Other Reserves	181.87	304.40	327.65	549.75	549.75
Statutory General Reserve	11.00	123.60	162.10	0.00	0.00
Retained Profits/(Loss)	5.14	61.96	59.63	79.41	112.01
Total Shareholders' Funds	214.21	506.16	565.59	645.37	677.97
TOTAL LIABILITIES & SHAREHOLDER	2,263.70	3,170.58	4,009.32	5,053.50	5,967.63
COMMITMENTS & CONTINGENCIES	0.00	0.00	0.00	0.00	0.00
TIER 1 CAPITAL	152.10	224.49	279.71	402.50	421.68
CAPITAL BASE	203.17	336.73	396.24	520.24	533.14

Financial Summary - Company

INCOME STATEMENT (LKR Million)	Restated			Unaudited	
	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Dec-08
Interest Income	376.71	453.88	586.78	800.50	849.09
Less: Amortisation Of Premium/(Accretion)	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	211.25	240.76	334.04	544.84	638.19
Net Interest Income	165.46	213.12	252.74	255.65	210.90
Non-Interest Income	143.83	161.12	182.83	162.08	133.04
Gross Income	309.29	374.23	435.57	417.73	343.94
Personnel Expenses	46.96	63.55	120.34	113.40	104.42
Other Non-Interest Expenses	195.04	211.93	200.38	224.87	164.18
Loan Loss Provisions	7.01	18.04	14.75	5.54	38.23
Share of results of Associated Companies	0.00	0.00	0.00	0.00	0.00
Pre-Tax Profit	60.28	80.72	100.10	73.92	37.11
Taxation	5.66	13.44	32.57	(11.53)	4.50
Profit After Tax	54.63	67.28	67.53	85.45	32.61
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Prior Year Adjustments	0.00	53.72	0.00	0.00	0.00
Minority Interests	0.00	0.00	0.00	0.00	0.00
Transfer To Statutory Reserves	11.00	13.60	13.50	4.30	0.00
Transfer To Other Reserves	38.75	45.72	48.25	55.70	0.00
Dividend	4.86	4.86	8.10	5.67	0.00
Retained Profit For The Year	0.02	56.81	(2.32)	19.78	32.61

Financial Ratios - Company

KEY RATIOS (%)	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Dec-08
Profitability					
Net Interest Margin	7.81%	7.84%	7.04%	5.88%	5.10%
Non-Interest Income Margin	6.79%	5.93%	5.09%	3.58%	3.22%
Cost To Income	78.24%	73.55%	73.63%	78.90%	78.10%
Return On Assets	2.85%	2.98%	2.79%	1.64%	0.90%
Return On Equity	31.91%	22.47%	18.68%	12.29%	7.43%
Dividend Payout	8.90%	7.20%	11.99%	6.60%	17.39%
Asset Quality					
Gross NPL Ratio	9.02%	4.63%	3.48%	3.33%	5.22%
Net NPL Ratio	1.40%	(0.72%)	0.09%	0.66%	1.85%
3-months Past Due Ratio	16.84%	13.47%	NA	9.60%	16.27%
Gross NPL Coverage	85.69%	114.76%	97.40%	80.63%	65.86%
Loan Loss Reserve Coverage	7.73%	5.31%	3.39%	2.68%	3.44%
Liquidity & Funding					
Statutory Liquid Asset Ratio	18.73%	16.02%	16.37%	16.59%	18.32%
Customer Deposits To Total Interest Bear	83.37%	73.70%	68.78%	62.79%	67.28%
Loans To Deposits Ratio	79.83%	109.09%	117.57%	131.00%	120.05%
Loans To Stable Funds Ratio	70.86%	81.80%	82.87%	83.27%	82.28%
Capital Adequacy					
Shareholders' Funds To Total Assets	9.46%	15.96%	14.11%	12.77%	11.36%
Tier 1 Risk Weighted Capital Adequacy Ra	7.79%	8.15%	8.01%	8.72%	8.20%
Overall Risk Weighted Capital Adequacy R	10.40%	12.23%	11.34%	11.27%	10.37%
Internal Rate Of Capital Generation	31.99%	17.39%	11.09%	13.26%	5.39%

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

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** The Financial institutions 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** The Financial institutions 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** The Financial institutions 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** The 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** The 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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