

RAM

RATINGS

CREDIT RATING RATIONALE

FINANCIAL INSTITUTIONS – SRI LANKA

A wholly owned subsidiary of RAM Holdings Berhad

THE MULTI FINANCE COMPANY LIMITED – Rating Review

Financial Institution**Ratings:**

Long-term: BB- [Reaffirmed]

Short-term: NP [Reaffirmed]

Rating Outlook:

Stable

Strength:

-Healthy liquidity and funding positions

Weaknesses:

-Loan-concentration risk
-Small size, vulnerable market position

Principal Activities:

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

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Summary

RAM Ratings Lanka has reaffirmed the long- and short-term ratings of The Multi Finance Company Limited ("MFL" or "the Company") of BB- (with a stable outlook) and NP, respectively. The ratings are premised on the Company's small size and concentration risks arising from exposure to large loans. These factors are, nonetheless, moderated by the fact that MFL has met the minimum core-capital requirement of LKR 200 million, which has consequently improved the Company's capital adequacy and liquidity levels.

MFL remains one of the smallest players in the registered finance companies ("RFCs") industry, accounting for 0.19% of the industry asset base as at end-December 2008. Meanwhile, the Company complied with the regulatory minimum core capital requirement (of LKR 200 million) mainly through the investment by Entrust Limited ("Entrust"), formerly Ceylinco Shriram Securities Holdings Limited. Entrust now has a 92.13% stake in the Company. Consequently, certain key functions were taken over by the new management team. The new management line-up is focused on streamlining MFL's back-office operations and tightening collections as well as recoveries. In this regard, all manual systems are being automated; this is envisaged to facilitate efficient monitoring and control.

Furthermore, under the new management, the Company has expanded its branch network; opening 2 branches in Matara and Kurunegala in the space of two months. This expansion may exacerbate the Company's operational risks and potentially transform its credit profile; as such, the new team's risk-management capabilities will be vital. Over the long term, the new management will have a bearing on the Company's asset quality. Improved recoveries and monitoring helped rein in NPLs from LKR 6.65 million as at end-FY Mar 2008 to LKR 4.25 million as at end-December 2008.

However, our concerns lie in the large loan exposures and the unseasoned loan portfolio. MFL's top 10 loans accounted for 27.14% of gross loans as at end-December 2008, even a few defaults on these loans could significantly deteriorate the Company's asset quality. Moreover, recovery efforts, with respect to mortgage-backed loans, could be hindered as the Company does not have *parate*¹ execution rights. As the Company begins to expand its portfolio, however, concentration risk is expected to be diluted, albeit still significant. Going forward, the management of MFL will limit their exposure in mortgage loans to 50% of the land value, and will extend these loans only on bare lands. The Company's loan book expanded from LKR 57.39 million to LKR 125.63 million during the first 9 months of FY Mar 2009. Although we note that the Company has adopted more stringent credit evaluation procedures, the long-term health of the loan portfolio will come to light once it seasons. This will inturn determine Company's financial performance in the long run.

¹ Rights generally given to state-owned and some commercial banks, to seize and dispose of property without legal proceedings.

The financial performance of MFL remained weighed down by rising interest expenses and heavy overheads. MFL's pre-tax profit has shrunk from LKR 5.95 million as at end-FY Mar 2006 to LKR 2.90 million as at end-FY Mar 2008. The Company's cost-to-income ratio of 85.40% as at end-FY Mar 2008 was weaker than the industry average of 66.45% as at the same date. Although MFL's short-term performance may improve owing to the correction in its policy on interest-income recognition (as per SLAS 33), its long-term performance still depends on the health of its loan portfolio.

Following the capital injection by Entrust, MFL now excess liquidity; its statutory liquid-asset ratio stood at 172.70% as at end-December 2008 (end-May 2009: 45.46%). In addition, its Tier-1 risk-weighted capital-adequacy ratio ("RWCAR") and overall RWCAR clocked in at 103.90% and 113.30%, respectively - well above the corresponding regulatory minimums of 5% and 10%. However, the Company's internal capital generation (end-March 2008: 1.70%; end-December 2008: 0.56%) remained poorer than the industry average (end-December 2008: 8.74%) due to its weak financials. Although RAM Ratings Lanka expects MFL's capital adequacy to return to industry levels over the medium term, the Company's long-term adequacy would still be dictated by its asset quality and, in turn, its internal capital generation.

Outlook

The stable outlook reflects RAM Ratings Lanka's expectation that any increase in defaults will be cushioned by the Company's capital buffer. In addition, the Company's funding and liquidity levels are expected to normalise.

An upward revision of the ratings could materialise if MFL can improve and sustain its asset quality and performance, whilst enhancing its market share. Conversely, there may be downward pressure on the ratings in the event of significant deterioration in the health of its credit portfolio or if the Company contravenes any regulations.

Corporate Profile

Incorporated in 1974, MFL is registered under the Finance Companies Act No. 78 of 1988, and is regulated by the Central Bank of Sri Lanka ("Central Bank"). It is also registered under the Finance Leasing Act No. 56 of 2000, to carry out its leasing business.

MFL remains one of the smallest RFCs in Sri Lanka, with a net lending base of LKR 125.63 million as at end-December 2008 and supported by 31 employees. Although the Company's head office remains in Kandy, most of MFL's transactions occur in Colombo. The Company's main line of business includes hire-purchase financing ("HP") for vehicles, finance leasing, mortgaging, and accepting public deposits. Meanwhile, the Company recently ventured into the pawning business.

Ownership

As at end-December 2008, MFL's largest shareholder was Entrust. Following Entrust's investment of LKR 171.17 million, it now owns 92.13% of the Company; MFL has thus come under the Ceylinco Group's fold. The remaining equity in MFL is spread among 62 shareholders.

