


RATINGS

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA
A wholly owned subsidiary of RAM Holdings Berhad

MERCHANT BANK OF SRI LANKA PLC – Rating Review

Financial Institution
Ratings:

Long-term: AA- [Reaffirmed]

Short-term: P1 [Reaffirmed]

Rating Outlook:

Stable

Instruments:

- (i) LKR300 million unsecured unlisted private debentures (2007/2010)
- (ii) LKR14.16 million unsecured unlisted public debentures (2007/2010)

Ratings

(i) AA- [Reaffirmed]

(ii) AA- [Reaffirmed]

Coupon Rates:

- (i) Weighted-average 1-year Treasury bill rate, excluding withholding tax + 300 basis points, with a cap of 17% and a floor of 13%.
- (ii) 3-year secondary-market bond rate before withholding tax + 110 bps, with a cap of 18% and a minimum fixed rate of 17.9% payable bi-annually and also to be revised bi-annually.

Strengths:

- State-owned parent
- Strong capitalisation

Weaknesses:

- Relatively high level of NPLs
- Comparatively hefty borrowing costs

Principal Activities:

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

Summary

RAM Ratings has lifted the Rating Watch (with a developing outlook) and simultaneously reaffirmed the respective long- and short-term financial institution ratings of Merchant Bank of Sri Lanka ("MBSL" or "the Bank"), at AA- and P1; the long term rating has a stable outlook. Meanwhile, the AA- ratings of the Bank's LKR 300 million Unlisted Private Debentures and LKR 14.16 million Unlisted Public Debentures have also been reaffirmed, with a stable outlook.

MBSL had been placed on Rating Watch in April 2009, following the acquisition of a licensed specialised bank ("LSB") and an insurance company. MBSL's reaffirmed ratings are firmly supported by the credit strength and financial flexibility stemming from its parent, state-owned Bank of Ceylon ("BOC").

BOC, the largest commercial bank in Sri Lanka in terms of assets, owns 76% of MBSL. BOC is a sovereign-owned entity that has consistently demonstrated its commitment to MBSL via long- and short-term loans, thereby enhancing the Bank's financial flexibility. Accordingly, despite MBSL being a relatively small player, accounting for just 4.34% of all specialised leasing companies' total assets as at the end of FYE 31 December 2008 ("FY Dec 2008"), the ratings are supported by continued parental support.

Subsequent to the collapse of several large financial conglomerates in Sri Lanka, the domestic financial system experienced liquidity problems with waning public confidence resulting in increased deposit withdrawals. In this context, MBSL has been appointed to stabilise 2 failed institutions, including the largest registered finance company ("RFC") in the country, i.e. The Finance PLC, in a bid to reinstate public confidence. Hence, we believe continued government support towards the Bank will be forthcoming, given its heightened importance in the financial system.

MBSL's overall position in the industry has been further enhanced by its recent acquisition of an LSB (formerly Ceylinco Savings Bank) and an insurance company (formerly ABC Insurance Company). Despite the integration risks that may arise from MBSL's simultaneous entry into 2 new areas, RAM Ratings Lanka is confident of the Bank's ability to effectively turn these entities around. Furthermore, MBSL's investments in these entities amount to only 3.74% of its asset base (or 10.97% of its capital).

The non-favourable economic conditions witnessed during 2008, resulted in the deterioration of asset quality for most industry players. Accordingly, MBSL's gross non-performing-loan ("NPL") ratio had reversed its improving trend and climbed back up to 12.46% as at end-FY Dec 2008 (end-FY Dec 2007: 10.29%) while being relatively weaker than its industry peers. Nevertheless, the Bank's

Analysts:

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

Prakash Jerome
ACMA, ASCMA
(9411) 2503551
prakash@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

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

gross NPL ratio eased to 11.57% as at end-March 2009, mainly driven by the recovery of a large loan during the quarter.

Despite the Bank's relatively low asset quality and narrowing interest-rate differentials, its net interest margin ("NIM"), amounted to 9.16% in FY Dec 2008 - significantly better than the industry average of 5.34%. On the other hand, increased provisioning and an expanded cost base had depressed profits, with MBSL's returns on assets ("ROA") falling to 4.08% as at end-FY Dec 2008 (end-FY Dec 2007: 6.73%), albeit still better than the industry's 2.87%.

Meanwhile, MBSL remained well capitalised with LKR 1.68 billion of shareholders' funds as at end-FY Dec 2008, accounting for a healthy 35.23% of its total assets. Given its parent's firm financial backing, this level of capitalisation is considered to be adequate.

Outlook

The stable outlook on MBSL's long-term ratings reflects the consistent support offered by its state-owned parent, and the resultant financial flexibility. However, downward pressure will be exerted in the event of further deterioration of the Bank's asset quality, any weakening in its interest coverage, or a significant deterioration in its performance.

Corporate Profile

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

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

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

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

Table 1: Products and services offered by MBSL

Leasing and hire-purchase	Trade financing	Corporate advisory	Capital market	Corporate secretarial
Finance leases	Bank guarantees	Loan/equity syndications	Listing/initial public offerings (“IPOs”) of equities and debt securities	Company incorporation
Hire-purchase facilities	Cheque discounting	Mergers and acquisitions	Management of mandatory and voluntary offers	Registrar for bonus and rights issues as well as IPOs
Operating leases	Project loans	Company restructuring	Private placements	Share-ledger management
	Real estate	Portfolio management	Underwriting of IPOs	
	Term loans	Margin trading	Securitisation	
	Trade bills	Project financing	Rights/bonus issues	
		Management training and consultancy		

Ownership and financial flexibility

Strength of sovereign-owned parent underscores ratings

MBSL’s ratings are anchored by the strength of its state-owned parent, BOC. With an asset base of LKR 484.38 billion, BOC is currently Sri Lanka’s largest commercial bank while also having the most extensive branch network in the industry. BOC has demonstrated its continued support to MBSL on numerous occasions; after a capital reorganisation, the parent subscribed for a 1:2 rights issue in 2005, followed by a LKR 1.75 billion 3-year debenture in 1996, which at that time constituted 30% of the Bank’s funding requirements. Additionally, MBSL has access to an LKR 800 million funding line that is inclusive of term loans, money-market loans and overdraft facilities from BOC.

