


RATINGS

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

A wholly owned subsidiary of RAM Holdings Berhad

ALLIANCE FINANCE COMPANY PLC - Rating Review

Financial Institution Ratings:

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

Rating Outlook:
Stable

Strengths:

- Reputable franchise
- Moderate financial performance
- Moderate capitalisation

Weakness:

- Weakened asset quality

Principal Activities:

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

Analysts:

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

Prashani Illangasekera MSc, BA
(9411) 2553089
prashani@ram.com.lk

Company Contact:

Adrian Perera
MBA, FCMA, FCCA, FSCMA, AIB
Chief Executive Officer
(9411) 2596099
adrian@ram.com.lk

Website: www.ram.com.lk

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 moderate financial performance, capitalisation and reputable franchise, but is weighed down by our concerns with regards to the Company's asset quality.

With a track record of nearly 54 years, AFC ranks among the oldest registered finance companies ("RFCs") in Sri Lanka. Despite its long operating history, the Company has remained a medium-sized entity, accounting for only 3.58% of the industry's assets as at end-March 2009. This has been underscored by AFC's conservative growth strategy and prudent management.

On the back of its cautious lending strategy, the Company has traditionally maintained above-industry-average asset quality. In tandem with the less conducive economic climate during the reviewed period, however, AFC had experienced an influx of non-performing loans ("NPLs"). As such, its gross NPL ratio (on a 6-month classification basis) had deteriorated to 5.84% by the end of FYE 31 March 2009 ("FY Mar 2009"), from 3.58% a year earlier; the ratio climbed up further to 7.97% as at end-September 2009. While this had been exacerbated by a contraction in its loan portfolio, we note that absolute NPLs had also increased by LKR 64.92 million (or 28.76%) over the same period. However, the management has taken steps to curb its rising NPLs; lending to sectors that experienced higher delinquencies have been either frozen or curtailed. That said, we remain concerned about the influx of NPLs and will continue monitoring the developments in this regard; downward rating pressure may be exerted in the event that asset quality deteriorates further.

Meanwhile, AFC's financial performance remained moderate, albeit easing marginally in line with higher funding costs and hefty overheads. The Company's pre tax profit ebbed slightly to LKR 70.65 million in FY Mar 2009 (FY Mar 2008: LKR 73.92 million). Consequently, its return on assets ("ROA") dipped from 1.63% to 1.30% as at end-FY Mar 2009, although still better than the industry average of 0.83% as at the same date.

On a separate note, the Company had strengthened its liquidity position during the reviewed period; its statutory liquid-asset ratio advanced to 16.29% as at end-September 2009, from 14.84% as at end-FY Mar 2009. Meanwhile, AFC had maintained the healthy growth of its deposit base, which expanded 34.97% year-on-year ("yoy") to LKR 3.36 billion as at end-FY Mar 2009, before augmenting further to LKR 3.56 billion by end-September 2009.

AFC's tier-1 and overall risk weighted capital-adequacy ratios ("RWCAR") clocked in at 10.56% and 12.94% as at end-September 2009, comfortably above the regulated minimums of 5% and 10%, respectively.

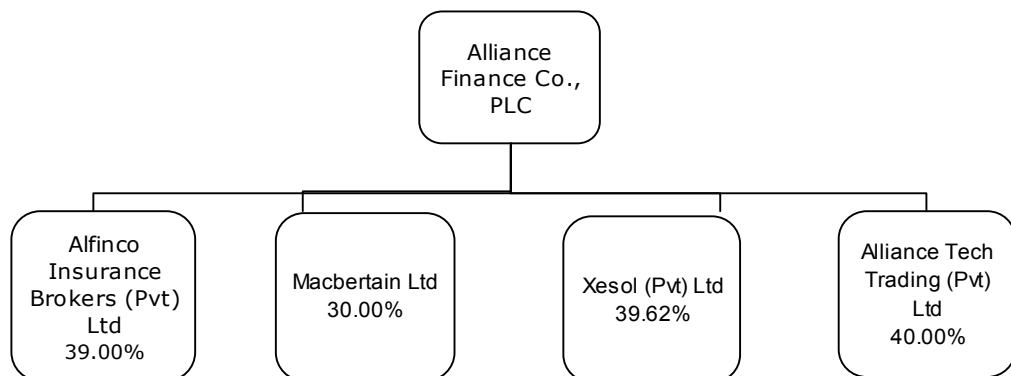
Outlook

The stable outlook on the long-term rating is premised on our expectation that the management's efforts to rein in NPLs will bear fruit over the medium term, while its liquidity and capital-adequacy levels remain intact. However, downward pressure will be exerted if the Company's asset quality or performance continues to deteriorate.

Corporate Profile

Incorporated in 1956, AFC is the third-oldest RFC in Sri Lanka; it is regulated by the Central Bank of Sri Lanka's ("Central Bank") supervision department for non-bank financial institutions. The Company is one of only 7 finance companies listed on the Colombo Stock Exchange ("CSE") and is the flagship of the Alliance Group; the other entities within this group are engaged in manufacturing, importing and trading activities (refer to Chart 1). AFC also has the distinction of being the first RFC in the country to obtain the prestigious ISO9001:2000 certification.

Chart 1: AFC's corporate structure as at end-FY Mar 2009



The Company primarily engages in the provision of finance leasing, hire-purchase ("HP") facilities, operational leases, consumer credit, gold loans and collaboration finance¹. The latter is a unique financial product for which AFC's Deputy Chairman, Mr Romani De Silva, won 2 bronze awards as *Entrepreneur of the Year* in 2002. Meanwhile, the Company has also diversified from its traditional lines of business and ventured into proprietary share trading, importing and trading vehicles and furniture. As at end-Mar 2009, the Company operated 3 branch offices, 7 collection centres, 9 business units and 15 gold loan centres.