**Established in
1974**

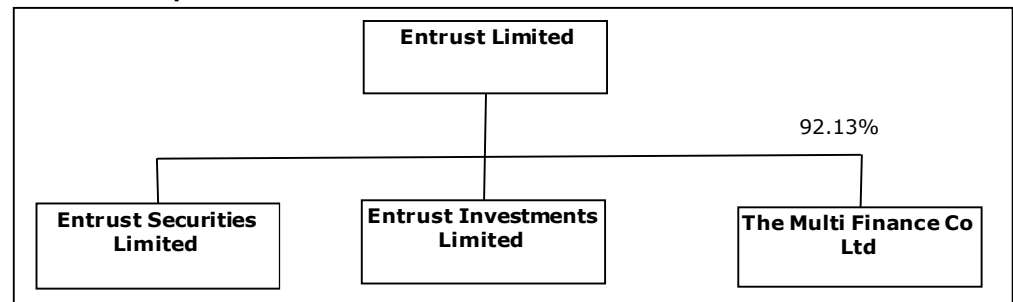
**Remains a small
player**

**Entrust now
largest stakeholder**

Entrust engaged in investment and fund management

Entrust is an investment-holding company with 2 subsidiaries. Entrust Securities Limited (formerly Ceylinco Shriram Securities Limited) is a primary dealer appointed by the Central Bank. Entrust Investments Limited (formerly Ceylinco Shriram Asset Management Limited), was an investment manager and margin provider supervised by the Securities and Exchange Commission of Sri Lanka ("SEC") (refer to Chart 1). However, Entrust Investment Limited had opted not to renew their license with the SEC which expired by end-April 2009. RAM Rating Lanka notes that Ceylinco Shriram Securities Holding Limited had changed its name to Entrust in March 2009, following the collapse of Golden Key within the Ceylinco fold.

Chart 1: Group structure



Management & Strategies

New Chairman and CEO

Following Entrust's investment, the management team of the Company is now led by its new Chief Executive Officer ("CEO"), Mr AHM Riyaz – who is vastly experienced in the field of investment management. The new management team focused on streamlining MFL's operations as well as tightening its monitoring and recovery systems in FY Mar 2008, thus laying the foundation for future growth.

Expanding branch network

The new management have increased MFL's geographical reach; operations in Colombo commenced in October 2008, while branches were opened in Matara (April 2009) and Kurunegala (May 2009). In addition, the management expect to open a third branch in Gampaha. As the Company now meets the Central Bank's minimum core-capital requirement, it is eligible to open a maximum of 15 branches. The 3 branches are spread over a wide geographical area, and the management expects these locales to act as springboards to their respective provinces. Meanwhile, all branch operations are expected to operate online, thereby facilitating closer monitoring.

Major part of IT system completed

Although the major modules of the Company's information-technology ("IT") system have been implemented, deployment of the full system has been hampered owing to difficulties during the data-conversion stage - as MFL had previously had a manual system, all data had to be entered from ledgers and then reconciled before being uploaded. RAM Ratings Lanka has a positive view of the managements' efforts to computerise operations, as a well-organised IT system is essential for effective monitoring and control. MFL's staff members are currently undergoing training on the operation of this new system. We note that loan expansion had been curtailed in FY Mar 2008 to allow the management to focus on revamping the Company's back-office operations, in efforts to incorporate the new IT system.

HP continues to drive loan growth

However, during the 9 months to end-December 2008, the Company shifted its focus back to expanding its loan books. The management continues to concentrate on HP and leasing for growth while shying away from consumer durable loans, due to the latter's high default rates (refer to Table 1). During the period under review, the management had ventured into pawn-broking as the demand for this product had been encouraging. Presently pawn-broking operations are limited to Kandy, looking ahead however, the management intend to expand these operations in the latter part of FY Mar 2010. In the funding side, the Company recently launched a minor savings product, but has not promoted it aggressively as it currently has ample liquidity.

Table 1: Default rates of MFL's products

	FY Mar 2006	FY Mar 2007	FY Mar 2008	end-December 2008
HP	5.22%	3.02%	0.32%	7.38%
Lease - Vehicle	N/A	N/A	13.54%	3.88%
Consumer Durables	12.07%	8.28%	17.43%	44.99%

MFL settles contingent liability; no more tax liabilities expected

Meanwhile, the contingent tax liability identified earlier has been settled, with the Company paying LKR 6.71 million in this regard. However, MFL's tax liabilities for 2005/06 and 2006/07 are still being negotiated with the Department of Inland Revenue. The Company has been advised by its tax consultant that it is not liable for any tax payment for the said periods; as such, no provision has been made. In addition, the auditors have noted that the Company's income-recognition policy does not comply with national accounting standards; this is expected to be addressed by end-FY Mar 2009. MFL had previously recognised interest income by equally spreading the total amount due throughout the period; however, SLAS 33 requires income to be recognised over the period of the facility, so as to provide a constant flow of return. RAM Ratings Lanka will keep close tabs on the outcome of both these matters, and take appropriate action if required.

Change in income-recognition method**New additions to board****Corporate Governance**

Following Entrust's entry, the Company's board composition had changed; as at end-December 2008 it comprised 8 members, of which 4 members are nominees of Entrust. However, by end-May 2009 the Board had shrunk to 6 members, with 2 nominees from Entrust exiting the Board. We note that Deshamanya Dr JLB Kotelawala and Mrs Karunanayke were on the Board of MFL, but had resigned by end-December 2008; Mr HK De Silva now chairs the Board. Board meetings are held monthly and in addition senior management meetings are convened to discuss specific issues. The board is also supported by audit and credit committees.

