



FINANCIAL INSTITUTIONS

LANKA RATING AGENCY LIMITED

A wholly owned subsidiary of Rating Agency Malaysia Berhad – an affiliate of Standard & Poor's

Financial Institution

Ratings:

Long-term: AA₃ [Reaffirmed]

Short-term: L1 [Reaffirmed]

Instrument:

Proposed Rs 600 million unsecured debentures

Rating:

AA₃ [Assigned]

Rating Outlook:

Stable

Coupon Rates:

Fixed and floating; fixed rate will be an effective annual 16% and floating rate will be the weighted-average 1-year treasury bill rate excluding WHT + 3%, with a cap of 17% and a minimum rate of 13%.

Principal Activities:

Provision of leasing, trade-financing and corporate-finance facilities

Strengths:

- State-owned parent
- Strong capitalisation
- Improving profitability

Weaknesses:

- Relatively high level of NPLs
- Relatively hefty borrowing costs

Analysts:

Prakash Jerome ACMA
(9411) 2503551
prakash@lankarating.com

Nazeel Muzammil ACMA
(9411) 2553089
nazeel@lankarating.com

Lee Kai Siew
Rating Agency Malaysia Berhad
(603) 7628 1020
kaisiew@ram.com.my

MERCHANT BANK OF SRI LANKA LIMITED – Rating Review

Summary

LRA has reaffirmed Merchant Bank of Sri Lanka's ("MBSL" or "the Bank") long-term financial institution rating of AA₃ and short-term rating of L1. The ratings are primarily based upon the credit strength and financial flexibility of MBSL, which stem from its parent – the state-owned Bank of Ceylon ("BOC"), i.e. the largest commercial bank in Sri Lanka. Meanwhile, the proposed Rs 600 million unsecured debentures of the Bank have been assigned a AA₃ rating. All the long-term ratings have a stable outlook. The rating of the proposed debt issue is similar to that of MBSL's long-term financial institution rating because the issue ranks *pari pasu* with the Bank's other senior unsecured debts. The proceeds from the proposed debenture issue will be used to fund MBSL's growing loan base and to repay the Bank's debts that are falling due in 2007.

Meanwhile, the ratings are also supported by the Bank's strong capitalisation, improving performance, recovering liquidity levels and healthier asset quality.

For FYE 31 December 2006 ("FY Dec 2006"), MBSL achieved a record pre-tax profit of Rs 269.18 million, a 43.69% increase from the previous year. The growth was supported by the Bank's expanding leasing and hire-purchase ("HP") bases, coupled with healthier lending and borrowing rates. With the Bank's cost-to-income ratio at 40.46%, its return on assets ("ROA") improved from 5.74% to 7.56%, while its return on equity ("ROE") trended upwards from 16.36% to 19.19%.

MBSL's better profit performance also strengthened its shareholders' funds, which remained the prime source of financing for the Bank. As a result, the Bank's capital adequacy ratio or CAR came up to a high 41.41% as at end-FY Dec 2006. This level of capitalisation is deemed strong; LRA derives further assurance from the support of the Bank's parent. The second major source of funding for MBSL has been its long-term borrowings. However, its gearing ratio only stood at a low 1.17 times as at end-FY Dec 2006 - well below the average of 4 times for specialised leasing companies and the regulatory limit of 7 times. Nonetheless, funding remains a moderating factor against the Bank's asset growth.

Meanwhile, the Bank's gross non-performing-loan ("NPL") ratio on a 6-month basis improved from 16.58% as at end-FY Dec 2005 to 10.41% as at end-FY Dec 2006, supported by write-offs and recoveries. As expected, the Bank had written off Rs 117.00 million of bad debts, which stemmed from lease facilities granted prior to FY Dec 2003, during the year. These bad debts were the residual amounts subsequent to the collateral disposal and had been fully provided for. The Bank had also recovered Rs 104.58 million of bad debts, the bulk (Rs 75.62 million) of which was from the lease portfolio. Nonetheless, new bad debts surged 40.39% to Rs 90.31 million, from Rs 64.33 million the previous year. LRA therefore opines that there is ample room to improve the Bank's underwriting and monitoring standards. The high level of bad debts was, however, cushioned by adequate specific and general provisions, with a gross NPL coverage of 66.94%.

Corporate Profile

Subsidiary of BOC

In response to a request by the World Bank, BOC set up a 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 subsequently listed on the Colombo Stock Exchange in 1991.

First merchant bank in Sri Lanka

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

Registered investment manager, margin provider and underwriter

MBSL is registered under the country's Securities and Exchange Commission ("SEC") Act No. 36 of 1987 - as an investment manager, margin provider and underwriter. Apart from the SEC, the Bank is also regulated by 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 & HP	Trade Financing	Corporate Advisory	Capital Market	Corporate Secretarial
Finance lease	Bank guarantees	Loan/Equity syndications	Listing/ IPOs of equities and debt securities	Company incorporation
Hire-purchase	Cheque discounting	Mergers & Acquisitions	Management of mandatory and voluntary offers	Registrar for bonus and rights issues as well as IPOs
Operating lease	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 & consultancy		

MBSL currently operates through 5 branches in Galle, Kandy, Kurunegala, Maharagama and Anuradhapura, which are linked to the central system at its head office in Colombo. In line with its plans to further augment its network to 10 branches by end-2007, the Bank has to date earmarked another 3 new locations. Meanwhile, MBSL had 120 staff members as at end-FY Dec 2006.