Ownership

Despite its listed status, AFC is a closely held entity; successive generations of the founders' families 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. AFC's top 20 shareholders controlled approximately 79.82% of the Company as at end-FY Mar 2009.

¹ 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.

**Closely held,
listed entity**

Management & Strategies

Two-pronged business strategy

The Company continues to be led by Mr Romani De Silva, the Joint Managing Director-cum-Deputy Chairman. AFC functions with a 2-pronged business strategy; its conventional business lines include HP, finance and operating leases, term loans, gold loans and collaboration finance. Meanwhile, the Company has also diversified into other areas, e.g. furniture trading, tile trading, vehicle hire. The objective of this diversification had been to achieve a more sustainable business model via venturing to areas that do not entail significant competitive pressures.

Focus on transportation sector

That said, persistent losses incurred by certain trading activities (e.g. furniture trading) have prompted the management to adopt a more cautious view. As such, the management intends to consolidate or discontinue these loss-making operations over the near to medium term. Prospectively, the Company intends to position itself as a “total transportation-solutions provider”, thereby aligning the conventional businesses of vehicle leasing and HP along with ancillary services such as the provision of office transport, school vans and vehicle hire. The management opines that there is vast potential in the vehicle-hiring segment, and intends to significantly expand this portfolio in the near to medium term. In this regard, the Company’s repossessed vehicles are to be utilised for the provision of these ancillary services.

Adopting product-based structure

On a separate note, the management is in the process of effecting a structural change in the Company. The objective is to move away from the present functional structure (compartmentalised as finance, marketing, human resources, and others) to a more customer-/product-centric model. In this regard, the Company will be broadly segmented based on each product line, such as leasing, HP and vehicle hire. Within these departments, specific subdivisions will operate for segments such as 3-wheel leasing and gold loans. With this structural change, each department will operate its own operations vis-a-vis marketing, finance and human-resource functions, with all of these adopting a more customer-focused approach. Furthermore, this will enable the management to identify the profitability of each product line more accurately. This process is expected to be completed in the latter part of 2010.

Conservative lending approach

On a separate note, the Company has frozen or curtailed lending to several sectors such as consumer durables, solar panels and outstation 4-wheeled vehicles; these segments had experienced more delinquencies during the reviewed period. Overall, AFC has curbed its lending because of the unfavourable economic conditions; it has also tightened its approval procedures.

Corporate Governance

AFC’s board comprises 3 independent non-executive directors and 4 executive directors, thereby complying with the Central Bank’s revised rules on corporate governance. The board is chaired by Mr Pratapkumar de Silva, who is also the Joint Managing Director. The board had convened 24 times during the year under review; performance indicators - including collection ratios, loan disbursements, NPL ratios, capital-adequacy ratios and deposit growth - are extensively discussed during the meetings.

The Company’s board is supported by 4 committees: audit, risk management, remuneration and asset-liability. The asset-liability committee (“ALCO”)

examines the potential options regarding funding, gap analysis, maturity mismatches and product mixes; the committee convened 8 times in fiscal 2009. Nevertheless, we note that ALCO meetings have not been held regularly in recent months; RAM Ratings Lanka views this with concern. On a separate note, all related-party transactions are deemed to be carried out in the ordinary course of the Company’s business, on commercial terms.

Asset Quality

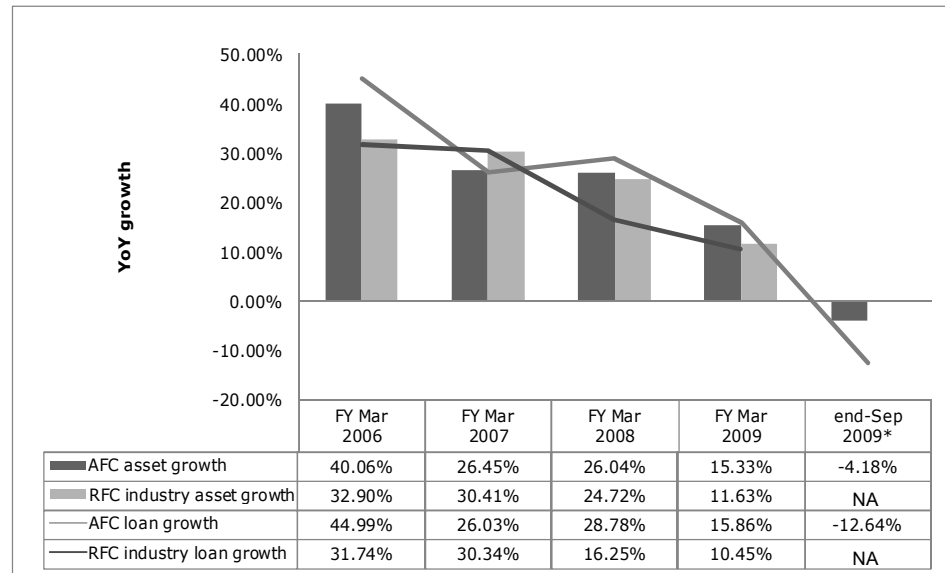
AFC’s asset quality had weakened during the reviewed period; new NPLs stemming primarily from equipment leasing had pushed up the Company’s gross NPL ratio. Nevertheless, AFC’s gross NPL ratio was still better than the industry average. As mentioned earlier, the Company has frozen lending to several sectors that had experienced an influx of NPLs during the reviewed period; these steps are anticipated to bear fruit over the near to medium term. AFC has also reduced its exposure to shares and other trading assets. RAM Ratings Lanka views these developments in a positive light.

The expansion of the Company’s asset base slowed to 15.33% in FY Mar 2009 (FY Mar 2008: +26.04%) and receded further to record a contraction of 4.18% (on an annualised basis) in 1H FY Mar 2010. AFC’s asset growth had been hampered by its decelerating loan growth during the reviewed period, primarily due to the non-conducive economic conditions and the management’s attempts to adopt a more conservative lending approach. As such, AFC’s gross loans expanded by a relatively modest 15.86% in FY Mar 2009; the portfolio contracted 12.64% (or LKR 246.10 million) in 1H FY Mar 2010 (refer to Chart 2). In this regard, the contraction had emanated from the leasing of 4-wheeled vehicles and equipment.