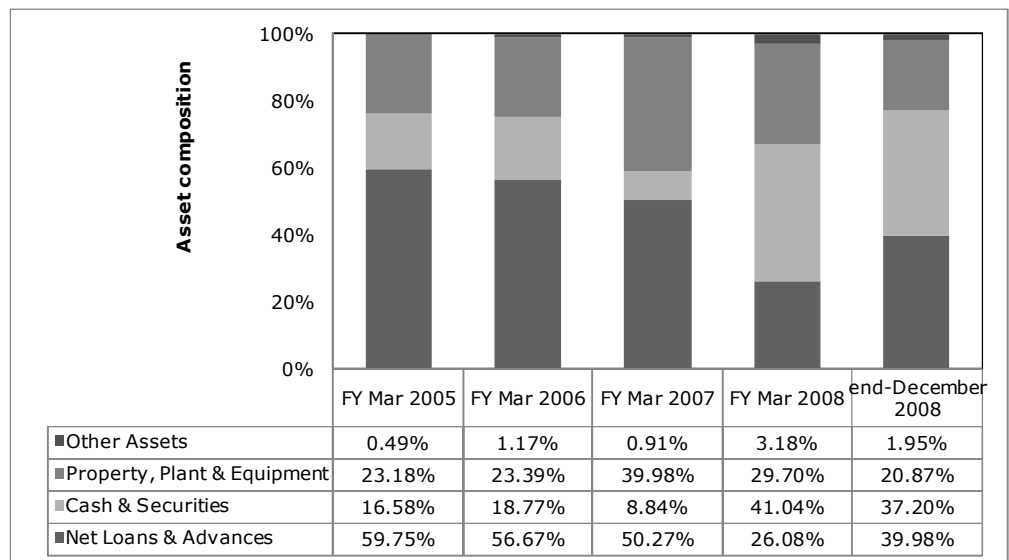
M/s KPMG Ford Rhodes & Co continue to be the Company's external auditors, while monthly internal audits are undertaken by M/s Ernst and Young. However, we note that the external auditors will be changed to M/s BR de Silva & Co, as the current one has been with the Company for 5 years; in line with Finance Companies (Corporate Governance) Direction 3 of 2008. In terms of related-party transactions, MFL had LKR 1.40 million of dealings with its sister company, The Multi Traders and Agencies Limited. These transactions pertain to rent, transportation services, and sales commissions; all are deemed to be at arms' length by the auditors.

Concerns on asset quality**Asset Quality**

RAM Ratings Lanka's concerns on MFL's asset quality hinge on the Company's high credit-concentration risk and unseasoned loan portfolio. The Company is exposed to significant concentration risk as its top 10 loans accounted for 27.14% of its portfolio as at end-December 2008; a single mortgage-backed loan accounted for bulk of the loans. In addition, the Company recorded an NPL ratio of 10.77% as at end-FY Mar 2008, poorer than the industry average of 6.64% as at the same date. Nonetheless, strong recovery and monitoring efforts helped rein in NPLs to LKR 4.25 million by end-December 2008 (end-FY Mar 2008: LKR 6.65 million). However, as the Company's loan portfolio had expanded from LKR 63.37 million to LKR 131.06 million in the first 9 months of FY Mar 2009 (+142.43%), the long-term credit quality of the portfolio will become apparent as it seasons.

Liquid asset base

The Company's asset composition has altered following its unprecedented growth in FY Mar 2008. MFL's asset base augmented 46.63% in FY Mar 2008, surpassing the industry's 24.28%. The prolific growth had been driven by investments in government securities, which burgeoned from LKR 7.17 million as at end-FY Mar 2007 to LKR 80.83 million as at end-FY Mar 2008. Accordingly, its balance sheet reflected a more liquid stance, with cash and securities making up the bulk (41.04%) of its asset base (end-FY Mar 2007: 8.84%) (refer to Chart 2). However, RAM Ratings Lanka opines that the excess liquidity in MFL's balance sheet - a corollary of the capital infusion by Entrust - will not be sustainable as the Company expands its loan books.

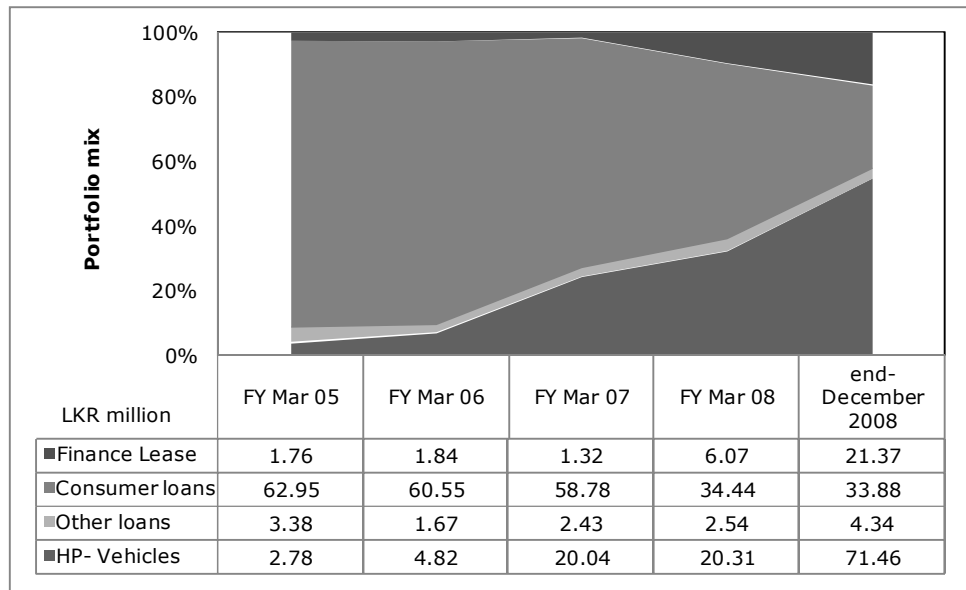
Chart 2: MFL's asset mix**Rapid expansion of loan portfolio**

Net loans and advances, which had taken up 50.27% of MFL's asset base as at end-FY Mar 2007, accounted for 26.08% as at end-FY Mar 2008, as the Company had restricted lending. However, the Company began to focus on lending during the 9 months to end-December 2008. MFL's loan portfolio expanded from LKR 63.37 million as at end-FY Mar 2008 to LKR 131.06 million as at end-December 2008, representing a growth of 142.43%. We are concerned about the Company's rapid loan expansion amid deteriorating economic environment.