Ownership and Financial Flexibility

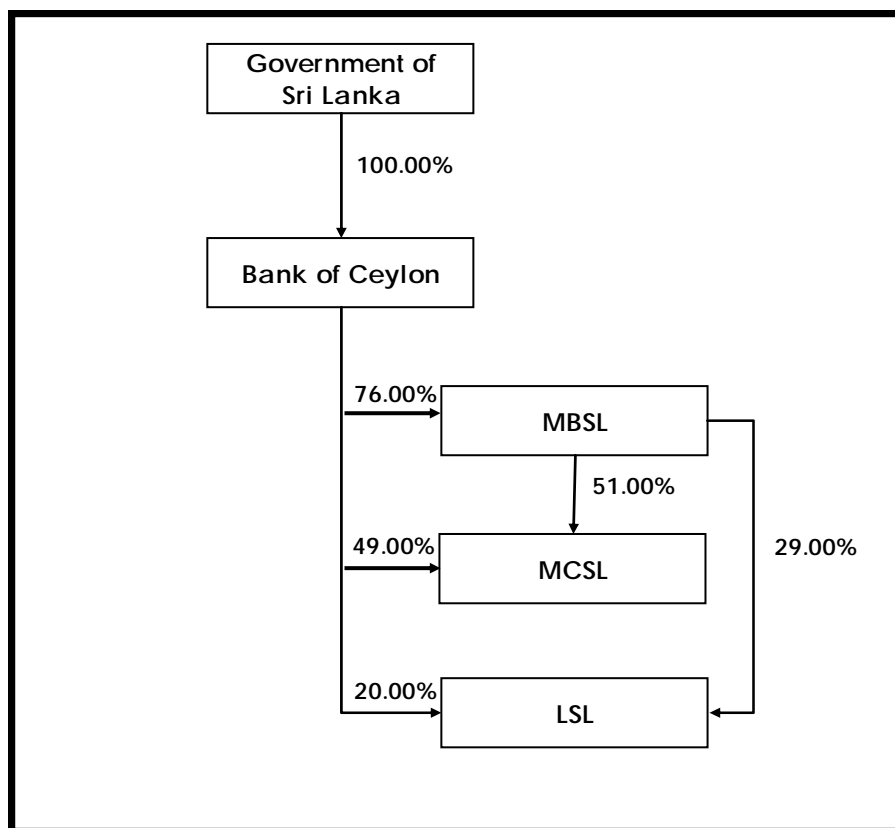
76%-held by state-owned BOC

As at end-FY Dec 2006, MBSL was 76%-held by the state-owned BOC (refer to Chart 1) - the largest commercial bank in the country with an asset base of Rs 325.64 billion¹. With a hefty deposit base of Rs 235.68 billion, BOC employs 8,417 employees throughout the country via its 305 branches, including 3 abroad.

¹ As at 30th Sep 2006

MBSL's other prominent minority shareholders include Ceybank Unit Trust, Distilleries Company of Sri Lanka and the Employees' Trust Fund Board ("ETFB"), which own 2.92%, 1.07% and 0.7%, respectively.

Chart 1: Group structure



Owns 51% of Merchant Credit of Sri Lanka

Merchant Credit of Sri Lanka ("MCSL"), a registered finance company, is a 51%-owned subsidiary of MBSL; the other 49% is held by BOC. MCSL is engaged in leasing, HP, loans, real estate and acceptance of public deposits. As at end-FY Dec 2006, the assets of MCSL amounted to Rs 2.61 billion; it reported a pre-tax profit of Rs 40.20 million for the year (FY Dec 2005: Rs 44.01 million).

Holds 29% of Lanka Securities Limited

Lanka Securities Limited ("LSL"), a registered stockbroker, is an associate of MBSL. The Bank holds 29% of LSL's equity while 20% is held by BOC and 51% is controlled by First Capital Securities Corporation Limited of Pakistan. As at end-FY Dec 2006, LSL's assets came up to Rs 171.85 million, with a pre-tax profit of Rs 38.05 million for the year (FY Dec 2005: Rs 77.55 million).

Very strong financial flexibility due to state-owned parent

The financial flexibility of MBSL principally stems from its sovereign-owned parent, BOC. The latter has demonstrated its firm commitment to MBSL over time, coming to its aid on numerous occasions through long-term loans, debentures and rights issues. In FY Dec 1996, BOC funded a Rs 1.75 billion 3-year debenture which, at that time, had constituted 30% of MBSL's total funding requirements. Furthermore, after the capital reorganisation, BOC took up the 1:2 rights issue in FY Dec 2005 - once again showing its unstinting support. In addition, the national Treasury has extended guarantees to the loans obtained by MBSL from the ETFB (Rs. 555 million as at end-FY Dec 2006) and the National Savings Bank (Rs 400 million as at end-FY Dec 2006). Given the relatively MBSL's small asset base, we opine that such parental support would be forthcoming if required.

As a listed company, MBSL also has the ability to raise funds from the equities market, if needed. Its market capitalisation stood at Rs 1.37 billion as at 16 Mar 2007, with the share price hovering around Rs 15/- and a price-earnings ratio of 9.25 times. The Bank had listed a Rs 163.35 million debenture, for the first time, in FY Dec 2005, to augment its lease portfolio, followed by another 2-year unlisted public issue (Rs 107.25 million) that same year.

Management & Strategies

Experienced and committed team

The Bank's operations are led by Chief Operations Officer Mr Gamini Karunathilake, a professional banker with more than 26 years' experience. An able team of deputy directors and assistant directors support Mr Karunathilaka. This, together with a dedicated staff force, has enabled MBSL to weather many storms.

Record performance in FY Dec 2006

MBSL delivered its best-ever performance, with a pre-tax profit of Rs 269.18 million, in FY Dec 2006. Leasing and HP activities remained its key revenue drivers, contributing approximately 75% of its total revenue while trade financing and corporate finance accounted for 16% and 9%, respectively. The Bank is currently awaiting the finalisation of some deals, which are expected to boost its revenue from operating leases over the coming years.

Trade Finance Unit focused on bad-debt recovery

Revenue from trade-financing activities augmented by 63.71% year-on-year in FY Dec 2006, mainly due to the trade-finance department's focus on bad-debt recoveries. However, the Bank intends to focus on expanding its trade-finance portfolio in FY Dec 2007. In line with the broadening of the Bank's retail base, the department had also introduced a personal loan product during the year. Two property-development projects, meanwhile, are scheduled to begin towards end-FY Dec 2007, with a total budget of Rs 50 million–Rs 100 million, while the Bank is finalising land purchases.