Owns 51% of RFC

MBSL holds a 51%-stake in Merchant Credit of Sri Lanka (“MCSL”), an RFC; the other 49% is owned by BOC. MCSL is engaged in leasing, hire purchase (“HP”), loans, real estate and acceptance of public deposits. As at end-March 2009, MCSL’s asset base amounted to LKR 3.05 billion (end-March 2008: LKR2.41 billion).

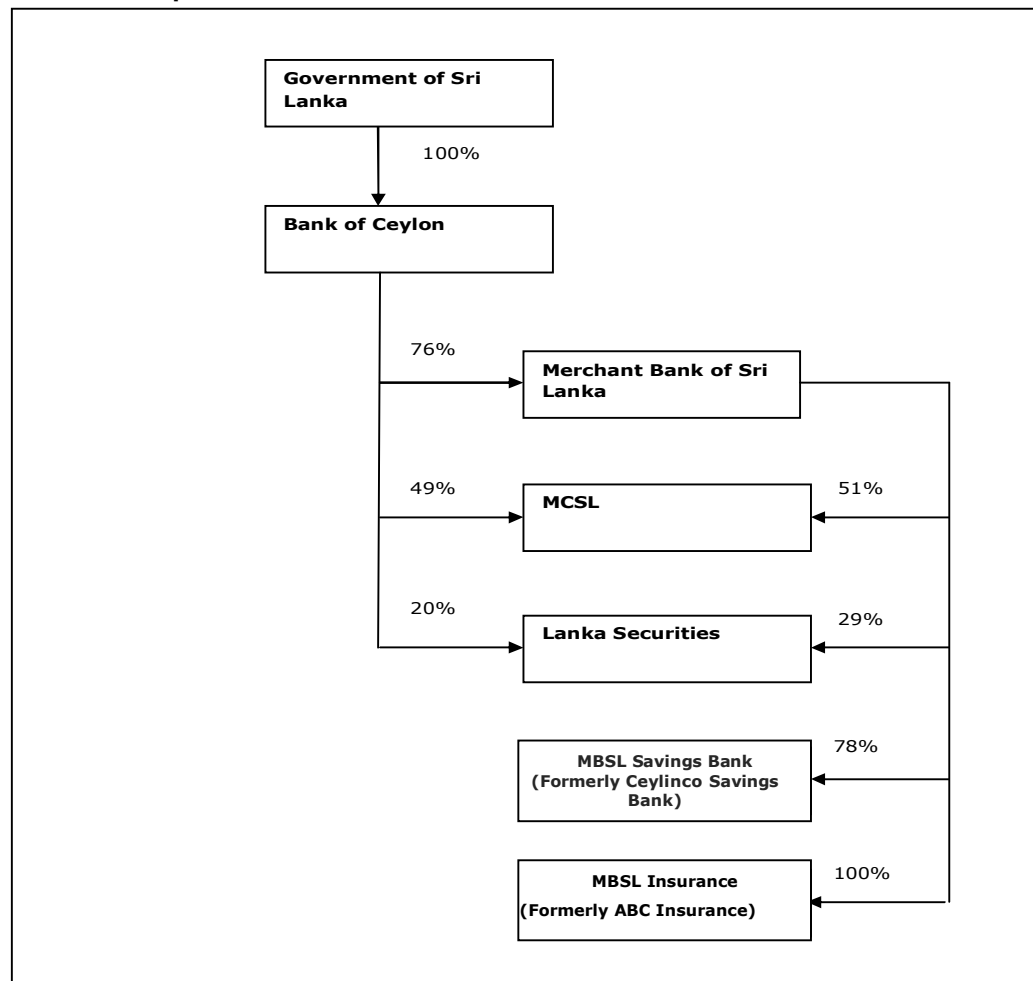
Associate stake in Lanka Securities Ltd

Lanka Securities Limited (“LSL”), a registered stockbroker, is an associate of MBSL. Accordingly, the Bank holds a 29% stake in LSL with another 20% owned by BOC and 51% controlled by First Capital Securities Corporation Limited of Pakistan.

Fresh acquisitions

In the preceding years, MBSL had pursued a specialized banking license, with a view to transforming its business model and obtaining approval to accept public deposits. Subsequent to the recent collapse of several Ceylinco Group institutions, MBSL has had the opportunity of acquiring 78% of Ceylinco Savings Bank (“CSB”) at a relative bargain, i.e. through a LKR 100 million capital infusion. CSB has now been rebranded as MBSL Savings Bank. MBSL has also acquired the troubled ABC Insurance Company for LKR 77 million, with the objective of venturing into the insurance market (refer to Chart 1).

Chart 1: Group Structure



Management & Strategies

The chairman of MBSL, Mr. Janaka Ratnayake, continues to spearhead the strategic direction of the Bank, working closely with the chief executive officer ("CEO") and senior management team, which is led by Mr Gamini Karunathilake.

Expanding outside traditional business

Despite the prevalent non-conducive economic conditions on the back of the global financial turmoil, MBSL has sought to increase its presence in the financial-services industry while expanding its operations outside its traditional scope of business. In the past few years, MBSL had been pursuing a specialised banking licence that would enable it to accept public deposits. Accordingly, subsequent to the crisis within the Ceylinco Group, MBSL seized the opportunity offered by acquiring 78% of CSB, at a relatively low cost of LKR 100.0 million - thereby securing its coveted specialised banking licence. As of September 2008, CSB's assets amounted to LKR2.72 billion, with LKR2.09 billion of customer deposits. Given CSB's access to public deposits, the management is confident of the Bank's ability to obtain low- cost funding in the future.

RAM Ratings Lanka notes the potential operational risks that the acquisition may instigate, particularly given the relatively weak historical performance of CSB. We are further concerned about CSB's core capital, which remains far below the Central Bank's stipulated minimum requirement. Nevertheless, given MBSL's management expertise, the Bank is in a strong position to effectively turn CSB around; whilst its focus on pruning overheads is expected to bear fruit in the medium term.