Consumer loans curtailed; HP drove loan growth

Although the Company remains focused on the HP and finance-lease segment, it also provides mortgage-backed loans. In the meantime, vehicle financing has continued expanding, accounting for 70% of its portfolio as at end-December 2008, while consumer loans, which took up 93.60% of the Company’s loan base in FY Mar 2005, made up the remainder (refer to Chart 3). We note that the management has decided to curtail lending for consumer products following the high defaults within this segment.

Chart 3: MFL's portfolio mix



High loan-concentration risk

MFL’s top 10 loans accounted for 27.14% of its gross loans as at end-December 2008, exposing the Company to high concentration risk, reflecting the management’s risk appetite. RAM Ratings Lanka views this with concern as defaults on large loans can significantly affect the health of the portfolio. Furthermore, a single mortgage-backed facility accounted for 42.17% of its top 10 loans; despite the better recovery prospects of real-estate-backed loans, we note that the recovery procedure is cumbersome as the Company does not have *parate* execution rights. Furthermore, all of these loans had only been extended during the 9-month period to end-December 2008; as such, the quality of the loans remains untested. As the Company continues expanding its loan base we expect its concentration risk to decrease, albeit remaining significant. Going forward, MFL intends to lend mortgage loans only to bare lands and cap their loan exposure to 50% of the land value.

Vehicle-financing portfolio still untested

MFL’s NPL ratio of 10.77% as at end-FY Mar 2008 was weaker than the industry average of 6.54%. Loans granted for the financing of consumer durables accounted for 67.29% of these NPLs. On the other hand, the Company’s expanding vehicle-financing portfolio remains untested. NPLs from this segment accounted for 22.53% of its total NPLs, most arising from loans disbursed in 2006 and 2007. As such, the incidence of new NPLs spiked up to 4.43% as at end-FY Mar 2008.

Noteworthy recovery efforts and stringent loan evaluations

Nonetheless, RAM Ratings Lanka notes that the Company’s NPL ratio eased to 3.28% as at end-December 2008, on the back of sustained recovery efforts and write-offs (refer to Table 2); the ratio was also suppressed by its expanding loan portfolio. On a positive note, the management continues to emphasise credit evaluation when disbursing loans. Before granting a facility, the customer is required to provide 2 guarantors while reports are obtained from the Credit

Information Bureau ("CRIB") and background checks are carried out. All credit facilities are also vetted by the CEO and a senior manager before final approval.

Table 2: MFL's NPL movements

LKR millions	FY Mar 2006	FY Mar 2007	FY Mar 2008	end-December 2008
Brought Forward	9.40	6.79	4.78	6.65
Add:				
New NPL	1.65	0.44	3.22	0.54
Less:				
Rescheduled	-	-	-	0.00
Write-off	2.02	0.95	0.11	0.91
Recoveries	2.24	1.50	1.24	2.03
Carried Forward	6.79	4.78	6.65	4.25

Provisioning still healthy, but expected to weaken

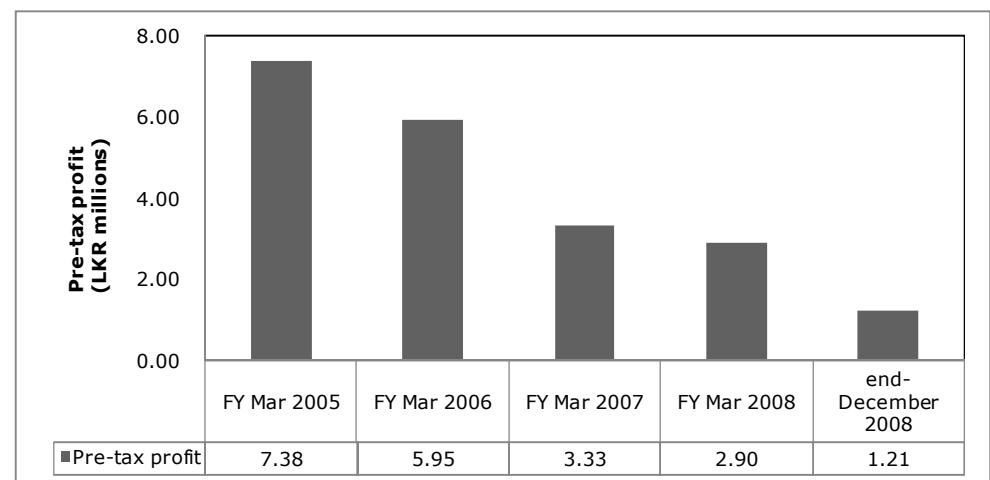
Meanwhile, the Company's gross NPL coverage of 65.25% as at end-FY Mar 2008 remained healthier than the industry average (of 49.30%). This reflects the more stringent provisioning policy of the Company; MFL has been following a more stringent provisioning regime while most industry players follow the less stringent Direction 3². Going forward, however, this coverage is likely to weaken as the Company adopts Direction 3.

Performance

Weak performance

MFL's performance is deemed weak owing to its heavy overheads. Although the Company's sliding net interest margin ("NIM") of 7.92% as at end-FY Mar 2008 (end-FY Mar 2007: 10.00%) remained above the industry average of 6.63%, its high overheads - as reflected in its greater-than-industry cost-to-income ratio of 85.40% as at the same date (industry: 66.33%) - weighed down its profitability; pre-tax profit declined from LKR 3.33 million to LKR 2.90 million over the same period (refer to Chart 4).