Corporate-finance activities gradually increasing

At the same time, contributions from the Corporate Finance Department also surged 62.88% year-on-year in FY Dec 2006, supported by fee- and interest-based activities, especially capital gains on share disposal, income from margin trading and loan-syndication fees. Nonetheless, the performance of this division depends much on the performance of the stock market. Given the generally positive trend of Sri Lanka's stock market in the recent past, the management plans to commence fund-management activities based on MBSL's MIDCAP index in FY Dec 2007, and will continue to explore further opportunities in the capital markets. Moreover, the Bank has been gradually increasing its share portfolio; the Board has approved an additional limit of Rs 60 million for FY Dec 2007; the limit had been Rs 60 million as at end-FY Dec 2006. MBSL's trading portfolio is under the Board's close supervision, and remains negligible at present vis-à-vis the capital base.

Adequate IT system

Meanwhile, the Bank's existing information technology ("IT") platform adequately serves its business needs, and is envisaged to remain so in the medium term. The management has ensured that the Bank's IT system is upgraded based on business requirements. In FY Dec 2006, the Bank installed a new server to enhance its IT platform, and is now in the process of testing its new online credit-approval system.

Corporate Governance

Moderate level of corporate governance

MBSL is chaired by Mr Udayasri Kariyawasam, who is also the Chairman of BOC. He is a chartered accountant by profession, with vast experience in this field. The Board of MBSL comprises 8 members, 4 of whom are from BOC, inclusive of its Chairman. The former General Manager of BOC, Mr SNP Palihena, a veteran banker with over 38 years' experience, continues to serve the Bank as its Managing Director. The Board meets monthly to deliberate on, among other things, the performance of each profit centre (leasing, trade financing and corporate finance), the progress of the Bank's non-performing portfolio, and the performance of its share portfolio. The Board convened 13 times in FY Dec 2006.

Meanwhile, the Board has appointed 5 sub-committees: Audit, Credit, Purchasing, Incentive, and Training and Investment. Meanwhile, internal audits are carried out half-yearly by Messrs Earnest & Young Chartered Accountants; external audits are conducted by SJMS Associates. Moreover, the Bank was in compliance with the Central Bank regulations pertaining to all registered finance-leasing companies and the requirements of the Securities and Exchange Commission of Sri Lanka as at end-FY Dec 2006.

Apart from the Bank's investments in subsidiaries and associates, MBSL's related-party transactions are limited to borrowing from its parent company, fees received for secretarial services rendered to companies within the group, and rent paid on account of its head-office premises.

Asset Quality

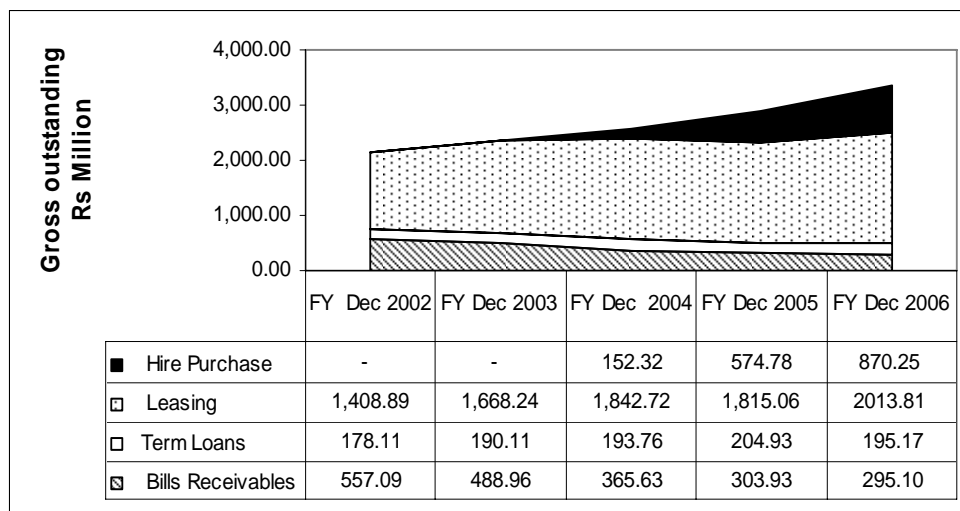
Assets dominated by interest-earning products

MBSL's assets amounted to Rs 3.56 billion as at end-FY Dec 2006, mostly consisting of net loans and advances (87.27%), other operating assets (7.36%) and non-operating assets (5.37%). Other operating assets, which chiefly comprised treasury securities, deposits with other financial institutions and investments in commercial papers, declined from Rs 502.96 million as at end-FY Dec 2005 to Rs 260.49 million as at end-FY Dec 2006 as these funds had been used to repay debts that had fallen due over the same period. Non-operating assets mainly included foreclosed properties, fixed assets, and investments in subsidiaries and associates.

HP grew faster in FY Dec 2006

Meanwhile, MBSL's gross loans and advances, which accounted for by leasing (59.18%), HP (25.57%) and other advances including bills receivables and term loans (15.25%), had appreciated by 16.25% during the year. The Bank's leasing portfolio increased by a modest 10.95% while its HP portfolio augmented by a staggering 51.41% (refer to Chart 2). On the contrary, other advances declined by 3.47% as the Trade Finance Department had focused on recovering bad debts vis-à-vis bills receivable and term-loan portfolios while servicing its existing clientele. However, this segment intends to expand these portfolios over the coming years and is also setting the stage for its debut in real-estate ventures, which are expected to begin in late FY Dec 2007, as planned. The technical aspects of the projects will be outsourced and the Bank expects to recruit a competent individual to oversee this function.

Chart 2: Portfolio trends*



* Excluding other loans such as staff loans

More room for improvement in asset quality

In terms of asset quality, MBSL registered a notable improvement in its gross NPL ratio, from 16.58% (Rs 484.45 million) as at end-FY Dec 2005 to 10.41% (Rs 354.18 million) as at end-FY Dec 2006, aided by write-offs and recoveries (refer to Chart 2). As expected, the Bank had written off Rs 117.00 million of bad debts, which stemmed from lease facilities granted prior to FY Dec 2003, during the year. These bad debts were the residual amounts subsequent to the collateral disposal and had been fully provided for and hence had no impact on the Bank's profit performance.