Venture into insurance industry

Elsewhere, the Bank has also expanded into the insurance industry through the acquisition of ABC Insurance Company, a former subsidiary of the troubled ABC Group. As at end end-FY Dec 2008, the asset base of ABC Insurance Company stood at LKR 358.21 million, with LKR 314.19 million of gross written premiums ("GWPs") for the year. Subsequent to the acquisition, ABC Insurance Company has been re-launched as MBSL Insurance. RAM Ratings Lanka remains confident about the growth prospects of MBSL Insurance, particularly given the company's skilled work force and its guaranteed access to all the insurance requirements of the MBSL Group and, possibly, all BOC subsidiaries. While we acknowledge the possible operational risks the acquisition may entail, we believe growth potential remains intact in the medium to long term.

Corporate Governance

The Bank's 8-member board convened 13 times in 2008. The board comprises 3 nominees of BOC and 5 independent directors, who are assisted by 7 committees: audit, compensation and corporate governance, credit, purchasing, incentive, training and investment. While matters are critically evaluated by all members of the board, we note that the chairman has significant influence in board decisions.

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

Asset Quality

RAM Ratings Lanka opines that MBSL's asset quality is weak compared to industry peers, although we acknowledge the management's recent initiatives to enhance the Bank's asset quality. We observe that the prevalent weak economic conditions and environment of high interest rates had posed a challenge for MBSL in 2008. Going forward, its asset quality is anticipated to improve over the medium term, supported by easing interest rates and improved business sentiments.

Weak asset quality**Asset growth moderates**

MBSL's asset base expanded by a moderate 8.27% year-on-year ("y-o-y") to LKR 4.77 billion as at end-FY Dec 2008, which we believe to be respectable given the current challenging economic conditions. Asset growth moderated in line with the contraction in loan growth, resulting in a change in composition of the asset structure (refer to Table 2). Accordingly, the Bank's exposure to loans and advances had dipped slightly during the reviewed period, tilting more towards the maintenance of liquid assets such as government securities.

Table 2: Composition of MBSL's asset base

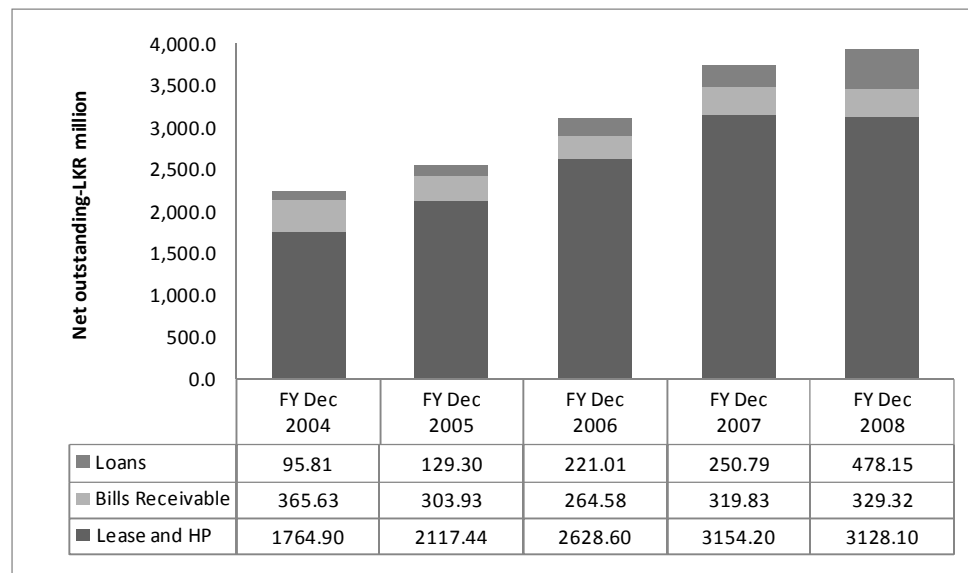
	FY Dec 2004	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008
Loans and advances	89.9%	77.9%	88.9%	84.6%	82.5%
-Leases and HP	71.3%	68.8%	75.0%	71.6%	65.6%
-Bills receivable	14.8%	9.9%	7.6%	7.3%	6.9%
-Loans	3.9%	4.2%	6.3%	5.7%	10.0%
Investment properties	3.1%	3.7%	3.0%	7.7%	7.1%
Government securities	0.0%	5.5%	0.0%	0.9%	2.7%
Dealing securities	0.1%	0.4%	2.1%	1.5%	1.1%

Growth driven by HP

Leases and HP continue to dominate MBSL’s overall loan growth, accounting for 79.50% of its total loans and advances as at end-FY Dec 2008. With the contraction of its leases and HP portfolio on the back of macroeconomic concerns, the overall growth in the Bank’s net loans and advances moderated to 5.66% last year. In addition, the composition of its leases and HP also altered in 2008, with a higher proportion of HP in the mix. This was mainly due to stronger demand for second-hand vehicles in relation to brand new vehicles, amid the escalating prices of new automotives. Nevertheless, we note a dip in overall demand for leases and HP given the high-interest-rate environment.

Meanwhile, the Bank’s portfolio of other loans augmented substantially, albeit against a small base mainly in view of the increased disbursement of term loans. Accordingly, MBSL’s other loans increased by LKR 227.36 million (or 90.66% y-o-y) to reach LKR 478.15 million as at end FY Dec 2008 (refer to Chart 2)

Chart 2: Portfolio trends



Gross NPL increases

The management’s initiatives to enhance the Bank’s asset quality through recoveries and stringent credit evaluation had been somewhat fruitful in the past, with its gross NPL ratio declining gradually until FY Dec 2007. Nevertheless, MBSL’s gross NPL ratio remains significantly higher than the industry peers, whilst the sliding economic fundamentals prevalent during FY Dec 2008 have resulted in further deterioration of the ratio. Accordingly, the Bank’s gross NPL ratio deteriorated from 10.29% as at end-FY Dec 2007 to 12.46% as at end-FY Dec 2008 (compared to the leasing industry’s estimated 4.80%).