Chart 4: MFL's profit performance



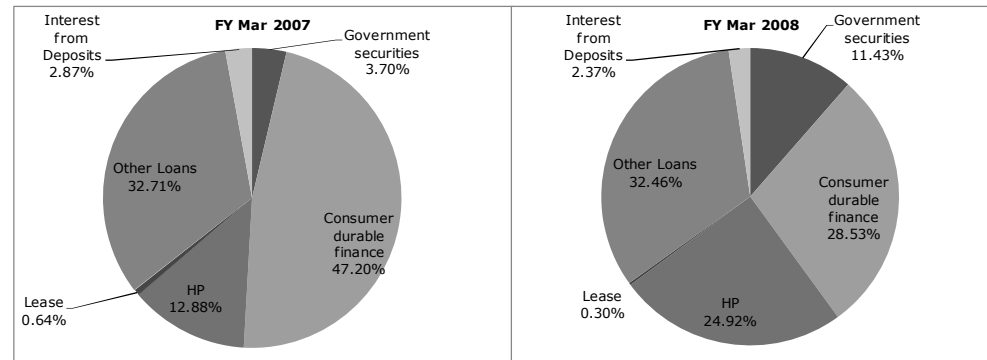
Interest income remains primary source of earnings

MFL's interest income has remained its primary source of revenue, accounting for 74.35% of its gross income in FY Mar 2008. At the same time, income from government securities contributed 11.43% to Company's interest income (FY

² Refer to page 13 for relevant Central Bank regulations

Mar 2007: 3.70%), reflecting its altered asset base (as discussed earlier under Asset Quality). Moreover, income from consumer-durables financing receded to 28.53% of MFL's interest income in FY Mar 2008, from 47.20% a year earlier, in line with the change in the Company's loan portfolio (refer to Chart 5). MFL had focused more on vehicle financing, with income from this segment contributing 25.22% to its interest income in FY Mar 2008 (FY Mar 2007: 13.53%).

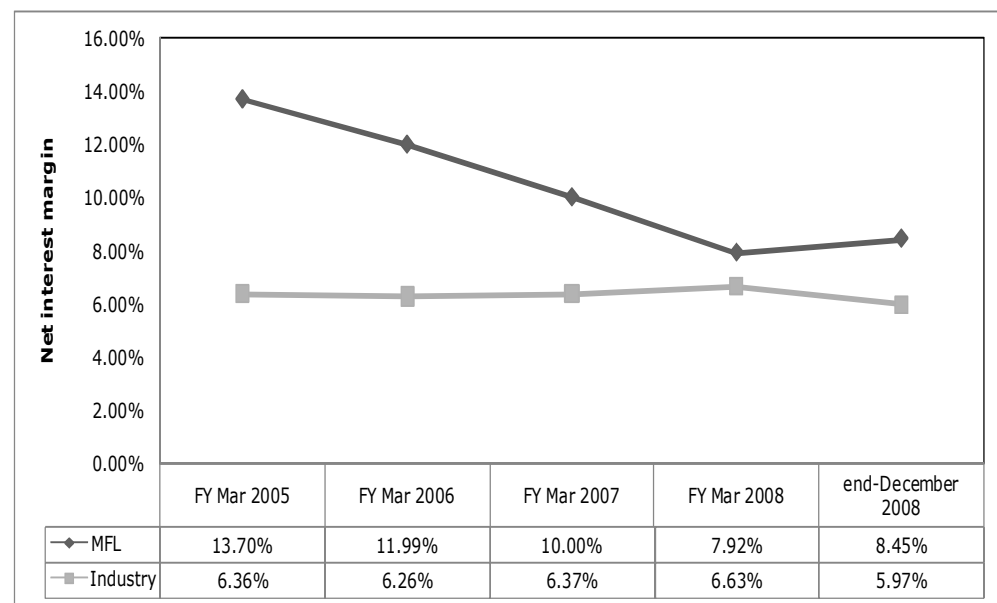
Chart 5: MFL's interest income composition



Deteriorating NIM, but better than industry

Meanwhile, MFL's NIM weakened from 10.00% as at end-FY Mar 2007 to 7.92% as at end-FY Mar 2008. We note that the NIM had been suppressed as the investment in interest earning assets had been made towards the end of FY Mar 2008. Nonetheless, this was still better than the industry average of 6.63% (refer to Chart 6). The Company's NIM improved to 8.45% as at end-December 2008, due to more loan disbursements. Going forward, MFL's NIM is anticipated to remain better than the industry average, as the Company begins to expand its lending portfolio.

Chart 6: MFL's NIM vs the industry



High overheads erode income

Although its cost-to-income ratio ameliorated from 87.18% as at end-FY Mar 2007 to 85.40% as at end-FY Mar 2008, this was poorer than the industry average of 66.33%. The ratio, however, deteriorated to 88.32% as at end-December 2008 following increased advertising and refurbishment costs. Looking ahead, the Company's overheads are expected to remain high in the short term as it begins expanding its branch network.

Performance indicators trending downwards

Funding and liquidity presently at healthy levels

Shareholders' funds provide bulk of financing needs

Lack of ALCO may become concern

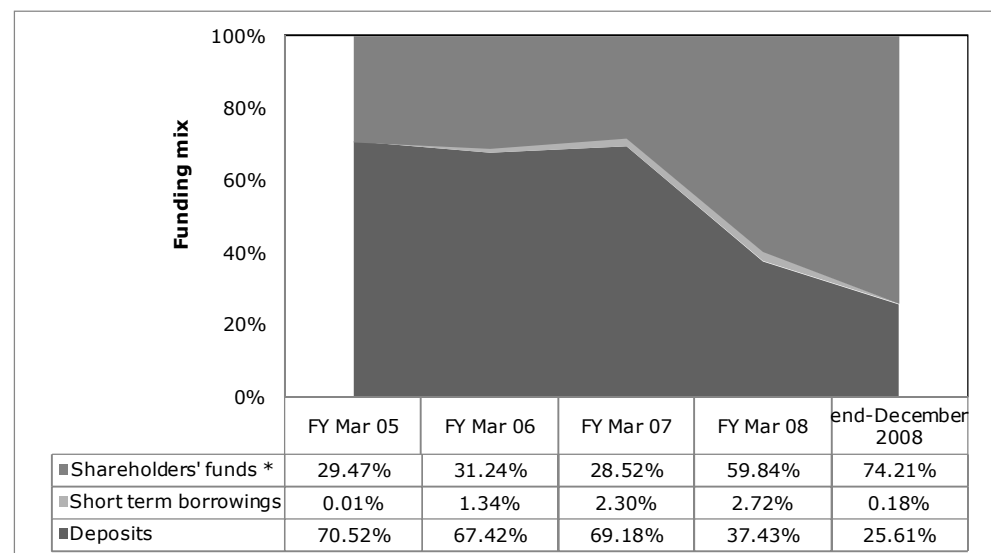
Despite its healthier pre-provision profit, MFL's pre-tax profit slid 12.99% to LKR 2.90 million in FY Mar 2008 (FY Mar 2007: LKR 3.33 million) owing to increased provisioning. In tandem with this, its ROA and ROE continued trending downwards to 1.57% and 2.85%, respectively (end-FY Mar 2007: 2.61% and 6.93%). This apart, the sharp decline in ROE can also be attributed to the expansion in MFL's shareholders' funds following an ordinary share issue in FY Mar 2008 (to be elaborated under Capital Adequacy).

