

Management Discussion & Analysis

Operations Review

■ Overview

The global and local economic downturn impacted many business sectors in the country reducing demand for capital asset funding. A wide range of businesses were simultaneously affected increasing their level of risk and making them more vulnerable. This resulted in DFCC Bank having to adopt a more cautious approach towards portfolio growth during the year under review, with a more focused and pro-active outlook on project follow-up and monitoring, especially in the case of project loans that had been committed and were in the implementation or commissioning stages.

■ Approvals

Facilities approved totalled Rs13,868 million, 15% lower than the previous year's Rs16,239 million. Project loans and investments accounted for 85% of approvals, finance leases for 9% and financial guarantees made up the balance. The Bank followed a much more cautious approach in granting fixed-rate finance leases to the more vulnerable SME sector, since the high interest rates that prevailed made the payment of installments difficult.

Nearly half of the approvals were for businesses in electricity and gas, communications and transport, construction, financial and business services, trade and diversified businesses. A further 10% was for the food and beverage sector.

The Branch Banking division that caters to the SME sector, contributed 45% of total approvals and the Corporate Banking division approved the balance 55%.

■ Portfolio

The total credit portfolio of the Bank which was Rs41,858 million as at FYE 31 March 2009 indicated a decline of 11% from the previous year's figure of Rs46,784 million. Capital repayments of Rs15,095 million exceeded new disbursements of Rs10,170 million causing the portfolio to contract. In the case of DFCC's portfolio, a relatively high percentage of credit facilities is repaid during a year unlike in the case of commercial banks whose advances for working and trade finance tend to revolve and even increase when the working capital cycle slows down.

The Bank's portfolio is made up of term loans (84%), finance leases (11%) and investment securities (5%). A significant reduction of

25% has been recorded in the case of the lease portfolio, which is a fixed interest rate product that is primarily demanded by the more vulnerable SME sector.

The portfolio is well diversified with nearly 75% being accounted for by 10 broad sectors and no single sector having an exposure exceeding 15%.

Diversified businesses & Trade	14.3%
Manufacture of Food & Beverages	11.0%
Finance & Insurance	9.0%
Community, Social & Personal Services	7.6%
Agriculture, Forestry & Fishing	7.5%
Real Estate & Business Services	5.3%
Manufacture of Non-Metallic Mineral Products, Glass etc.	5.3%
Construction Industries	4.7%
Electricity, Gas & Water Industries	4.7%
Telecommunications	4.6%

■ Portfolio Quality

The stressed economic environment led to greater levels of delinquency. The Non-Performing Asset (NPA) ratio increased to 9.1% from the previous year's figure

of 6.2%. This year as well, the adverse variance in the NPA ratio is attributable to an increase in infections of the SME portfolio, for both loans and leases. The reduction in the portfolio size also contributed to the increase in the ratio. In contrast, maintaining a less than 1% NPA ratio in the Corporate Banking portfolio is considered satisfactory given the current context.

In the light of increasing pressure on the quality of the portfolio, the Bank allocated more resources to project follow-up, monitoring and rehabilitation with a view to assisting enterprises, particularly in the SME sector to revive projects facing difficulties. Indications are that the problems of the borrowers are of a temporary nature as most of them still continue to be in business but are affected by lower business volumes. The Government has also provided relief schemes to the apparel industry and tea smallholders in which the Bank is participating and some signs of revival are already visible. A recent scheme introduced by the Government to reduce the burden on finance leases is also expected to provide a further degree of relief to the SME Sector.

Corporate Banking

The environment for large-scale project financing remained challenging during the year. While Rs7,331 million in new facilities was approved, the uncertain macro situation caused many projects to be shelved or delayed in implementation. With disbursements lagging behind loan repayments, the Bank's corporate banking portfolio also underwent a contraction towards the latter part of the financial year. Even so, the focus remained on portfolio profitability and quality rather than volume. Interest margins were judiciously managed while a special effort was made towards improving project follow-up and monitoring. This resulted in the overall profitability of the portfolio improving with an increase in net interest income. At the same time, portfolio quality was maintained, recording a NPA ratio of 0.83% while the average of loans in arrears was 0.42%.

As regards sector-wise approvals, Manufacturing accounted for 39% followed by Power & Energy 22%, Trade 9%, Transport & Communications 8% and Construction 8%. Major projects and financing activity in most business sectors were confined to areas such as incremental

capacity enhancement, technology upgrading and working capital. However, there was sustained interest in the renewable energy sector, and in addition to several run-on-the-river hydropower projects, the Bank was also evaluating new projects using wind and biomass energy technologies.

Branch Banking

The branch relocation programme that commenced three years ago is nearing completion. Two more branches in Kurunegala and Kalutara were relocated to more modern and spacious premises. The programme is helping to provide the full range of banking to the public in conjunction with our commercial banking subsidiary, DFCC Vardhana Bank Limited. A new branch was opened in Galle in December 2008 increasing the total number of branches to 14 and easing operational constraints in the Matara Branch, which was servicing three districts in the Southern Province. In line with the Government initiative to develop the Eastern and Northern Provinces, the Bank is exploring opportunities to set up branches in suitable locations during 2009 and 2010.

Small and Medium Enterprise Financing

The year was marked by a severe drought in the tea and rubber producing areas, which caused a decline in prices of these commodities in the latter half of 2008 affecting the overall performance of the Small and Medium Enterprise (SME) sector. Credit approvals to SMEs through our branch network accounted for only Rs6,193 million compared with Rs6,563 million in the previous year reflecting the lower demand for capital asset funding. The funds approved were mainly for sectors such as agriculture, processing of agricultural commodities, food and beverage, healthcare services, professional and vocational education and transport services. The total SME credit portfolio contracted by 8% to Rs18,041 million compared to Rs19,628 million in the previous year. The reduction of the finance leases portfolio by 22.6% from Rs6,698 million to Rs5,183 million was the main cause for the overall contraction of the total credit portfolio.