Despite marginal improvements in collection and monitoring measures, the gross NPL ratios of the Bank’s leases and HP portfolio as well as bills portfolio had risen during the reviewed period. On the other hand, the gross NPL ratio of its “other loans” portfolio had eased significantly, attributable to aggressive recovery techniques and the robust growth of the Bank’s loan base (refer to Chart 3)

On a more positive note, MBSL’s gross NPL ratio ameliorated to 11.57% as at end-1Q FY Dec 2009, mainly driven by the recovery of a lumpy loan during the quarter. Going forward, we anticipate this ratio to improve further along with the favourable changes in the macroeconomic environment.

Chart 3: Gross delinquency ratios-product wise

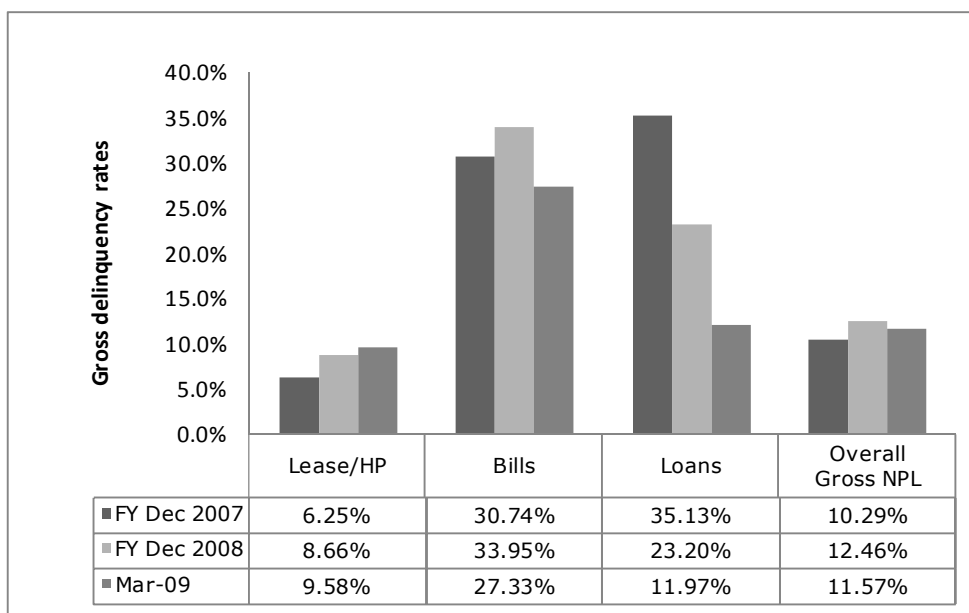


Table 3: NPL Composition

	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008
HP/leases	52.82%	51.27%	56.12%	59.14%
Bills receivable	27.27%	27.31%	23.05%	20.60%
Loans	19.91%	21.43%	20.82%	20.26%

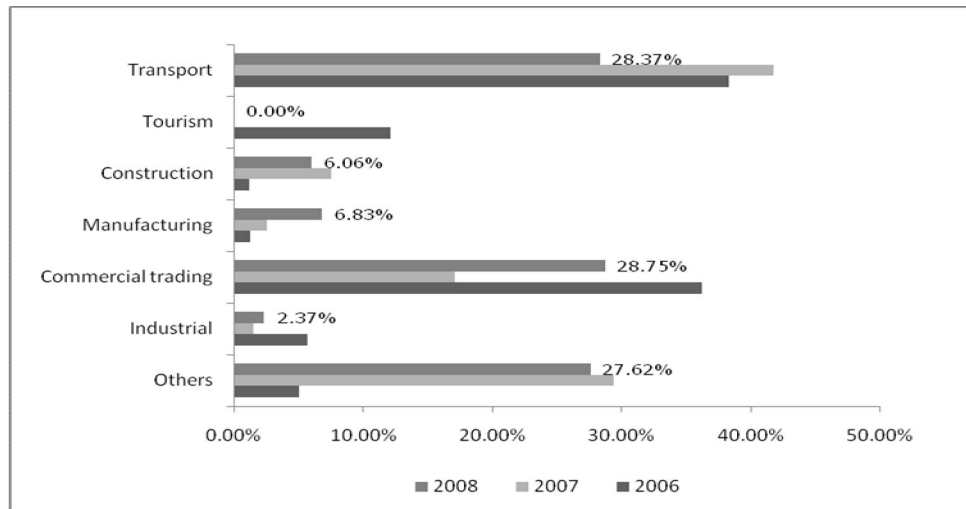
Adequate provisioning

RAM Ratings Lanka deems MBSL’s provisioning to be adequate, and better than its peers’. In addition to the Central Bank’s regulations on provisioning for bad and doubtful debts, MBSL also adopts its own hair-cut rule with regard to the netting off of immovable property for the purpose of provisioning, which we believe to be more stringent. In line with the weakened asset quality during the year, the Bank’s net NPL ratio worsened to 7.65% as at end-FY Dec 2008 (end-FY Dec 2007: 6.26%). Nevertheless, given that MBSL maintains discretionary general loan loss reserves in addition to the mandatory provisioning, coupled with its moderate gross NPL coverage of 60.72% as at end-FY Dec 2008 we believe provisioning remains adequate.

Moderately diversified lending portfolio

RAM Ratings Lanka opines that MBSL’s lending portfolio is moderately diversified. Sector-wise, nearly 57% of its lending is focused on 2 key sectors: transport and commercial trading; however, these large sectors are also highly diversified (refer to Chart 4). Structurally, the Bank’s credit concentration remains moderate, with its 10 largest exposures amounting to just 8.6% of its entire loan portfolio as at end-FY Dec 2008.