Funding & Liquidity

RAM Ratings Lanka opines that MFL's funding and liquidity positions are healthy at present, but is expected to moderate over the medium and long term. Following the capital infusion by Entrust, the Company's shareholders' funds have become its major source of funding. This has in turn improved MFL's liquidity position; its statutory liquid-asset ratio spiked up to 141.53% as at end-FY Mar 2008 (end-FY Mar 2007: 18.69%), well above the regulatory minimum of 15%.

Shareholders' funds now fulfil the bulk (end-December 2008: 74.21%) of MFL's funding needs, following Entrust's equity injection of LKR 171.17 million. MFL's deposit base stood at LKR 67.51 million as at end-December 2008, making up 25.61% of its funding base (refer to Chart 7). Furthermore, deposit concentration was low, with its top 10 depositors accounting for 6.14% of the Company's deposit base as at end-September 2008. Meanwhile, external borrowings also remained relatively minimal, comprising only 0.18% of its funding base as at the same date. MFL's funding mix is envisaged to remain relatively unchanged in the immediate term.

Chart 7: MFL's funding mix



*Excluding revaluation reserves

On the other hand, MFL's asset-liability maturity profile weakened; negative gaps have arisen in the "1 to 3 years" and "more than 3 years" buckets. This has been the phenomenon across the RFC sector, due to the rising interest rate environment. As MFL begins augmenting its loan base and its liquidity levels normalise, however, it will be exposed to interest-rate and liquidity risks; in this context, the management have taken steps to form an ALCO by April 2009.

**Liquid assets
outweigh deposit
liabilities**

Following the collapse of two unregulated financial institutions, there had been a flight in deposits across the RFC sector. MFL's deposit base had contracted from LKR 67.51 million as at end-December 2008 to LKR 56.18 million by end-March 2009. Nonetheless its liquid asset base still outweighed its deposit liabilities; the Company's liquid asset ratio stood at 122.80% as at end-March 2009. We will continue to monitor developments in this regard.

Prospectively, RAM Ratings Lanka opines that MFL's liquidity profile will moderate – albeit remain at a healthy level - over the medium to long term, as the Company uses its excess liquidity to extend loans. Similarly, the Company's funding position is expected to be dominated by shareholders' funds over the short to medium term.

Capital Adequacy**MFL meets core-
capital
requirement**

The equity injection by Entrust has helped the Company meet the Central Bank's minimum core-capital requirement of LKR 200 million; MFL's core capital stood at LKR 202.43 million as at end-December 2008. As expected, the Company had managed to meet the first tranche through a LKR 71.17 million investment by Entrust. Following this, Entrust had invested another LKR 100 million in the form of ordinary shares by end-December 2008. MFL's overall RWCAR subsequently spiked up from 34.98% as at end-FY Mar 2007 to 91.71% as at end-FY Mar 2008, and further to 113.30% as at end-December 2008. Moving forward, this ratio is expected to recede to industry levels as the Company focuses on expanding its loan books, facilitated by its widening branch network.

**Internal capital
generation**

Meanwhile, MFL's internal capital generation clocked in at 0.56% as at end-December 2008 (end-FY Mar 2008: 1.70%), lower than the industry's 8.74%, suppressed by an enlarged capital base. Nonetheless, the Company's current capital position is adequate for business operations over the immediate term, however, its long-term capital adequacy will hinge upon the health of its credit portfolio and internal capital generation. RAM Rating notes that the payment of contingent liabilities vis-à-vis VAT payments, which had not been provided for, had eroded its reserves.

Industry Overview

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

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

Table 3: Overall and sectoral GDP growth

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

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

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

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

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

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

On the funding side, the deposit structure has tilted towards shorter tenures as depositors seek to take advantage of volatile interest rates. Many RFCs consequently face widening negative liquidity gaps in the short term. As such, deposit franchise and asset-liability management become crucial. Although RFCs are now allowed to offer savings accounts, they are still at a disadvantage as they lack the infrastructure vis-à-vis branches and automated teller machines to effectively compete against commercial banks. Moreover, following the collapse of 2 unregulated finance companies, liquidity levels in the RFC sector have been pressured. Nonetheless, the Central Bank's easing monetary policy is expected to provide some respite to the industry.