NPL recoveries were also stronger in FY Dec 2006 as some large customers had settled their dues. The Bank recovered Rs 75.62 million from its leasing portfolio alone, compared with only Rs 28.70 million the previous year. Including bills and term loans, MBSL's recoveries amounted to Rs 104.58 million in FY Dec 2006. Moreover, MBSL is in the process of finalising the settlement of some of the largest bad debts in its trade-financing portfolio; this is expected to have a positive impact on the Bank's gross NPL ratio in FY Dec 2007.

Nonetheless, new bad debts increased by 40.39% over the same period, from Rs 64.33 million in FY Dec 2005 (2.34% of average gross loans) to Rs 90.31 million (2.85% on average gross loans) in FY Dec 2006, primarily due to new bad debts from MBSL's leasing and HP portfolios; this had also increased provisions for the year. Hence, although there had been an improvement in terms of the Bank's overall gross NPL ratio, LRA believes that there is still ample room for improvements in MBSL's underwriting and monitoring processes. However, no significant new bad debts were reported in its bills and term-loan portfolios.

Table 2: Movements in gross NPLs (Rs '000)

	FY Dec 2003	FY Dec 2004	FY Dec 2005	FY Dec 2006
Balance at the beginning of the year	877,588	784,764	543,214	485,446
Add : new NPL	50,563	38,568	64,329	90,312
Less:				
Write offs	(79,949)	(77,580)	0	(117,000)
Recoveries	(63,438)	(202,538)	(122,097)	(104,577)
Balance at the end of the year	784,764	543,214	485,446	354,181

Adequate provisioning

Despite its relatively high ratio of bad debts, MBSL's provisions remained adequate. The Bank adopts the Central Bank's Direction 1 of 1991, issued to registered finance companies ("RFCs") vis-à-vis provisions for bad debts; this is more stringent than the direction applicable to leasing companies - Finance Leasing (Provision for Bad & Doubtful Debts) Direction 2 of 2005². Although Direction 1 allows the netting off of immovable properties, MBSL applies its own hair-cut rule³ on provisions, which we consider to be more stringent. Apart from specific provisions, the Bank also makes a general provision of a minimum 0.5% of the aggregate value of its net portfolio (after specific provisions), subject to cumulative general provisions not exceeding 2.5% of its net portfolio. As a result, the Bank's gross NPL coverage stood at an adequate 66.94% as at end-FY Dec 2006.

Performance

Pre tax profit surged 43.69%

MBSL's gross income jumped 45.95% year-on-year to Rs 515.34 million in FY Dec 2006, supported by loan growth. A broader net interest margin ("NIM"), coupled with a well-managed cost structure, had propelled its pre-tax profit to Rs 269.18 million for the year, a 43.69% growth over the previous year.

80% of revenue from interest-earning assets

MBSL derives 80% of its gross revenue from interest-earning activities, which are considered more sustainable, and 20% from non-interest-earning assets. Its net interest income jumped 45.51% year-on-year while non-interest income – mainly composed of gains on disposal of quoted and unquoted shares (Rs 20.392 million), bad-debt recoveries (Rs 17.76 million), fee income (Rs 16.80 million) and commissions (Rs 13.82 million) – vaulted 47.96%. However, LRA notes that this growth in non-interest income had been mainly due to an increase in documentation charges relating to HPs (i.e. the fee income above) and a Rs 18 million one-off gain on sales of unquoted shares.

Healthier net margin

One of the key reasons for its stronger profit showing had been the Bank's broadening NIM, which had in turn been supported by healthier lending and borrowing rates. The weighted-average lending rate improved from 17.26% in FY Dec 2005 to 19.26% in FY Dec 2006, chiefly due to the utilisation of funds that had previously been invested in low-yielding liquid assets and, secondarily, due to the uptrend in market rates.

The Bank's weighted-average borrowing cost was also reduced from 11.88% in FY Dec 2005 to 11.38% in FY Dec 2006. On one hand, this had been mainly due to the use of funds from the rights issue in the latter part of FY Dec 2005 instead of interest-bearing funds. On the other, it had also been due to the Bank's increased borrowings in the latter part of FY Dec 2006, which had added only a few months' interest expense. However, LRA expects MBSL's borrowing costs to rise in FY Dec 2007, when the full-year interest expenses are accounted for.

Improving ROA

A higher NIM, coupled with well-managed overheads, resulted in a better ROA of 7.56% as at end-FY Dec 2006 vis-à-vis 5.74% a year earlier; this was despite a more than 2-fold increase in provisions for bad debts, from 16.12 million to Rs 38.91 million. The Bank's cost-to-income ratio improved from 46.14% to 40.46% over the same period, thanks to its effective cost-management techniques, such as

² Refer to page 11 for the new regulations issued to specialised leasing companies in January 2006.

³ Provisions are made after deducting the discounted forced-sale value of the mortgaged immovable collateral. The discount rate is progressively increased along with the age of the NPL.

Kaizen and 5S, and enlarged revenue base. In line with its healthier ROA, the Bank's ROE also increased from 15.95% to 18.82%.

Funding & Liquidity

Better funding structure

MBSL's funding mix remained dominated by shareholders' funds (39.83%) and long-term loans (37.21%) in FY Dec 2006. Short-term borrowings increased towards the later part of the year, accounting for 9.50% of its total assets as at end-FY Dec 2006. Other liabilities also expanded their share to 13.47% as at the same date (refer to Table 3).

To further support the Bank's loan base in FY Dec 2007, MBSL intends to issue Rs 300 million of unsecured debentures through a private placement. In the event of over-subscription, the Bank expects to issue a further Rs 300 million. The initial issue will bear fixed and floating rates and will be for a tenure of 3 years. LRA does not expect this issue to have a major impact on the Bank's gearing level as some debts will be settled during the year. Elsewhere, MBSL has also lined up revolving lines and term loans with 2- to 3-year tenures to support its business growth.

Table 3: MBSL's funding structure

	FY Dec 2002	FY Dec 2003	FY Dec 2004	FY Dec 2005	FY Dec 2006
Long-term borrowings	94.60%	92.74%	52.65%	45.47%	37.21%
Short-term borrowings	7.05%	4.04%	6.67%	5.26%	9.50%
Other liabilities	10.14%	11.86%	10.75%	10.34%	13.47%
Shareholders' funds	-11.79%	-8.64%	29.93%	38.93%	39.83%

Maturity mismatches adequately managed

MBSL has also been able to achieve a better alignment between its assets and liabilities, owing to the long-term nature of its key funding sources - debentures and shareholders' funds. Despite this, the Bank is negotiating with its creditors to renew at least part of the Rs 650 million of debts falling due in FY Dec 2007, so as to reduce cash outflow during its growth period. Should this fall through, other plans are also on the cards, including a rights issue to settle these liabilities in a timely manner. Nevertheless, the pace of funding remains a moderating factor against the Bank's asset growth.