Chart 4: MBSL's sectoral exposure



Contraction of equity portfolio

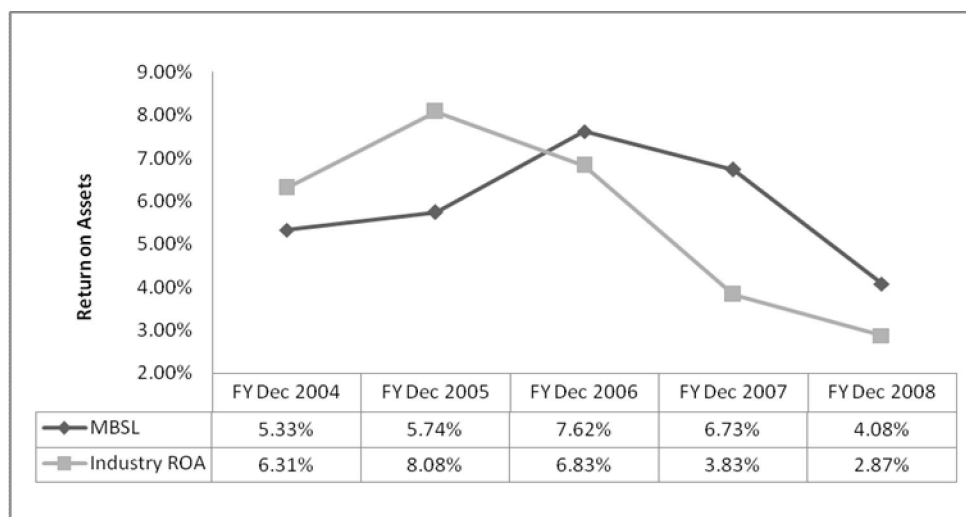
Despite its high level of liquidity and diversity, the value of MBSL's equity trading portfolio (which accounts for merely 1.08% of its total assets and 1.18% of its entire capital) has diminished in line with the broad market dip in the Colombo Stock Exchange; the Bank's portfolio contracted 21.09% y-o-y to LKR 51.51 million as at end-FY Dec 2008. Nevertheless, as the current exposure of its equity portfolio is relatively small, we believe any gains or losses would be minimal. Moreover, the Bank has increased its provisions pertaining to the decline in value of dealing securities during the year, thereby mitigating potential losses.

Moderate financial performance

Performance

MBSL's financial performance is deemed moderate. In line with our expectations, the Bank's performance eased somewhat in FY Dec 2008, hampered by persistently lofty interest rates that had pushed up interest expenses; its more fragile asset quality had also led to increased provisions. Accordingly, its pre-tax ROA declined to 4.08% during the review period-albeit still outperforming the industry average of 2.87% (refer to Chart 5)

Chart 5: Trends in ROA



Rising interest expenses

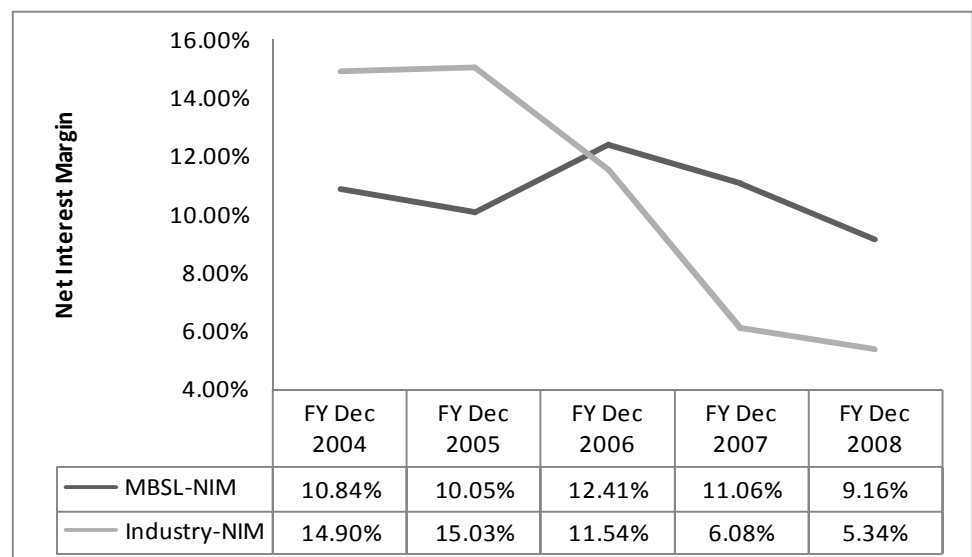
Despite a commendable 18.64% y-o-y rise in total income, MBSL’s gross income moderated to LKR 487.83 million in FY Dec 2008, as heftier interest expenses eroded its income. Withstanding the slowdown in the economy, the Bank’s interest income grew sharply by 25.57% dominated by growth in the HP segment. With the prices of new vehicles expected to remain at the current high levels, we anticipate the Bank’s HP portfolio to maintain its steady growth in the coming year, although tempered by the global slowdown. Meanwhile, its non-interest income was boosted by fee income in 2008, as the Bank had engaged in capital-market and debt-market advisory activities. Going forward, MBSL is well poised to benefit from the fee income arising from its management of The Finance Company PLC and The Finance and Guarantee Company.

In the meantime, the escalation of interest expenses in FY Dec 2008 remains a concern, as the Bank’s interest expenses had eroded its income, thereby overshadowing the growth in interest income. Interest expenses had leapt 64.28% y-o-y to LKR 547.39 million, affected by persistently high interest rates, while MBSL’s increased gearing had also exerted further pressure on interest expenses. This is reflected in the Bank’s interest coverage, which declined to 1.36 times as at end-FY Dec 2008. Consequently, its net interest income shrank 3.39% y-o-y to LKR 419.92 million last year.

Relatively broad NIM

The Bank’s NIM continues to be relatively broader than its peers, albeit declining during the period under review. MBSL has maintained consistent double-digit margins since FY Dec 2004, although they were somewhat squeezed to 9.16% in FY Dec 2008 (FY Dec 2007: 11.06%) due to the escalation of interest rates, coupled with the increased use of short term financing lines (refer to Chart 6). As interest rates are currently on the decline, however, we believe that MBSL will be in a position to maintain healthy NIMs in the coming year.