Asset quality deteriorated

Slower expansion of loan base

Chart 2: AFC’s asset and loan growth vs the industry



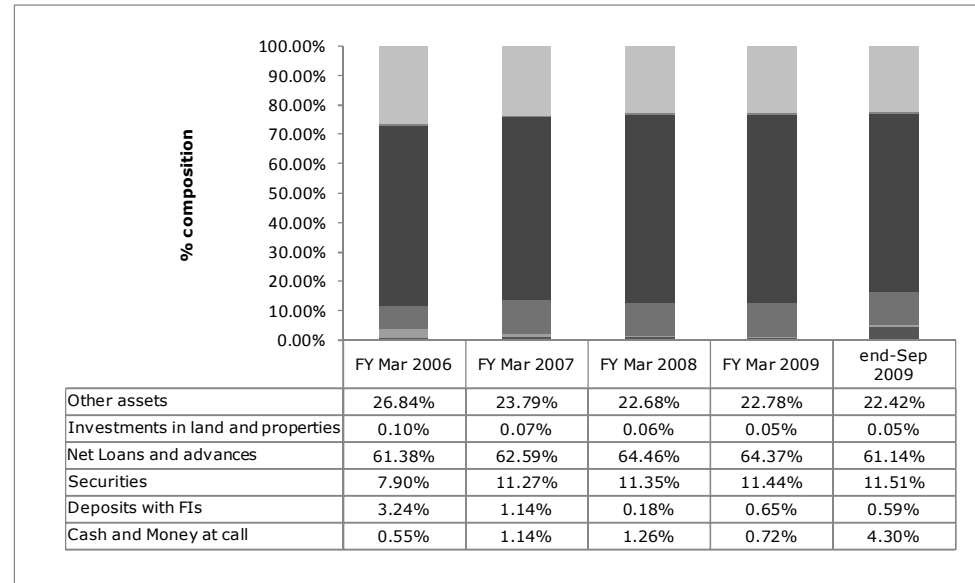
*Annualised

More liquid asset base

In line with AFC’s contracting loan portfolio, credit assets accounted for a reduced 61.14% of its assets as at end-September 2009 (end-FY Mar 2008: 64.46%). Similar to many industry players, the Company’s curtailed loan growth had rendered its asset base more liquid (refer to Chart 3). Nevertheless, with loan growth anticipated to pick up over the medium term, the Company’s asset mix is expected to revert to its traditional structure.

Growth via 3-wheeler financing

Chart 3: AFC's asset composition



Meanwhile, AFC's loan portfolio remained dominated by leases (refer to Chart 4); nevertheless, the leasing portfolio's pace of expansion had slowed to 9.06% in FY Mar 2009 (FY Mar 2008: +26.15%), before contracting 18.63% (annualised) in 1H FY Mar 2010. Looking ahead, the Company intends to focus on financing 3-wheeled vehicles to drive the growth of its leasing portfolio (refer to Chart 5). RAM Ratings Lanka views this move positively, as the financing of 3-wheelers usually entails lower delinquency rates. Elsewhere, gold loans (involving loans collateralised by jewellery) have been posting robust growth; this portfolio expanded 128.38% y-o-y (or LKR 127.27 million) in 1H FY Mar 2010. The management anticipates this segment to chart strong growth over the medium term. RAM Ratings Lanka notes that the Company's overall credit-concentration risk is low; its top 10 borrowers accounted for only 6.19% of its loans as at end-September 2009.

Chart 4: AFC's loan composition as at end-FY Mar 2008 and end-FY Mar 2009

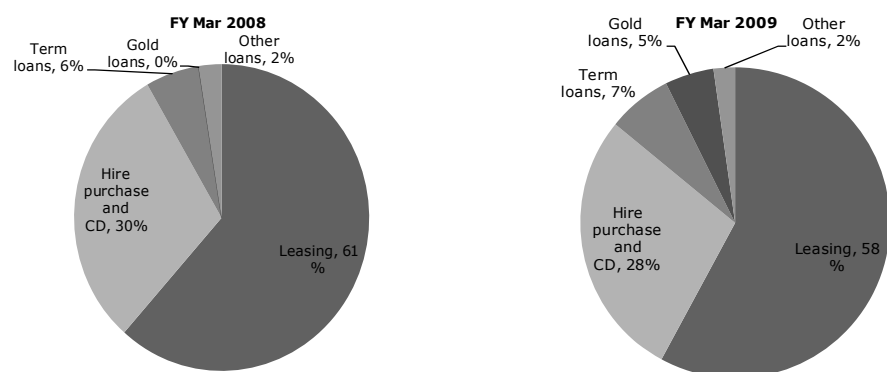
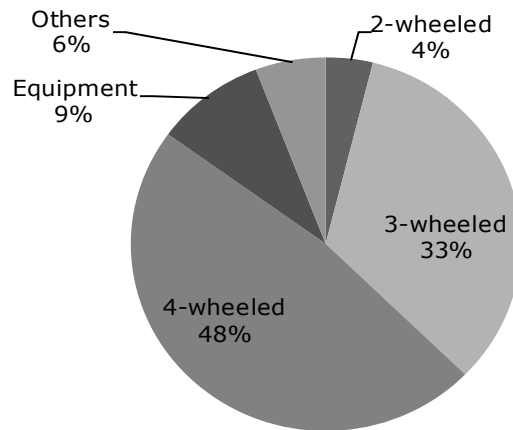