Gearing level better than most of its peers'

Elsewhere, the Bank's gearing ratio stood at 1.17 times its shareholders' funds as at end-FY Dec 2006; this was better than those of most of its peers, as well as the industry's average of 4.0 times. We note that the Bank's gearing level is already within the regulatory limit of 7 times, as stipulated by the Central Bank's directive to specialised leasing companies (issued in January 2006). LRA expects MBSL's gearing ratio to remain below 2 times in FY Dec 2007, after incorporating the Bank's proposed debenture issue.

Meanwhile, LRA notes an increase in the Bank's other liabilities, from Rs 338.44 million as at end-FY Dec 2005 to Rs 478.96 million as at end-FY Dec 2006. This was mainly due to an increase in deferred taxes (by Rs 64.15 million) on account of the change in the accounting standard on deferred tax, and a rise in bank-guaranteed facilities, which came up to Rs 80.70 million as at end-FY Dec 2006 compared to Rs 10.93 million a year earlier.

Capital Adequacy

Strong capitalisation

The Bank's shareholders' funds stood at Rs 1,416.25 million as at end-FY Dec 2006, and accounted for a comfortable 42.62% of its total assets; this level of capitalisation is deemed strong. Further assurance can also be derived from the Bank's parent. Moreover, MBSL's capital-generating ability has also been strengthening, anchored by its growing profitability and moderate dividend pay-out ratio.

Industry Overview

Sri Lanka's gross domestic product ("GDP") expanded by 6.0% in 2005, followed by more than 8% in the first half of 2006. The relatively strong growth is attributable to the country's more robust economic activities during the post-tsunami recovery and reconstruction period, and the favourable performance of the agricultural sector under good weather conditions. However, the Central Bank estimates growth to have tapered down to 7%-7.5% in 2006 as a result of the escalated violence that is envisaged to constrain economic activities.

The country's annual average inflation rate, as measured by the Colombo Consumers' Price Index, came down from 11.6% in 2005 to 11.2% in September 2006 – albeit still high. Although it had been reduced to single digits between March and May 2006, underpinned by favourable weather conditions that had led to strong agricultural yields and more robust economic activities, this again climbed up to 12.7% in November following higher oil prices and defence expenditure, which may drive the inflation rate much higher in the final quarter of 2006.

Meanwhile, with the increased economic activities the total assets of the financial system grew by 10.09% to Rs 3,462.0 billion in the first half of 2006. Licensed commercial banks accounted for 57.57% of the total assets followed by licensed specialised banks (9.53%), registered finance companies (2.80%), insurance companies (3.18%) and specialised leasing companies (1.98%). However, the merchant-banking sector was only responsible for a meagre 0.73%, with a 5.20% growth (FY Dec 2005: 14.29%).

Merchant banks generally derive their revenue from fee-based activities: arranging and underwriting initial public offerings and debt issues, providing corporate advisory services and venture capital, loan syndication and other long-term financing. However, merchant banks in Sri Lanka, which had initially started off as pure merchant banks, had been compelled to diversify into interest-earning activities when the stock market experienced a sharp downturn in the early 1990s. As a result, the banks that had possessed significant share-trading portfolios had suffered heavy losses during that period.

At present, the lion's share of the merchant banks' assets is taken up by loans and advances, which generate 70% - 80% of their total revenue. Leasing and HP remain the anchor products, which in aggregate, grew by over 30% in the non-bank financing sector.

Although the equities market has been performing well since the ceasefire agreement in 2001, political tensions which have been surfacing intermittently have cast a pall over future prospects. The corporate debt market, on the other hand,

continues to remain subdued due to lack of tax incentives, the high cost of issuance and deficiency in investor education vis-à-vis debt quality.

Unlike other financial institutions, merchant banks are not regulated. However, specific areas of business are regulated - leasing under the Central Bank, and underwriting and provision of margin facilities under the Securities and Exchange Commission. As most of the merchant banks are also registered finance leasing companies, the new set of prudential guidelines (refer to page 13) issued under the Leasing Act became applicable effective January 2006.

Moving forward, LRA expects the local merchant banks to remain focused on the leasing and HP segments given the growth prospects for these areas. Nevertheless, competition from other banks and non-bank financial institutions has increased markedly, exerting pressure on the margins. Moreover, the outlook for fee-based activities will depend on the country's peace prospects and, in turn, a much-hoped-for revitalisation of the stock market.

Relevant Central Bank Directions Applicable to Registered Finance Leasing Establishments