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

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

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

Relevant Central Bank Directions Applicable to Registered Finance Companies

<p><i>Liquid assets</i></p>	<p>Every finance company must have a minimum holding of liquid assets at any given time. Liquid assets mean:</p> <ol 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 Lankan Government Treasury Bills, free from any charge or lien. d) Sri Lankan 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 limits are as follows:</p> <ol style="list-style-type: none"> 1. For time deposits, 15% of outstanding deposits. 2. For certificates of deposits, 15% of the face value of the certificates. 3. For savings deposits, 20% of the outstanding deposits. <p>The companies should maintain the liquid assets in the form of (c), (d) and (e) above, equivalent to 10% of its average month-end deposit liabilities of the preceding financial year.</p>
<p><i>Provision of bad and doubtful debts</i></p>	<p>Every finance company had been required to follow either one of the following directions on provisioning for bad and doubtful debts until 1 April 2007:</p> <p><u>Direction No. 1 of 1991</u></p> <p>Bad and doubtful debts provided for under this direction are subject to a minimum of:</p> <ol style="list-style-type: none"> 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> <ol 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 the case of residential properties occupied by the borrower or a tenant, there should be an agreement to grant vacant possession in the event of the sale of such property. <p><u>Direction No. 2 of 1991</u></p> <p>Bad and doubtful debts provided for under this direction are subject to a minimum of:</p> <ol style="list-style-type: none"> 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 came into effect on 1 April 2007 (Direction No. 3 of 2006); this is very similar to Direction 1. However, Direction 3 requires all finance companies to follow a more stringent formula in the calculation of collateral value that is deductible for</p>

	<p>With effect from 1 April 2007, Direction No. 3 of 2006 will be applicable to every RFC and will replace Directions 1 and 2.</p> <p><u>Direction No. 3 of 2006</u></p> <p>Bad and doubtful debts provided for under this direction are subject to a minimum of:</p> <p>(a) 50% of all advances in arrears for a period of 6 to 12 months. (b) 100% of all advances in arrears for 13 months or more.</p> <p>A finance company may deduct the value of the following items held as collateral in arriving at the amount of provisioning;</p> <ol style="list-style-type: none"> 1. Sri Lankan Government securities, free from any lien or charge. 2. Central Bank securities, free from any lien or charge. 3. Time deposits in a licensed commercial bank, specialised bank or RFC, free from any lien or charge. 4. Bank guarantees. 5. With regard to repossessed vehicles and machinery, 80% of the valuation obtained in the preceding 6 months and by an approved valuer. 6. With regard to mortgaged land and buildings that are held as collateral, if the accommodation has been in arrears for a period of: <ol style="list-style-type: none"> a) 6-36 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) more than 120 months, 0% of the value is deductible
<p>Capital adequacy</p>	<p>Every finance company must maintain a minimum total risk-weighted capital-adequacy ratio of 10% in relation to its risk-weighted assets. The constituents of the capital are divided into:</p> <p>(a) Tier I - Core Capital</p> <p>This represents permanent shareholders' equity and reserves created or increased by appropriation of retained earnings or other surpluses, including share premiums, retained profits and other reserves. The core-capital ratio should constitute not less than 50%, i.e. this has to be at least half, of the total risk-weighted capital-adequacy ratio.</p> <p>(b) Tier II - Supplementary Capital</p> <p>Represents revaluation reserves, general provisions and other capital instruments which combine certain characteristics of equity and debt, such as hybrid capital instruments and unsecured subordinated debts. Supplementary capital should not exceed 100% of the core capital.</p> <p>The Central Bank also issues guidelines from time to time, to be used in computing total risk-weighted assets.</p>
<p>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 stands at 15% for any group of corporate or unincorporated borrowers with common directors or common partners or common proprietors.</p> <p>Capital funds generally mean paid-up capital and permanent free reserves, and may include unsecured debentures and other loan stocks if approved by the Monetary Board.</p>

<p>Minimum core-capital requirement</p>	<p>Every finance company must at all times maintain an unimpaired core capital of LKR 200 million. However, companies that could not meet this requirement by February 2006 had been granted a 30-month extension, subject to the following:</p> <p>(c) A finance company with a core capital of less than LKR 100 million must:</p> <p>enhance its core capital to at least LKR 100 million by February 2007; and bring the remaining LKR 100 million or the deficit up to the core-capital requirement of LKR 200 million by July 2008.</p> <p>(d) A finance company with a core capital of between LKR 100 million and LKR 200 million must bring in:</p> <p>at least 50% of the deficient amount to meet the core-capital requirement of LKR 200 million by February 2007; and the balance of the deficient amount up to the core capital requirement of LKR 200 million by July 2008.</p>
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Corporate Information

Date of Incorporation: 14 October 1974

Commencement of Business: 1974

Major Shareholders:

Ceylinco Shriram Securities Holdings Ltd	92.13%
Mrs J Kalubowila	3.13%
Dr NW Karunaratne	0.67%
Mr C Madugalle	0.57%
Mr SB Rangamuwa	0.48%

Directors:

Mr HK De Silva	Chairman
Mrs JK Ranapura	Deputy Chairperson
Mr AHM Riyaz	Director/Chief Executive Officer
Mrs CJ Attapattu	Director / General Manager
Mr C Madugalle	Director
Mr UR Wijetunga	Director

Auditor: Ford, Rhodes, Thornton & Co

Listing: Not listed

Key Management:

Mr AHM Riyaz	Director/Chief Executive Officer
Mrs CJ Atapattu	Director / General Manager
Mr S Gonnaruwa	Accountant

Major Subsidiaries and Associates:

Capital History:	Year	Remarks	Amount	Cumulative
			(LKR million)	Total (LKR million)
	2000	Brought forward	6.79	6.79
	2000	Rights issue	0.23	7.02
	2001	Rights issue	0.06	7.08
	2003	Rights issue	0.70	7.78
	2004	Rights issue	2.10	9.87
	2005	Rights issue	3.34	13.21
	2006	Rights issue	0.50	13.71
	2007	Rights issue	0.05	13.76
	2008	Ordinary share	71.17	84.93
	2008	Ordinary share	100.00	184.93