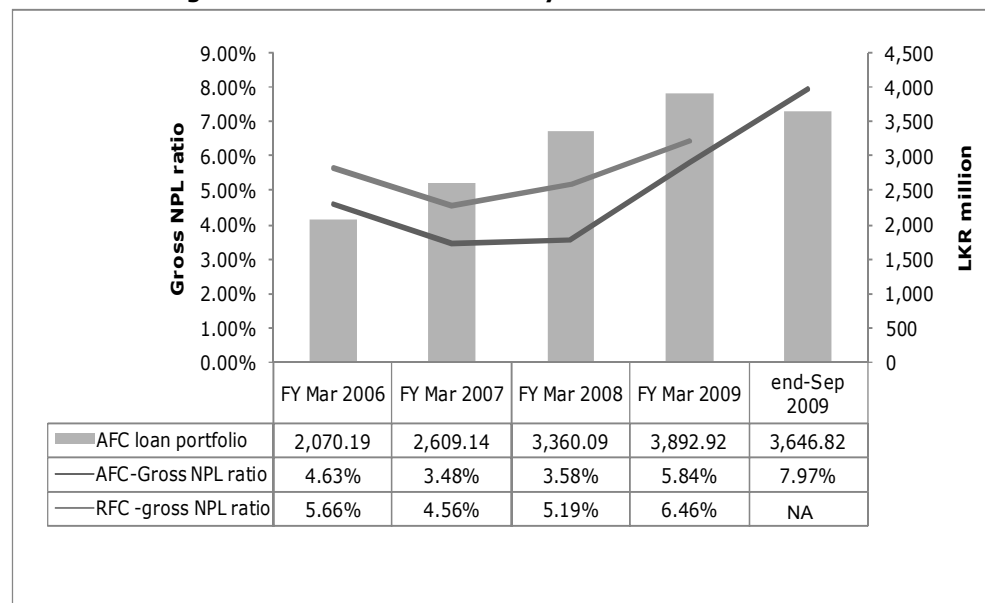
Chart 5: Profile of loan exposure as at end-September 2009



Influx of NPLs from consumer durables

In line with the non-conducive economic environment, AFC’s credit quality had weakened during the reviewed period – albeit still better than the industry average. The Company’s gross NPL ratio worsened to 5.84% as at end-Mar 2009 (end-FY Mar 2008: 3.58%), and further to 7.97% as at end-September 2009 (refer to Chart 6). AFC’s gross NPL ratio - excluding gold loans - came in at 8.75% as at the same date. The Company faced an influx of NPLs in 1H FY Mar 2010 mainly due to rising defaults in consumer durables. As such, its NPLs augmented by LKR 64.92 million (or 28.76%) over the same span.

Chart 6: AFC’s gross NPL ratio vs the industry



Tightened credit-approval procedure

RAM Ratings Lanka notes that the new NPLs had primarily originated from the leasing of consumer durables (mainly electrical equipment) and 4-wheeled vehicles in outstation regions. NPLs from equipment leasing surged LKR 57.31 million in 1H FY Mar 2010 (refer to Table 1), due to issues with product quality and the macroeconomic climate. The management has therefore discontinued this line of business and is focusing solely on recoveries. Additionally, the management has taken steps to tighten its credit-evaluation procedures relating to outstation 4-wheeled vehicles which had experienced higher NPLs during the reviewed period. In this regard, AFC has centralised the approval process for all outstation 4-wheeled vehicles leased to the metropolitan branch. RAM Ratings Lanka views these developments positively.

Table 1: AFC's product wise default rates

Asset type	FY Mar 2009		end-Sept 2009	
	Absolute NPLs	Default rate	Absolute NPLs	Default rate
2-wheel vehicles	3.34	2.19%	8.19	6.40%
3-wheel vehicles	14.95	1.31%	21.41	1.95%
4-wheel vehicles	109.68	6.25%	123.40	7.88%
Equipment	28.29	7.60%	85.61	28.31%
Unclassified	59.78	31.43%	52.03	27.18%

**Reduced
exposure to
trading assets**

On a more positive note, the Company's exposure to proprietary share trading was reduced to 3.81% as at end-FY Mar 2009 (end-FY Mar 2008: 4.42%). Notably, the Company's equity portfolio is well diversified in sectors such as banking and finance, food and beverage, hotels and plantations, and consists of investments in relatively liquid shares. AFC's exposure to equity trading is envisaged to be further trimmed in the future.

Besides loan assets, the Company also engages in the trading of vehicles, furniture, ceramic tiles, refrigerators, ventilators and real estate. Exposure to these trading stocks declined from 13.71% of AFC's total capital as at end-FY Mar 2009 and to 4.99% as at end-September 2009. This is also expected to be trimmed over the medium term; the management is currently evaluating the possibility of discontinuing the Company's furniture-trading business. AFC's reduced exposure to these trading assets is viewed in a positive light.

Looking ahead, RAM Ratings Lanka anticipates AFC's asset quality to be maintained at current levels and also above the industry average. The management's efforts to curb lending to sectors with higher default rates are anticipated to bear fruit over the medium to long term. With the country's economic fundamentals set to improve over the medium term, AFC's overall credit quality is also anticipated to ameliorate in tandem.

Performance

The Company's financial performance has remained moderate; despite a surge in its top line, AFC's performance has been pressured by rising interest expenses and hefty overheads. As such, its ROA had declined during the reviewed period, albeit still better than the industry average.