<p><i>Minimum Capital</i></p>	<p>Every registered finance leasing establishment shall maintain at all times an unimpaired minimum core capital of an amount not less than the minimum issued and paid up capital prescribed by the Minister under the provisions of section 3(c) of the Finance Leasing Act, No. 56 of 2000. At present the minimum issued and paid up capital should be Rs 75 million.</p> <p>Where the core capital of any relevant establishment is below the amount prescribed by the Minister as the minimum issued and paid up capital at the commencement of this Direction, the Director may give such establishment a period of one year from the commencement of this Direction to comply with the requirement under this Direction.</p>
<p><i>Provision for Bad Debts</i></p>	<p>Every registered finance leasing establishment shall make provision for bad and doubtful debts before any profit or loss is declared and ensure that such provision is made subject to a minimum of -</p> <ul style="list-style-type: none"> (a) twenty per cent (20%) of all accommodation in arrears for a period of 6 months and upto 12 months; (b) fifty per cent (50%) of all accommodation in arrears for a period of 12 months and upto 18 months; (c) hundred per cent (100%) of all accommodation in arrears for a period of 18 months and over; (d) hundred per cent (100%) of all accommodation where instalments are not paid on a monthly basis, whenever the company has realised that instalments will not be paid on the due dates. <p>A relevant establishment may deduct the value of the following items held as collateral in respect of a particular accommodation in arriving at the provisions:</p> <ul style="list-style-type: none"> (a) cash or cash equivalents (including securities such as Treasury bills, Treasury bonds and fixed deposits in a licensed commercial bank, licensed specialised bank or in a registered finance company, free of any lien or charge); (b) bank guarantees; (c) with regard to vehicles that have been repossessed by the relevant establishment, eighty per cent (80%) of the valuation obtained during the preceding six months from a valuer approved by the Director- (d) with regard to land and buildings, the full value, in case of a primary mortgage. Such value shall not exceed the value decided by a professional valuer at the time of providing the accommodation. However, occupied residential properties taken as security without an agreement to hand over vacant possession in the event of sale for the recovery of dues, shall not be reduced in arriving at the required provision. <p>Where rescheduling occurs before an account is classified as non-performing, the rescheduled account shall be classified as non-performing when, in the aggregate, the period of time the account is in arrears before rescheduling (if any) and after rescheduling is six months or more.</p> <p>(a) Where rescheduling occurs after an account has been classified as non-performing, the rescheduled account shall continue to be classified as non-performing. Rescheduled accommodation classified as non-performing can be declassified only when the repayments under the rescheduled terms have been made for a continuous period of six months.</p>

<p>Gearing Ratio</p>	<p>The maximum outstanding amount of borrowings of a registered finance leasing establishment to which this Direction is applicable shall not exceed -</p> <p>(a) Subject to paragraphs 2 and 3 hereunder, ten (10) times the capital funds of the relevant establishment, at any time, during the first three years from the commencement of this Direction;</p> <p>(b) seven (7) times the capital funds of the relevant establishment, at any time, from the beginning of the fourth year from the commencement of this Direction.</p> <p>Where the outstanding amount of borrowings of a relevant establishment exceeds the limit specified in paragraph 1(a) above at the commencement of this Direction, such establishment may be given a period of two years from the commencement of this Direction to comply with the requirement under paragraph 1(a) above.</p> <p>A relevant establishment that has not completed one year in finance leasing business at the commencement of this Direction shall comply with the requirement under paragraph 1(b) of this Direction within 5 years from the date of commencement of this Direction.</p>
<p>Single-Borrower Limit</p>	<p>Subject to the provisions in paragraph 3 hereunder, the maximum of a single accommodation or the aggregate of accommodation granted to and outstanding at any point of time from an individual borrower, shall not exceed 15 per cent of the capital funds as shown at its last audited balance sheet.</p> <p>Subject to the provisions in paragraph 3 hereunder, the maximum of a single accommodation or the aggregate of accommodation granted to and outstanding at any point of time from any group of borrowers shall not exceed 20 per cent of the capital funds as shown at its last audited balance sheet.</p> <p>The maximum of a single accommodation or the aggregate of accommodation granted to and outstanding at any point of time from any director, holding company or subsidiary companies of the relevant establishment shall not exceed 15 per cent of the capital funds as shown at its last audited balance sheet.</p>
<p>Accrued Interest</p>	<p>Subject to the provisions of paragraph 2 hereunder, no registered finance leasing establishment shall take into account as income, any accrued interest on an accommodation on which interest and/or capital repayments are in arrears for six months or more.</p> <p>In the case of any accommodation where instalments are not paid on a monthly basis, no relevant establishment shall take into account as income, any accrued interest on an accommodation whenever it has realised that instalments in respect of such accommodation will not be paid on the due dates.</p>
<p>Reserve Fund</p>	<p>A registered finance leasing establishment shall maintain a reserve fund and shall, out of the net profits after the payment of tax of each year, before any dividend is declared, transfer to the Reserve Fund-</p> <p>(a) a sum equivalent to not less than 5 per cent of such profits until the amount of the Reserve Fund is equal to 50 per cent of the issued and paid-up ordinary share capital of the relevant establishment; and</p> <p>(b) a further sum equivalent to not less than 2 per cent of such profits until the amount of the Reserve Fund is equal to the issued and paid-up ordinary share capital of the relevant establishment.</p> <p>Relevant establishments that have reserves and retained profits which are not earmarked for any specified purposes by statute or by the Sri Lanka Accounting Standards, may transfer such reserves to the Reserve Fund.</p>

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		2.92%	
	Distilleries Company of Sri Lanka Ltd		1.07%	
	JB Cocoshell (Pvt) Ltd		0.95%	
	Waldock Mackenzie Ltd/ Mr Lalith Prabash		0.84%	
	Employee Trust Fund Board		0.71%	
	Mr DS Tennakoon		0.56%	
Directors:	Mr Udayasri Kariyawasam	Chairman		
	Mr SNP Palihena	Managing Director		
	Mr Chaminda Kumara Kularatne	Director		
	Mr Gunaratne Gallage	Director		
	Mr Raju Sivaraman	Director		
	Dr Budhdhadasa Kaluarachchi	Director		
	Ms WA Nalani	Director		
	Mr PMC Thilakerathne	Director		
Auditor:	SJMS Associates Chartered Accountants			
Listing:	1991			
Key Management:	Mr Gamini Karunathilake	Chief Operations Officer		
	Mr Ranjith Siriwardena	Deputy Director – Strategic Planning & Risk		
	Mr Lakshman Kaluarachchi	Deputy Director – Leasing		
	Ms Shyamalie Amaratunga	Deputy Director – Trade Finance		
	Mr AMA Cader	Assistant Director – Corporate Advisory & Capital Markets		
	Mrs Marina Phillips	Assistant Director – HR & Administration		
	Mr Rizvi Jurangpathy	Assistant Director – Finance & Treasury		
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%	
Capital History:	Year	Remarks	Amount (Rs million)	Cumulative Total (Rs million)
	1989	Ordinary share capital	25.0	25.0
	1990	Share issue	65.0	90.0
	1991	Rights issue	60.0	150.0
	1993	Rights issue	130.0	280.0
	1994	Bonus issue	220.0	500.0
	2004	Write off of losses	(270.0)	230.0
	2004	Conversion of preference shares to ordinary shares	370.0	600.0
	2005	Rights issue	300.0	900.0