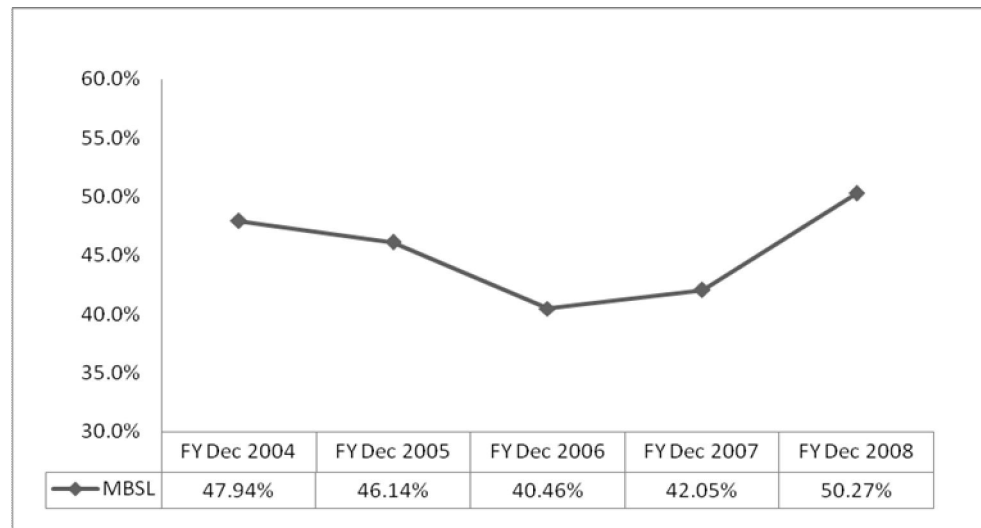
Chart 6: Trends in net interest margins



Higher cost-to-income ratio

The Bank’s overhead cost management weakened during the reviewed period, albeit still deemed to be moderate. MBSL’s continued focus on cost reduction had been fruitful in the past, with its cost-to-income ratio having declined consistently to a commendable 42.05% as at end-FY Dec 2007 (refer to Chart 7). However, the ratio spiked up to 50.27% in FY Dec 2008, mainly due to increased personnel costs (+20.98%).

Chart 7: Trends in cost-to-income ratio



Heftier provisions

The worsening of the Bank’s NPLs had resulted in higher provisions during the period under review, thereby further depressing its overall performance. Accordingly, its loan-loss provisions increased 28.22% y-o-y to LKR 47.90 million as at end-FY Dec 2008. In addition to the mandatory specific provisions, MBSL also maintains discretionary general loan-loss reserves amounting to a minimum of 0.5% of the aggregate value of its net portfolio.

Meanwhile, the declining quality of MBSL’s leases and HP segment remain a concern; specific provisions for this portfolio jumped up to LKR 51.16 million in FY Dec 2008 (compared to LKR 30.32 million the preceding year).

Funding & Liquidity

Marginal liquidity level

RAM Ratings Lanka opines that MBSL has marginal liquidity and funding levels. Nevertheless, we believe that its liquidity risk is mitigated given the financial viability of its parent.

As projected, the Bank’s short-term financing lines have been attaining increasing importance since FY Dec 2005, accounting for 24.61% of its asset base as at end-FY Dec 2008 (refer to Table 4). Accordingly, the Bank has been relying more on commercial papers, call money and bank loans. Consequently, the lofty interest rates in FY Dec 2008 had heightened its interest expenses, especially for its short-term borrowings base. However, with interest rates currently on the downtrend we believe the rise in interest expenses would moderate in the coming year.

Table 4: MBSL’s funding structure

	FY Dec 2004	FY Dec 2005	FY Dec 2006	FY Dec 2007	FY Dec 2008
Shareholders’ funds	29.93%	41.42%	37.05%	35.53%	35.23%
Long-term borrowings	52.65%	48.37%	37.05%	37.87%	31.98%
Short-term borrowings	6.37%	5.02%	10.36%	16.77%	24.61%
Others	11.04%	5.18%	15.54%	9.83%	8.18%

Movements in borrowings

MBSL secured LKR 162.56 million of extra banking lines in 2008, along with LKR 230.15 million of commercial papers and LKR 96.98 million of additional money-market borrowings (refer to Table 5) The Bank had also repaid 183.35 million of debentures that had matured during the period under review.

Table 5: Movements in MBSL's borrowings

	LKR million
Borrowings as at end-FY Dec 2007	2,406.59
Add: Additional borrowings	
Secured borrowings	162.56
Commercial Papers	230.15
Money market borrowings	96.98
Less: Repayments/reduction in borrowings	
Repayment of NSB debenture	(20.00)
Repayment of unsecured debentures	(163.35)
Reduction in overdraft	(14.83)
Borrowings as at end-FY Dec 2008	2,698.11

With receding loan growth, the short-term liquidity position of the Bank has strengthened. As such, its cash balances augmented to LKR 38.24 million as at end-FY Dec 2008 (end-FY Dec 2007: LKR 0.31 million) while investments in government treasury bills also increased significantly to LKR 131.08 million (end- FY Dec 2007: LKR 41.74 million)

Asset-liability mismatch

The increased use of short-term financing lines had also resulted in a mismatch between MBSL's assets and liabilities, particularly up to the 2-year bracket. Nevertheless, we believe that these concerns are mitigated by the recent declining trend in interest rates and the anticipated firm parental support from BOC.

Meanwhile, MBSL's heavier debt load had pushed its gearing ratio up to 1.62 times as at end FY Dec 2008 (end-FY Dec 2007: 1.59 times). Despite the increased leverage, we remain unconcerned as the Bank's gearing level is still well within the regulatory ceiling stipulated by the Central Bank.

Funding options

Going forward, MBSL intends to roll over LKR 400 million and LKR 430 million of debentures from National Savings Bank and the Employees' Trust Fund Board, respectively. Alternatively, funds may be raised via a new debenture issue or a rights issue within the next few months. As such, we believe that the Bank's funding risk will be mitigated.

Capital Adequacy

RAM Ratings Lanka believes that MBSL is adequately capitalised, with LKR 1.68 billion of shareholders' funds as at end-FY Dec 2008 that accounted for a healthy 35.23% of its total assets. We deem this level of capitalisation to be adequate, particularly given the financial backing from the Bank's parent. Nevertheless, weakened asset quality had pushed up MBSL's ratio on net NPLs to shareholders' funds to 16.31% as at end-FY Dec 2008. We note that the poorer performance last year had also adversely affected its capital adequacy.