**Heavy interest
expenses crimp
NIM**

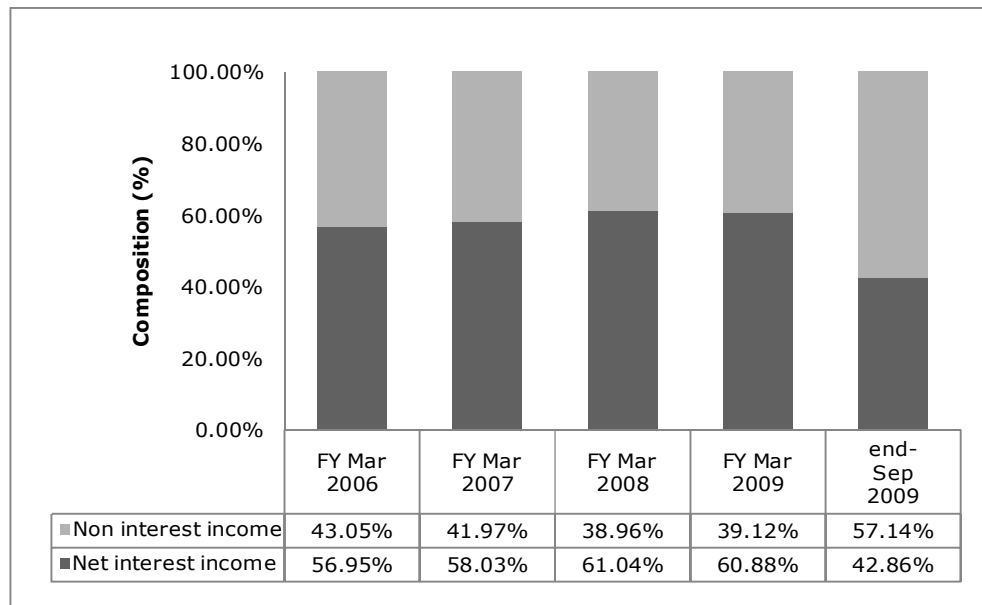
AFC's interest income surged 45.47% y-o-y in FY Mar 2009, supported by its key leasing and HP portfolios. Nevertheless, this growth had been offset by burgeoning interest expenses, which had escalated a hefty LKR 343.99 million (or 63.14% y-o-y) during the reviewed period. The surge in interest expenses had been driven by AFC's enlarged deposit base and the scenario of high interest rates. Consequently, the Company's net interest income had expanded by a moderate 7.71% in FY Mar 2009; this translated to a net interest margin ("NIM") of 5.05% (industry: 5.83%). In line with the contraction in interest income, the Company's NIM narrowed further to 3.25% in 1H FY Mar 2010.

**Persistent losses
from furniture
trading**

Meanwhile, AFC's non-interest income advanced to LKR 176.46 million in FY Mar 2009 (FY Mar 2008: LKR 162.76 million). This was primarily underpinned by income from vehicle hires and gains on its share trading portfolio; its share trading income surged to LKR 60.12 million in 1H FY Mar 2010. However, we note that AFC's furniture-trading business had continued to incur losses during the reviewed period. These losses had amounted to LKR 21.43 million in FY Mar 2009. Looking ahead, the Company intends to either consolidate its trading

businesses or discontinue its loss-making operations. RAM Ratings Lanka views this approach positively. Nevertheless, in the event that losses from trading businesses continue, downward rating pressure may be exerted. Meanwhile, we note that the Company’s gross income had tilted more towards non-interest income as at end-September 2009 (refer to Chart 7). Nonetheless, its gross income mix is anticipated to revert to its traditional composition as lending picks up.

Chart 7: Composition of AFC’s gross income



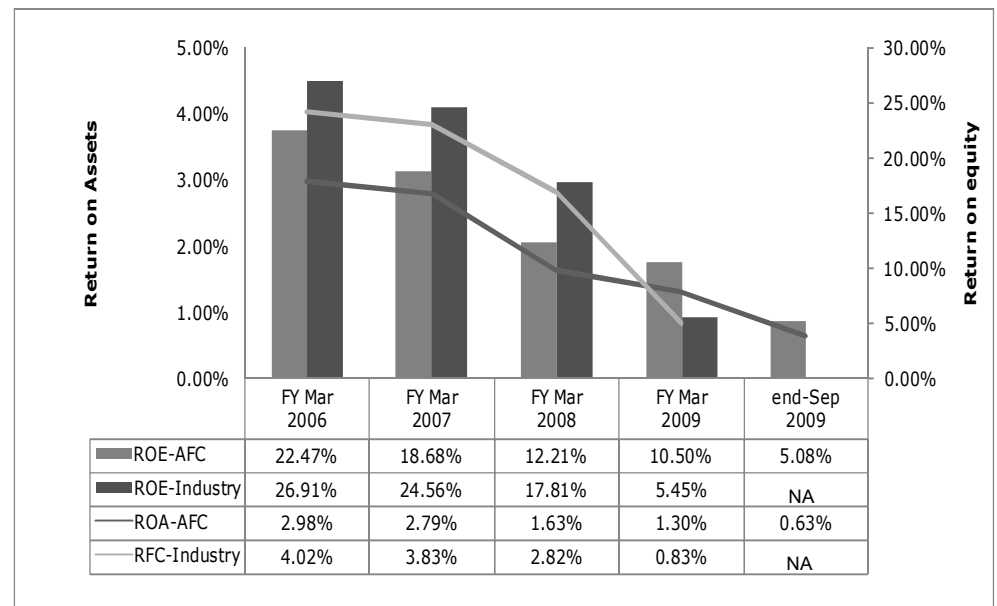
Pressured by overheads

AFC’s performance remained pressured by its hefty overheads; its cost-to-income ratio remained relatively unchanged at 76.58% as at end-September 2009 (FY Mar 2009: 77.99%). The higher overheads had been mainly driven by augmented personnel costs. Nevertheless, RAM Ratings Lanka notes that AFC’s overheads have been pushed up by discretionary provisions; excluding these provisions, the Company’s cost-to-income ratio would have been slightly lower at 74.33% as at end-September 2009.

ROA better than industry average

Meanwhile, AFC’s weakened asset quality had impinged on its performance; the Company’s loan-loss provisions swelled to LKR 28.64 million in FY Mar 2009 (FY Mar 2008: LKR 5.54 million). Consequently, its ROA had dipped to 1.30% as the same date, albeit still better than the industry average (refer to Chart 8).

Chart 8: AFC's profitability trends vs the industry



Prospectively, RAM Ratings Lanka expects the Company's performance to improve moderately over the medium to long term, supported by the expansion of its loan portfolio and the termination of loss-making trading operations. However, AFC's performance will remain pressured by its heavy overheads.