Financial Summary - Company

BALANCE SHEET (Rs million)	31-Dec-02	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06
Property, Plant and Equipment	30.44	25.12	31.36	29.23	27.16
Investment in Associates/Subsidiaries	36.40	44.46	40.21	55.37	56.94
Other Investments	203.07	88.63	76.63	121.91	106.79
Gross Debtors	2379.76	2362.67	2575.49	2927.35	3402.94
Hire Purchase	0.00	0.00	152.32	574.78	870.25
Leasing	1408.89	1668.24	1842.72	1815.06	2013.81
Others	970.87	694.43	580.45	537.51	518.88
Estimated Residual Values	0.00	0.00	0.00	0.00	0.00
Less : Deposits	(65.93)	(50.13)	(58.20)	(62.73)	(62.48)
Less : Loan Loss Reserves	(582.36)	(431.71)	(290.95)	(313.97)	(237.08)
Net Debtors	1731.47	1880.83	2226.34	2550.65	3103.38
Amounts due from Holding/Related Companies	0.00	0.00	0.00	0.00	0.00
Other Loans & Advances	0.00	0.00	0.00	0.00	0.00
Cash and Bank Balances	14.43	3.82	4.31	12.78	1.42
Other Current Assets	149.85	85.35	96.59	502.96	260.49
TOTAL ASSETS	2165.66	2128.21	2475.44	3272.90	3556.18
Long Term Deferred Liabilities	11.92	14.71	22.05	76.61	112.07
Redeemable Hybrid Capital	800.00	800.00	0.00	0.00	0.00
Long Term Private Debt Securities	0.00	0.00	0.00	0.00	0.00
Less : Sinking Fund	0.00	0.00	0.00	0.00	0.00
Other Long Term Loans	1248.63	1173.63	1303.35	1488.10	1323.10
Total Long Term Debt	2048.63	1973.63	1303.35	1488.10	1323.10
Short Term Private Debt Securities	0.00	0.00	0.00	0.00	0.00
Amounts due to Holding/Related Companies	0.00	0.00	0.00	0.00	0.00
Other Short Term Loans	152.63	85.99	165.01	172.15	337.87
Total Short Term Debt	152.63	85.99	165.01	172.15	337.87
Trade Creditors	0.00	0.00	0.00	0.00	0.00
Provision for Dividend	0.00	0.00	0.00	0.00	0.00
Provision for Taxation	0.00	0.00	0.00	0.00	0.00
Other Current Liabilities	207.78	237.69	244.07	261.84	366.89
TOTAL LIABILITIES	2420.96	2312.02	1734.48	1998.70	2139.93
Equity Share Capital	500.00	500.00	600.00	900.00	900.00
Irredeemable Hybrid Capital	0.00	0.00	0.00	0.00	0.00
Reserves	770.00	770.00	17.00	167.00	181.67
Less : Intangible Assets	0.00	0.00	0.00	0.00	0.00
Retained Profit/(Loss)	(1525.30)	(1453.81)	123.96	207.20	334.58
Minority Interests (MI)	0.00	0.00	0.00	0.00	0.00
TOTAL SHAREHOLDERS' FUNDS + MI	(255.30)	(183.81)	740.96	1274.20	1416.25
TOTAL LIABILITIES + SHAREHOLDERS' FUNDS + MI	2165.66	2128.21	2475.44	3272.90	3556.18

Financial Summary - Company

INCOME STATEMENT (Rs million)	31-Dec-02	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06
Interest Income	335.05	361.62	398.60	474.90	609.52
Less : Interest Expense	(196.14)	(150.57)	(148.97)	(185.91)	(189.02)
Net Interest Income	138.91	211.05	249.63	288.99	420.50
Non-interest Income	11.59	25.03	36.37	64.10	94.84
Gross Income	150.50	236.08	286.00	353.09	515.34
Less : Non-interest Expenses	(89.35)	(109.77)	(137.11)	(162.91)	(208.49)
Less : Bad & Doubtful Debt Provisions	(50.60)	(58.12)	(17.17)	(16.12)	(38.91)
Less : Depreciation & Amortisation	(9.30)	(8.59)	(9.09)	(9.18)	(9.79)
Operating Profit/(Loss) Before Tax	1.25	59.60	122.63	164.88	258.15
Share in Results of Associated Companies	5.82	16.27	5.34	22.45	11.03
Prior Year Adjustments	0.00	0.00	0.00	0.00	0.00
Exceptional Items	0.00	0.00	0.00	0.00	0.00
Adjusted Profit/(Loss) Before Tax	7.07	75.87	127.97	187.33	269.18
Less : Tax	0.00	(4.38)	(3.20)	(21.30)	(59.64)
Adjusted Profit/(Loss) After Tax	7.07	71.49	124.77	166.03	209.54
Extraordinary Items	0.00	0.00	0.00	0.00	0.00
Less : Transferred to Statutory Reserve	0.00	0.00	0.00	0.00	(14.66)
Less : Dividends	0.00	0.00	0.00	(30.00)	(67.50)
Retained Profit/(Loss) For The Year	7.07	71.49	124.77	136.03	127.38

CASH FLOW STATEMENT (Rs million)	31-Dec-02	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06
Cash Flow From Operating Activities	209.14	(8.50)	(136.12)	(228.71)	(181.33)
Cash Flow From Investing Activities	(4.25)	11.54	10.97	0.31	(26.26)
Cash Flow From Financing Activities	(202.68)	(75.00)	129.72	604.75	(226.25)
Net Increase/(Decrease) in Cash During The Year	2.21	(71.96)	4.57	376.35	(433.84)
Cash Balance at Beginning of the Year	62.22	64.43	(7.53)	(2.96)	373.39
Cash Balance at End of the Year	64.43	(7.53)	(2.96)	373.39	(60.45)