Healthy capitalisation level

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 agricultural sector had accelerated during this period, the industrial and services sectors' pace had slowed down (refer to Table 6).

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

Table 6: 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%

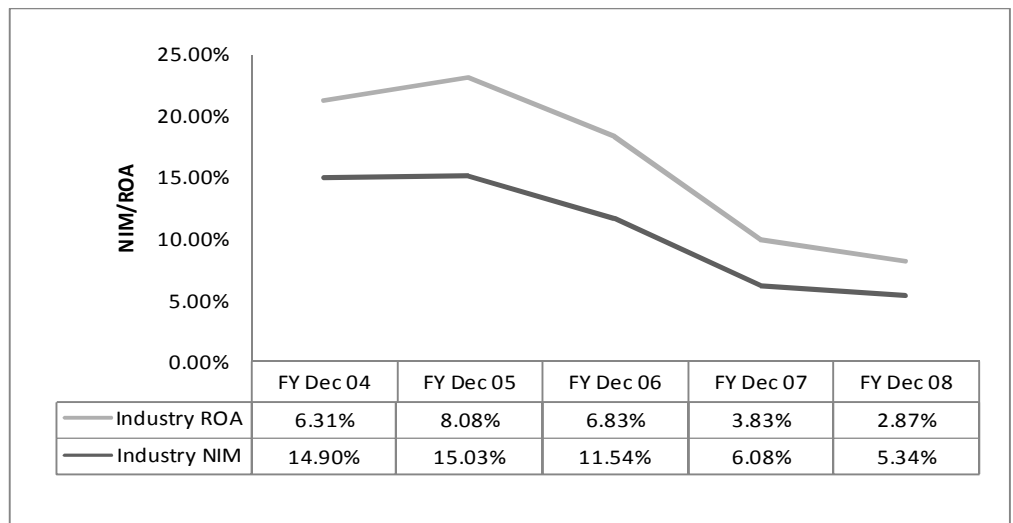
Meanwhile, the rate of inflation, which had been on the rise since 2H 2007, is now showing a reversing trend. The Colombo Consumer Price Index ("CCPI"), which hit an all-time high of 28.2% in June 2008, has been easing significantly since the latter part of last year, to 0.9% in June 2009. Favourable domestic supply factors, as well as easing international commodity prices - especially crude oil - have supported the deceleration in inflation. The tight monetary policies adopted by the Central Bank in 1H 2008 have also been a contributing factor.

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. We believe the declining trend in interest rates is not sustainable in the long term, particularly given rising government expenditure which will widen the budget deficit.

The Sri Lankan leasing industry is structurally fragmented, with a total of 22 SLCs in operation in 2008. Competition within the industry has intensified further as all licensed commercial banks ("LCBs") and RFCs have obtained leasing licences, thereby increasing the number of industry players to 74. The fierce market competition has hampered the growth of the SLCs, which are at a disadvantage in terms of pricing.

SLCs rely mainly on bank borrowings for their funding requirements. Since banks also engage in leasing operations, most SLCs encounter difficulties in securing funding at competitive rates. In contrast, as LCBs and RFCs have access to public deposits, they are able to source financing at more favourable rates. In this respect, SLCs are highly vulnerable to interest-rate movements and the high interest rate scenario which prevailed in the preceding months hurt sector profitability (refer to Chart 8) With interest rates projected to decline in the medium term, however, SLCs are expected to benefit from the lower cost of funding. Nevertheless, we believe that this benefit will primarily be enjoyed by the relatively large players; the smaller ones will continue experiencing funding constraints.

Chart 8: Trends in industry NIM/ROA



On a more positive note, SLCs have managed to retain their competitiveness through their higher efficiency levels. As larger SLCs have identified the various weaknesses in the leasing business model, there has been a tendency towards the acquisition of RFCs, thereby obtaining access to public deposits. On this note, we believe that the number of SLCs will dwindle, as industry consolidation takes place over the longer term.

Corporate Information

Date of Incorporation:	1982		
Commencement of Business:	1982		
Major Shareholders:	Bank of Ceylon		76.00%
	Bank of Ceylon A/C Ceybank Unit Trust		5.57%
	Distilleries Company of Sri Lanka Ltd		1.07%
	Waldock Mackenzie Ltd/Mr Lalith Prabash		0.94%
	Employee Trust Fund Board		0.71%
	Associated Electrical Corporation Ltd		0.55%
Directors:	Mr Janaka Ratnayake	Chairman	
	Ms WA Nalani	Director	
	Dr Ranjith Bandara	Director	
	Mr Mervyn Paramananda	Director	
	Mr Lakshman Perera	Director	
	Mr JGBP Tissera	Director	
	Mr PG Rupasinghe	Director	
	Mr V Kanagasabapathy	Director	
Auditor:	SJMS Associates Chartered Accountants		
Listing:	1991		
Key Management:	Mr Gamini Karunathilake	Chief Executive Officer	
	Mr Ranjith Siriwardena	Deputy Director – Strategic Planning & Risk	
	Mr Lakshman Kaluarachchi	Deputy Director – Leasing	
	Ms Shyamalie Amaratunga	Deputy Director – Trade Finance	
	Mr MA Cader	Deputy Director – Corporate Advisory & Capital Markets	
	Mr Priyantha Herath	Assistant Director – Finance & Treasury	
	Mrs Marina Phillips	Company Secretary	
Major Subsidiaries and Associates:	Merchant Credit of Sri Lanka		51.0%
	Lanka Securities Limited		29.0%
	GTB Colombo Corporation Ltd		20.3%
	Mega Containers Ltd		18.3%
	MBSL Savings Bank		78.0%
	MBSL Insurance		100.0%
Capital History			
	Year	Remarks	Cumulative Total (LKR million)
		Amount (LKR million)	
	1989	Ordinary share capital	25.0
	1990	Share issue	90.0
	1991	Rights issue	150.0
	1993	Rights issue	280.0
	1994	Bonus issue	500.0
	2004	Write off of losses	230.0
	2004	Conversion of preference shares to ordinary shares	600.0
	2005	Rights issue	900.0