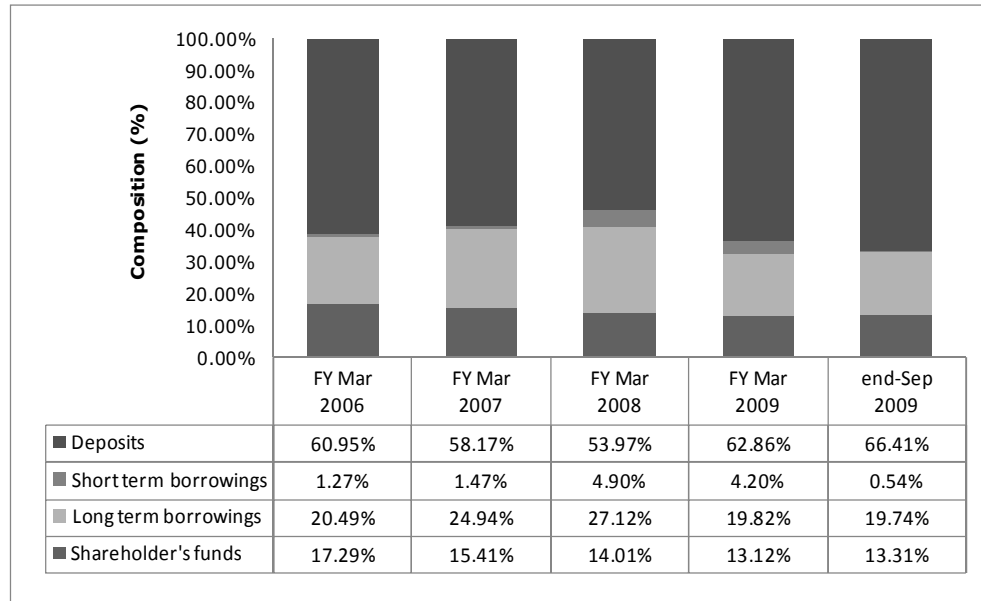
Funding & Liquidity

In line with the challenging macroeconomic environment and the resultant heightened liquidity risk, AFC has strengthened its liquidity position. As such, the Company's statutory liquidity-asset ratio came up to 16.29% as at end-September 2009 (end-FY Mar 2008: 14.84%). Meanwhile, RAM Ratings Lanka notes that the Company's funding position had improved during the reviewed period, with less reliance on securitised and bank borrowings, while its deposit base had charted robust growth.

AFC's funding structure is still dominated by deposits; these covered 66.41% of its funding needs as at end-September 2009. Furthermore, we note that the Company had reduced its reliance on securitised borrowings during the reviewed period (refer to Chart 9). As such, AFC's portfolio of securitised borrowings had receded by LKR 191.54 million to LKR 1.06 billion as at end-FY Mar 2009, and further to LKR 933.77 million as at end-September 2009. As a result, the Company's loans-to-deposits ratio had eased to 97.99% as at end-September 2009.

Better funding structure

Chart 9: AFC's funding composition



Healthy growth in deposits

AFC's deposits enlarged 34.94% y-o-y (or LKR 868.91 million) in FY Mar 2009, and further expanded LKR 204.58 million by end-September 2009. However, we note that the Company's deposit-concentration risk is somewhat high; its top 20 depositors accounted for 16.07% of its total deposits. Meanwhile, AFC's deposit-renewal rate remained healthy, albeit lower, at 86.54% as at end-September 2009 (end-FY Mar 2009: 88.87%). In line with the environment of falling interest rates, its deposit tenures have shifted slightly towards more long-term maturities, thereby alleviating liquidity risks.

In consonance with the high interest rates last year and the Company's augmented deposit base, the negative gap in AFC's asset-liability maturity profile had widened, particularly in the "less than 1 year" bucket (refer to Table 2). Nevertheless, we believe that this position has improved as the Company is currently flushed with excess liquidity. Moreover, AFC has secured LKR 150 million of unutilised banking lines.

Table 2: AFC's asset-liability maturity mismatch

Maturity Bucket	FY Mar 2009				FY Mar 2008			
	Interest earning assets	Interest bearing liabilities	Gap	% of assets	Interest earning assets	Interest bearing liabilities	Gap	% of assets
<1 Year	2,337	3,617	(1,280)	-55%	1,713	2,406	(693)	-40%
1 to 3 Years	1,732	776	956	55%	1,655	1,295	360	22%
> 3 Years	160	308	(148)	-92%	362	454	(93)	-26%
Total	4,229	4,701	(472)	-11%	3,729	4,155	(426)	-11%

Capital Adequacy

Improved capital adequacy

The Company's tier-1 and overall capital-adequacy ratios improved from 8.72% and 11.27% as at end-FY Mar 2008 to 10.56% and 12.94% as at end-September 2009, respectively. However, we expect its capital adequacy to ease in the medium term as the Company resumes lending. Meanwhile, in line with its higher NPLs, AFC's ratio on net NPLs to shareholder funds deteriorated from 4.63% as at end-March 2008 to 18.57% as at end-September 2009 - although still lower than the industry average.

Industry Overview

Sri Lanka’s gross domestic product (“GDP”) expanded 4.2% in 3Q 2009. Although this is weaker than the 6.3% growth attained in 3Q 2008, it must be put in the context of the present global downturn. Not surprisingly, all 3 major sectors of the Sri Lankan economy have been hit by the widespread upheaval.