Financial Ratios - Company

KEY RATIOS	31-Dec-02	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06
Profitability (%)					
Net Interest Margin	6.12%	9.83%	10.84%	10.05%	12.32%
Cost/Income Ratio	59.37%	46.50%	47.94%	46.14%	40.46%
Return on Average Assets	0.06%	2.78%	5.33%	5.74%	7.56%
Return on Average Equity	(0.48%)	(27.15%)	44.02%	16.36%	19.19%
Capitalisation (times)					
Gearing Ratio	(8.62)	(11.21)	1.98	1.30	1.17
Long Term Gearing Ratio	(8.02)	(10.74)	1.76	1.17	0.93
Short Term Gearing Ratio	(0.60)	(0.47)	0.22	0.14	0.24
Capital Adequacy Ratio (%)	(11.04%)	(4.94%)	32.77%	40.29%	41.41%
Coverage (times)					
Interest Coverage Ratio	1.05	1.45	1.88	1.94	2.42
Asset Quality (%)					
Gross NPL	36.71%	33.22%	21.09%	16.58%	10.41%
Loan Loss Reserve Coverage	24.47%	18.27%	11.30%	10.73%	6.97%
General Loan Loss Reserve Coverage	2.10%	5.03%	3.93%	2.50%	2.43%
Loan Loss Reserve Coverage (Gross NPL)	66.66%	55.01%	53.56%	64.68%	66.94%

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 / Average Total Assets
Return on Average	Operating Profit Before Tax / Average Total Assets
Return on Average Equity	Operating Profit Before Tax / Average (Shareholders' Funds + Minority Interest)
After Tax Return on Equity	Adjusted Profit After Tax / Average (Shareholders' Funds + Minority Interest)
Effective Tax Rate	Tax / Adjusted Profit Before Tax
External Liabilities Ratio	Total Liabilities / (Shareholders' Funds + Minority Interests)
Gearing Ratio	Total Debt / (Shareholders' Funds + Minority Interests)
Net Gearing Ratio	(Total Debt - Cash & Bank Balances) / (Shareholders' Funds + Minority Interests)
Long Term Gearing Ratio	Long Term Debt / (Shareholders' Funds + Minority Interests)
Short Term Gearing Ratio	Short Term Debt / (Shareholders' Funds + Minority Interests)
Capital Adequacy Ratio	(General Loan Loss Reserve + Shareholders' Funds + Minority Interests - Investment in Subsidiaries) / Total Assets
Interest Coverage Ratio	Operating Profit Before Depn. Interest & Tax / (Interest Expense + Preference Dividend + Interest Capitalised)
Pre-tax Interest Coverage Ratio	Operating Profit Before Tax / (Interest Expense + Preference Dividend + Interest Capitalised)
Adjusted Interest Coverage Ratio	Adjusted Profit Before Depn. Interest & Tax / (Interest Expense + Preference Dividend + Interest Capitalised)
General Loan Loss Reserve Coverage	General Loan Loss Reserve / (Net Debtors + General Loan Loss Reserve)

LRA'S CREDIT RATING DEFINITIONS (FINANCIAL INSTITUTIONS)

LRA's rating of a financial institution is an assessment and current opinion on the strength and performance of the rated institution.

LONG-TERM RATINGS

AAA Financial institutions rated in this category are adjudged to offer the highest safety for timely payments of financial obligations. This level of rating indicates entities with strong balance sheets, favourable credit profiles and consistent records of above-average profitability. Their capacities for timely payments of contractual financial obligations are unlikely to be impacted seriously by any foreseeable changes in economic conditions.

AA₁
AA₂
AA₃ Financial institutions rated in this category are adjudged to offer high safety for timely payments of financial obligations. This level of rating indicates entities with sound credit profiles and without significant problems. Entities rated in this category are, however, considered to be somewhat more vulnerable to adverse changes in economic conditions than those entities rated in the highest category. The subscript 1, 2 and 3 indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.

A₁
A₂
A₃ Financial institutions rated in this category are adjudged to offer adequate safety for timely payments of financial obligations. This level of rating indicates entities with adequate credit profiles, but which possess one or more problem areas, giving rise to the possibility of future riskiness. Entities rated in this category have generally performed at industry average and are considered to be more vulnerable to changes in economic conditions than those rated in the higher categories. The subscript 1, 2 and 3 indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.

BBB₁
BBB₂
BBB₃ Financial institutions rated in this category are adjudged to offer only a moderate degree of safety for timely payments of financial obligations. This level of rating indicates entities which have been significantly under-performing in some areas. These entities are, however, considered to have the capability to overcome such problems in the short term, though adverse changes in economic conditions could impair their ability to make timely payments of financial obligations. The subscript 1, 2 and 3 indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.

BB₁
BB₂
BB₃ Financial institutions rated in this category are adjudged to lack key protection factors, which could result in inadequate safety for timely payments of financial obligations. This level of rating indicates that the entities may need certain favourable economic changes in order to meet financial obligations in a timely fashion. The subscript 1, 2 and 3 indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.

B₁
B₂
B₃ Financial institutions rated in this category are adjudged to be of high risk. Timely payments of financial obligations are impaired by serious problems which the entities face. Whilst entities rated in this category might be currently meeting obligations on time, continuance of this would depend upon favourable economic conditions or some degree of external support. The subscript 1, 2 and 3 indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.

C₁
C₂
C₃ Financial institutions rated in this category are adjudged to be of very high risk in relation to timely payments of financial obligations. This level of rating indicates entities with very serious problems and, unless external support is provided, they would be unable to meet their financial obligations in a timely fashion. The subscript 1, 2 and 3 indicate that the financial institution ranks at the higher, mid or lower end within this generic rating category respectively.

D Financial institutions rated in this category are either currently in default or expected to be in default, whether or not formally declared. This level of rating indicates that the entities are unlikely to meet maturing financial obligations, which calls for immediate external support of a high order.

SHORT-TERM RATINGS

- L1** Financial institutions in this category have superior capacities for timely payments of obligations.
- L2** Financial institutions in this category have strong capacities for timely payments of obligations.
- L3** Financial institutions in this category have adequate capacities for timely payments of obligations. The ability to honour the obligations is more vulnerable to adverse changes in business, economic or financial conditions.
- NP** Financial institutions in this category have doubtful capacities for timely payments of obligations.

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Lanka Rating Agency Limited
No. 9 Arthur's Place
Colombo 4
Sri Lanka

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

E-mail: lra@lankarating.com
Website: <http://www.lankarating.com>