Financial Summary - Company

Unaudited

BALANCE SHEET (LKR million)	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	31-Mar-09
Property, Plant and Equipment	29.23	27.16	25.53	32.24	31.42
Investment in Associates/Subsidiaries	55.37	56.94	95.54	103.90	102.95
Other Investments/Investment Properties	121.91	106.79	340.16	339.09	300.39
Gross Debtors	2,927.35	3,353.34	3,998.97	4,257.65	4,242.84
Leasing & Hire Purchase	2,389.84	2,815.57	3,387.71	3,405.31	3,435.69
Others	537.51	537.77	611.26	852.34	807.15
Estimated Residual Values					
Less : Deposits	(62.73)				
Less : Loan Loss Reserves	(313.97)	(239.19)	(274.15)	(322.05)	(336.62)
Net Debtors	2,550.65	3,114.15	3,724.82	3,935.60	3,906.22
Amounts due from Holding/Related Companies					
Other Loans & Advances					
Cash and Bank Balances	12.78	1.42	0.31	38.24	67.11
Other Current Assets	502.96	197.24	217.72	319.08	322.35
TOTAL ASSETS	3,272.90	3,503.70	4,404.08	4,768.15	4,730.44
Long Term Deferred Liabilities	23.82	127.27	101.32	81.91	82.81
Redeemable Hybrid Capital					
Long Term Private Debt Securities					
Less : Sinking Fund					
Other Long Term Loans	1,488.10	1,298.10	1,667.86	1,524.83	1,420.84
Total Long Term Debt	1,488.10	1,298.10	1,667.86	1,524.83	1,420.84
Short Term Private Debt Securities	154.50	362.87			
Amounts due to Holding/Related Companies					
Other Short Term Loans	17.65	73.91	822.68	1,200.390	1,236.45
Total Short Term Debt	172.15	436.780	822.68	1,200.39	1,236.45
Trade Creditors					
Provision for Dividend					
Provision for Taxation					
Other Current Liabilities	314.63	225.300	247.50	281.22	376.89
TOTAL LIABILITIES	1,998.70	2,087.45	2,839.36	3,088.35	3,116.99
Equity Share Capital	900.00	900.00	1,067.00	1,067.00	1,067.00
Irredeemable Hybrid Capital					
Reserves	167.00	181.67	31.36	45.72	45.72
Less : Intangible Assets					
Retained Profit/(Loss)	207.20	334.58	466.36	567.08	500.73
Minority Interests (MI)					
TOTAL SHAREHOLDERS' FUNDS + MI	1,274.20	1,416.25	1,564.72	1,679.80	1,613.45
TOTAL LIABILITIES + SHAREHOLDERS' FUNDS + MI	3,272.90	3,503.70	4,404.08	4,768.15	4,730.44

Financial Summary - Company

	<i>Unaudited</i>				
INCOME STATEMENT (LKR million)	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	31-Mar-09
Interest Income	474.90	609.52	770.34	967.30	235.54
Less : Interest Expense	(185.91)	(189.02)	(333.20)	(547.39)	(145.47)
Net Interest Income	288.99	420.50	437.13	419.91	90.07
Non-interest Income	64.10	94.84	102.26	67.92	22.24
Gross Income	353.09	515.34	539.39	487.83	112.31
Less : Non-interest Expenses	(162.91)	(208.49)	(226.83)	(245.24)	(66.46)
Less : Bad & Doubtful Debt Provisions	(16.12)	(38.91)	(37.36)	(47.90)	(14.57)
Less : Depreciation & Amortisation	(9.18)	(9.79)	(9.07)	(7.76)	(1.69)
Operating Profit/(Loss) Before Tax	164.88	258.15	266.13	186.93	29.59
Share in Results of Associated Companies	22.45	11.03	7.14	16.47	(0.94)
Prior Year Adjustments					
Exceptional Items					
Adjusted Profit/(Loss) Before Tax	187.33	269.18	273.27	203.40	28.65
Less : Tax	(28.90)	(59.64)	(34.80)	1.66	(5.00)
Adjusted Profit/(Loss) After Tax	158.43	209.54	238.47	205.06	23.65
Extraordinary Items					
Less : Transferred to Statutory Reserve					
Less : Dividends		(67.50)	(90.00)	(90.00)	
Retained Profit/(Loss) For The Year	158.43	142.04	148.47	115.06	23.65

Financial Ratios - Company

Unaudited

KEY RATIOS	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	31-Mar-09
Profitability (%)					
Net Interest Margin	10.05%	12.41%	11.06%	9.16%	* 7.59%
Cost/Income Ratio	46.14%	40.46%	42.05%	50.27%	59.17%
Return on Average Assets	5.74%	7.62%	6.73%	4.08%	* 2.49%
Return on Average Equity	16.36%	19.19%	17.86%	11.52%	* 7.19%
Capitalisation (times)					
Gearing Ratio	1.30	1.22	1.59	1.62	1.65
Long Term Gearing Ratio	1.17	0.92	1.07	0.91	0.88
Short Term Gearing Ratio	0.14	0.31	0.53	0.71	0.77
Capital Adequacy Ratio (%)	40.29%	42.03%	37.23%	36.73%	33.67%
Coverage (times)					
Interest Coverage Ratio	1.94	2.42	1.83	1.36	1.22
Asset Quality (%)					
Gross NPL	16.58%	11.81%	10.29%	12.46%	11.57%
Loan Loss Reserve Coverage	10.73%	7.13%	6.86%	7.56%	7.93%
General Loan Loss Reserve Coverage	2.50%	2.42%	2.51%	2.30%	0.00%
Loan Loss Reserve Coverage (Gross NPL)	64.68%	60.42%	66.62%	60.72%	68.57%

NOTES:

* annualised

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

Financial Ratios - Company

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

CREDIT RATING DEFINITIONS

(Financial Institution Ratings)

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

Long-Term Ratings

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

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

Short-Term Ratings

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

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

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

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

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