Financial Summary - Company

BALANCE SHEET (LKR Million)	Re-stated				Un- audited
	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Dec-08
ASSETS					
Cash & Money At Call	9.68	1.52	2.32	5.41	4.68
Deposits & Placements With Financial Institutions	0.00	11.45	3.46	3.74	2.41
Securities Purchased Under Resale Agreements	0.00	0.00	0.00	0.00	0.00
Securities					
Dealing Securities	6.03	6.51	7.17	80.83	109.51
Investment Securities	0.31	0.31	0.31	0.31	0.31
Gross Loans & Advances	70.87	68.88	81.86	63.37	131.06
Interest-In-Suspense	3.32	2.86	1.94	1.64	1.39
General Loan Loss Reserves	0.00	0.00	0.00	0.00	0.00
Specific Loan Loss Reserves	9.79	6.27	4.48	4.34	4.03
Net Loans & Advances	57.76	59.75	75.43	57.39	125.63
Investments in Subsidiaries/Associates	0.00	0.00	0.00	0.00	0.00
Investment Land and Properties	0.00	0.00	0.00	0.00	0.00
Other Assets	0.48	1.23	1.37	6.99	6.12
Property, Plant and Equipment	22.41	24.67	59.99	65.35	65.59
TOTAL ASSETS	96.67	105.45	150.06	220.03	314.24
LIABILITIES					
Customer Deposits					
Savings	0.00	0.00	0.00	0.00	0.00
Fixed	61.10	63.11	69.25	63.58	67.51
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	0.01	1.25	2.30	4.63	0.47
Subordinated Debt & Hybrid Capital	0.00	0.00	0.00	0.00	0.00
Other Liabilities	8.54	10.35	13.14	13.56	13.96
TOTAL LIABILITIES	69.65	74.71	84.70	81.76	81.94
Paid-up Capital	13.21	13.71	13.82	84.99	184.93
Minority Interest	0.00	0.00	0.00	0.00	0.00
Share Premium & Other Reserves	9.79	12.83	48.08	47.90	47.96
Statutory General Reserve	1.54	1.79	1.83	1.91	1.91
Retained Profits/(Loss)	2.49	2.41	1.64	3.46	(2.50)
Total Shareholders' Funds	27.03	30.74	65.36	138.27	232.30
TOTAL LIABILITIES & SHAREHOLDERS' FUNDS	96.67	105.45	150.06	220.03	314.24
COMMITMENTS & CONTINGENCIES	0.00	0.00	0.00	0.00	0.00
TIER 1 CAPITAL	24.78	29.29	28.54	101.63	202.43
CAPITAL BASE	26.28	30.79	47.67	119.95	220.74

Financial Summary - Company

INCOME STATEMENT (LKR Million)	Re-stated			Un- audited	
	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Dec-08
Interest Income	19.46	19.75	21.36	23.82	26.01
Less: Amortisation Of Premium/(Accretion Of Discount)	0.00	0.00	0.00	0.00	0.00
Less: Net Interest Suspended	0.00	0.00	0.00	0.00	0.00
Less: Interest Expense	6.93	7.63	8.59	9.17	9.09
Net Interest Income	12.54	12.11	12.77	14.66	16.92
Non-Interest Income	5.56	5.30	6.58	5.06	5.66
Gross Income	18.09	17.42	19.36	19.71	22.58
Personnel Expenses	6.09	7.28	9.45	8.22	8.34
Other Non-Interest Expenses	4.52	5.69	7.43	8.61	11.61
Loan Loss Provisions	0.10	(1.51)	(0.85)	(0.02)	1.43
Share of results of Associated Companies	0.00	0.00	0.00	0.00	0.00
Pre-Tax Profit	7.38	5.95	3.33	2.90	1.21
Taxation	1.27	1.06	2.70	1.16	0.44
Profit After Tax	6.11	4.89	0.63	1.73	0.77
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Prior Year Adjustments	(0.17)	0.00	0.00	0.18	0.00
Minority Interests	0.00	0.00	0.00	0.00	0.00
Transfer To Statutory Reserves	0.32	0.25	0.04	0.09	0.00
Transfer To Other Reserves	3.50	3.00	0.00	0.00	0.00
Dividend	1.18	1.72	1.37	0.00	0.00
Retained Profit For The Year	0.93	(0.07)	(0.78)	1.83	0.77

Financial Ratios - Company

KEY RATIOS (%)	31-Mar-05	31-Mar-06	31-Mar-07	31-Mar-08	31-Dec-08
Profitability					
Net Interest Margin	13.70%	11.99%	10.00%	7.92%	8.45% *
Non-Interest Income Margin	6.07%	5.25%	5.15%	2.73%	2.83%
Cost To Income	58.64%	74.50%	87.18%	85.40%	88.32%
Return On Assets	8.06%	5.88%	2.61%	1.57%	0.60% *
Return On Equity	32.13%	20.59%	6.93%	2.85%	0.87% *
Dividend Payout	19.39%	35.11%	216.31%	0.00%	0.00%
Asset Quality					
Gross NPL Ratio	15.39%	9.47%	6.27%	10.77%	3.28%
Net NPL Ratio	1.05%	(0.03%)	0.69%	4.03%	0.17%
Specific Loan Loss Provisions For Current Year	2.13%	1.06%	0.99%	1.85%	1.96%
Gross NPL Coverage	94.18%	100.27%	89.57%	65.25%	94.86%
Loan Loss Reserve Coverage	14.49%	9.49%	5.61%	7.03%	3.11%
Liquidity & Funding					
Liquid Asset Ratio	25.71%	30.27%	18.09%	131.93%	171.51%
Statutory Liquid Asset Ratio	25.72%	30.87%	18.69%	141.53%	172.70%
Customer Deposits To Total Interest Bearing Funds	99.98%	98.05%	96.79%	93.22%	99.31%
Loans To Deposits Ratio	94.55%	94.69%	108.92%	90.27%	186.07%
Loans To Stable Funds Ratio	87.88%	84.84%	98.06%	40.67%	53.53%
Capital Adequacy					
Shareholders' Funds To Total Assets	27.96%	29.15%	43.56%	62.84%	73.92%
Tier 1 Risk Weighted Capital Adequacy Ratio	31.65%	33.75%	20.95%	77.70%	103.90%
Overall Risk Weighted Capital Adequacy Ratio	33.57%	35.47%	34.98%	91.71%	113.30%
Internal Rate Of Capital Generation	21.45%	10.99%	(1.53%)	1.70%	0.56% *

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	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.

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