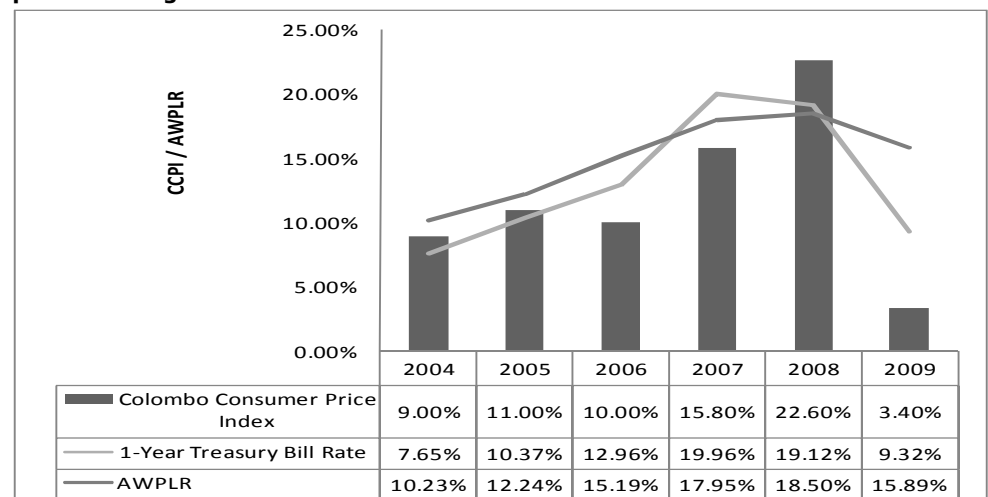
The performance of the island’s primary sector (i.e. agriculture, forestry and fishing) had been hampered by droughts, weaker prices and receding world demand. The sector contracted 0.9% in 3Q 2009, in sharp contrast to a 12.4% growth in 3Q 2008. Value addition from all major export crops had declined, depressed by droughts and reduced production following the steep fall in commodity prices in the latter part of 2008. Other sectors, meanwhile, had advanced at a slower pace, principally due to poorer export demand (refer to Table 1). All things considered, the country’s GDP growth for 2009 is expected to clock in at 3.5%, i.e. significantly lower than the 6.0% recorded for 2008.

Table 1: Sectoral contributions to GDP

Sector	3Q 2008	3Q 2009
Agriculture, forestry and fishing	12.4%	-0.9%
Industrial	5.6%	4.4%
Services	5.5%	5.1%
GDP	6.3%	4.2%

On a more positive note, the end of the 25-year war against the separatist Tamil Tigers has spawned renewed hope for the country. The advent of the stand-by facility from the International Monetary Fund, together with the issuance of USD500 million of sovereign bonds in the latter half of 2009, has also helped augment Sri Lanka’s depleted foreign-exchange reserves. Moreover, both inflation (as measured by the Colombo Consumer Price Index) and interest rates - which peaked in 2008 - have been easing consistently since early 2009 (refer to Chart 1). While these augur well for the economy, sluggish export demand is still a concern. Furthermore, interest rates have dipped sharply, in tandem with the Central Bank’s loosened monetary policy. While continually lower interest rates may not be sustainable given the country’s budget deficit, RAM Ratings Lanka also notes that interest rates will not revisit the highs of 2008. On the whole, however, we envisage the credit cycle to chart a rising trend.

Chart 1: Movements in Colombo Consumer Price Index and average-weighted prime lending rate



In the context of the financial-services industry, the collapse of 2 unregulated financial institutions during early 2009 had triggered a crisis of confidence among depositors. However, the contagion effects of the collapse had been halted by the Central Bank's timely intervention. The regulator's well-timed move of vesting the vulnerable Ceylinco-related institutions with state-owned or state-linked enterprises had helped avert a full-blown crisis. Concurrently, there have been changes in ownership, which RAM Ratings Lanka considers positive on the whole. Furthermore, the Central Bank launched a LKR 4.2 billion stimulus package to counter any liquidity strains affecting other troubled RFCs and leasing companies.

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

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

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

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

In the interim, RAM Ratings Lanka expects the industry's general profit performance to come under pressure from slower loan growth. Nonetheless, this is expected to be a short-term phenomenon; the sector's profitability is expected to bottom out in FY Mar 2010. This view is anchored by our expectations vis-à-vis low interest rates and economic recovery. As it is, the sector's funding costs have already begun easing as deposit rates have dropped, while rates on lending have not declined in tandem.

At present, leading RFCs in the country are flushed with liquidity due to slower loan growth and augmenting deposits. Public confidence, which had ebbed in the first quarter of 2009, is now staging a return. Apart from revitalised liquidity, the industry's funding structure - although improving - is still fragile. RFCs still rely

on bank funding, which poses additional liquidity risk. Over the medium and long term, however, RAM Ratings Lanka notes that the industry's funding structure could weaken should RFCs resort to bank borrowings to expand their loan books.

Meanwhile, the industry's regulatory capital-adequacy levels are sufficient to support a 40% growth in its asset base. However, we note that these capital-adequacy measures do not encapsulate the entire spectrum of risks inherent in RFCs.

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

Relevant Central Bank Directions Applicable to Registered Finance Companies

<p>Liquid Assets</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>Provision of Bad and Doubtful Debts</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.
--	---

Corporate Information

Date of Incorporation: 18 July 1956

Commencement of Business: 1956

Major Shareholders:

Mr RKEP de Silva	24.37%
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 Director
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 Director
Mr Rohan Perera	Finance Director
Mr J F R de Saram	Executive Director
Mr Viville Perera	General Manager/Operations

Major Subsidiaries and Associates:

Alfinco Insurance Brokers (Pvt) Ltd	39.00%
Xesol (Pvt) Ltd	39.62%
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-06	31-Mar-07	31-Mar-08	31-Mar-09	30-Sep-09
ASSETS					
Cash & Money At Call	17.37	45.64	63.85	41.74	245.14
Deposits & Placements With Financial Instituti	102.67	45.67	9.18	37.77	33.45
Securities Purchased Under Resale Agreement:	0.00	0.00	0.00	0.00	0.00
Securities					
Dealing Securities	213.64	439.22	562.82	660.01	577.98
Investment Securities	36.85	12.78	10.86	6.47	78.60
Gross Loans & Advances	2,070.19	2,609.14	3,360.09	3,892.92	3,646.82
Interest-In-Suspense	15.00	11.74	12.59	26.88	0.00
General Loan Loss Reserves	0.00	0.00	0.00	0.00	0.00
Specific Loan Loss Reserves	109.09	87.99	89.83	114.66	158.14
Net Loans & Advances	1,946.10	2,509.41	3,257.68	3,751.38	3,488.68
Investments in Subsidiaries/Associates	27.84	27.84	27.84	64.31	0.00
Investment Land and Properties	3.04	2.95	2.95	2.95	2.95
Other Assets	303.41	312.85	452.52	584.24	635.84
Property, Plant and Equipment	519.66	612.96	665.81	679.32	643.73
TOTAL ASSETS	3,170.58	4,009.33	5,053.50	5,828.19	5,706.36
LIABILITIES					
Customer Deposits					
Savings	0.00	0.00	0.00	0.00	0.00
Fixed	1,783.89	2,134.45	2,486.77	3,355.68	3,560.26
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 Agreements	0.00	0.00	0.00	0.00	0.00
Other Borrowing	636.66	969.06	1,473.48	1,345.24	1,011.39
Subordinated Debt & Hybrid Capital	0.00	0.00	0.00	0.00	0.00
Other Liabilities	243.87	340.23	447.88	426.80	421.11
TOTAL LIABILITIES	2,664.42	3,443.74	4,408.13	5,127.72	4,992.77
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	304.40	327.65	549.75	605.61	618.74
Statutory General Reserve	123.60	162.10	0.00	78.66	78.66
Retained Profits/(Loss)	61.96	59.63	79.41	0.00	0.00
Total Shareholders' Funds	506.16	565.59	645.37	700.47	713.60
TOTAL LIABILITIES & SHAREHOLDERS' FUND	3,170.58	4,009.32	5,053.50	5,828.19	5,706.36
COMMITMENTS & CONTINGENCIES	0.00	0.00	0.00	0.00	0.00
TIER 1 CAPITAL	224.49	279.71	402.50	443.97	474.93
CAPITAL BASE	336.73	396.24	520.24	567.91	581.60

Financial Summary - Company

INCOME STATEMENT (LKR Million)	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	30-Sep-09
Interest Income	453.88	586.78	799.82	1,163.48	576.83
Less: Amortisation Of Premium/(Accretion Of I	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	240.76	334.04	544.84	888.84	483.09
Net Interest Income	213.12	252.74	254.97	274.64	93.74
Non-Interest Income	161.12	182.83	162.76	176.46	158.52
Gross Income	374.23	435.57	417.73	451.10	252.26
Personnel Expenses	63.55	120.34	113.40	182.69	80.97
Other Non-Interest Expenses	211.70	200.38	224.87	169.12	112.20
Loan Loss Provisions	18.04	14.75	5.54	28.64	40.96
Share of results of Associated Companies	0.00	0.00	0.00	0.00	0.00
Pre-Tax Profit	80.95	100.10	73.92	70.65	18.13
Taxation	13.44	32.57	(11.53)	9.08	5.00
Profit After Tax	67.51	67.53	85.45	61.58	13.13
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Prior Year Adjustments	53.72	0.00	0.00	0.00	0.00
Minority Interests	0.00	0.00	0.00	0.00	0.00
Transfer To Statutory Reserves	13.60	13.50	0.00	0.00	0.00
Transfer To Other Reserves	45.70	48.25	60.00	0.00	0.00
Dividend	4.86	8.10	5.67	0.00	0.00
Retained Profit For The Year	57.06	(2.32)	19.78	61.58	13.13

Financial Ratios - Company

KEY RATIOS (%)	31-Mar-06	31-Mar-07	31-Mar-08	31-Mar-09	30-Sep-09
Profitability					
Net Interest Margin	7.84%	7.04%	5.63%	5.05%	3.25%
Non-Interest Income Margin	5.93%	5.09%	3.59%	3.24%	5.50%
Cost To Income	73.55%	73.63%	80.98%	77.99%	76.58%
Return On Assets	2.98%	2.79%	1.63%	1.30%	0.63%
Return On Equity	22.47%	18.68%	12.21%	10.50%	5.08%
Dividend Payout	7.20%	11.99%	6.64%	0.00%	0.00%
Asset Quality					
Gross NPL Ratio	4.63%	3.48%	3.58%	5.84%	7.97%
Net NPL Ratio	(0.72%)	0.09%	0.92%	2.96%	3.80%
3-months Past Due Ratio	13.47%	NA	9.60%	16.52%	NA
Gross NPL Coverage	114.76%	97.40%	75.03%	50.80%	54.41%
Loan Loss Reserve Coverage	5.31%	3.39%	2.68%	2.97%	4.34%
Liquidity & Funding					
Statutory Liquid Asset Ratio	16.02%	16.37%	16.59%	15.47%	18.34%
Customer Deposits To Total Interest Bearing F	73.70%	68.78%	62.79%	71.38%	77.88%
Loans To Deposits Ratio	109.09%	117.57%	131.00%	111.79%	97.99%
Loans To Stable Funds Ratio	81.80%	82.87%	83.27%	80.54%	75.16%
Capital Adequacy					
Shareholders' Funds To Total Assets	15.96%	14.11%	12.77%	12.02%	12.51%
Tier 1 Risk Weighted Capital Adequacy Ratio	8.15%	8.01%	8.72%	9.15%	10.56%
Overall Risk Weighted Capital Adequacy Ratio	12.23%	11.34%	11.27%	11.71%	12.94%
Internal Rate Of Capital Generation	17.39%	11.09%	13.18%	9.15%	3.68%

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.

This page has been intentionally left blank

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

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

Tel: (9411) 2553089 Fax: (9411) 2553090
E-mail: ram@ram.com.lk
Website: <http://www.ram.com.lk>