One of the major sectors financed by the branch network has been tea, both cultivation and manufacturing. With the sharp decline of the tea market in August 2008, the Bank proactively offered a relief package to tea factory owners by way of deferment of both interest and capital repayments. This measure helped ease their

working capital and cash flow constraints and enabled the tea factory owners to make timely payments to green-leaf suppliers and be in continuous production.

In June 2008, DFCC launched a new Credit Scheme "Small & Medium Enterprises Regional Development Credit Scheme" funded by the Asian Development Bank for financing SMEs located outside the Western Province. Additionally, the Bank continued to use funds that became available under SMILE 111, SMILE 11 Revolving, DASUNA and E-Friends 11 with a view to offering facilities at concessionary rates.

DFCC Vardhana Bank Limited

Assets of DFCC Vardhana Bank Limited (DVB) grew by Rs7.9 billion to Rs24.8 billion, a 47% increase over the year.

The proportion of loans and advances to total assets declined from 63% to 58% due to higher allocations to Government securities though the loan portfolio itself grew by Rs4.2 billion. Customer advances grew from Rs10.9 billion to Rs15.1 billion being a 38% increase during 2008. New credit exposures were to businesses and individuals in trade, industry, professions or vocations. Corporate credit represented Rs8.6 billion or 57% of the loans and advances portfolio while the balance Rs6.8 billion was credit granted through branch banking to the SME sector.

Deposits from customers remained the main funding source for DVB with the total deposit base standing at Rs18.9 billion as at 31 December 2008, an increase of 58% over the previous year's Rs12.1 billion. The Bank had a successful campaign to increase lower cost savings deposits by 74% from Rs1,360 million to Rs2,362 million. This is a notable achievement during a year when time deposit rates were very much higher. Amongst other things, the expansion of the branch network and distribution outlets to a total of 43 in 2008 was a contributory factor in growing the deposit base.

The profitability of DVB was affected by an increase in the NPAs relating to a few borrowers in the tea exports, construction and apparel sector. Although, individual exposures were not large in the context of the DFCC Group, the level of provisioning was much higher than in the previous year.

Capital Markets and Investment Banking

The year under review was a challenging period for the Colombo stock market. With corporate earnings under pressure, investors opted to stay on the sidelines or shift from equities into risk-free fixed income securities, which were yielding attractive returns. The All Share Price Index dropped 36% while the sensitive

Milanka Price Index was hit further to fall by 45%. Even though Colombo was not as badly affected as some regional share markets, its liquidity was low with turnover frequently dropping well below the Rs100 million mark. Market average statistics however, improved as a result of two strategic transactions that boosted the average daily turnover to Rs448 million compared to last year's Rs363 million. The acquisition of NTT's 35% stake in Sri Lanka Telecom by Global Telecommunication Holdings enabled the Colombo Stock Exchange (CSE) to record the largest ever transaction (Rs32.1 billion), as well as the highest daily turnover (Rs33.4 billion) in its history. The other notable transaction was the acquisition of a majority stake in Associated Motorways by the AI Futtaim Group, which totalled Rs6.9 billion. Even so, general market activity levels remained low as investors chose to focus on the macro economic environment.

The market trend meant that DFCC had to carefully consider its strategy for managing its portfolio of quoted and unquoted shares and holdings in Unit Trusts. While a passive investment strategy was adopted, at the same time, opportunities to divest from mature holdings were actively pursued. During the year, a total of Rs135 million in capital gains was achieved. As at FYE 31 March 2009, the market value of the total quoted portfolio and unit trust holdings was Rs799 million of which Rs57 million was the unrealised capital gain.

While DFCC manages its own equity portfolio and undertakes the in-house fund-based investment banking activity, the fee-based corporate finance and advisory business is now carried out by Acuity Partners (Pvt) Limited, the equally owned joint venture with Hatton National Bank PLC. Acuity Partners is also the holding company for the stockbroking companies earlier owned by DFCC and HNB and the primary dealer company earlier fully owned by HNB. It is especially noteworthy that DFCC Stockbrokers (since renaming Acuity Stockbrokers) participated in both the major strategic share transactions that took place on the CSE in 2008 that were referred to earlier and was ranked the first in market share for the year.

Treasury Operations

Group Treasury is responsible for managing liquidity, interest rate and foreign exchange risks arising out of the Bank's core activities, funding and permitted investments. Since the acquisition of DFCC Vardhana Bank Limited in year 2003, Treasury has been functioning as a Group unit which helps to exploit the opportunities available in the market utilising the individual strengths of both institutions while optimising resources.

During the year, the cost of funds of both Banks was managed efficiently. The Treasury

optimised funding costs through planned exposure to the wholesale and inter-bank market within stipulated limits laid down by the Asset and Liability Management Committee (ALCO) and the Board Integrated Risk Management Committee. The high marginal cost of customer deposits is always a challenge for DFCC with its single deposit product type of fixed deposits. Since the average investment horizon of the depositor in Sri Lanka ranges from three months to a year, optimising marginal cost based on a changing interest environment was achieved with proactive pricing strategies. DFCC Vardhana Bank focused on retail fund raising activities to support its own operations.

The fixed income market provided opportunities in the latter half of the financial year which were exploited. The mismatch risk arising out of such investments is well within the guidelines stipulated for such risk. The Bank maintains an investment portfolio of highly liquid Rupee Government Securities that have an average residual tenor to maturity of under two years.

Funding

Domestic market liquidity was tight during the first half of the financial year. The global financial crisis tightened global liquidity available for lending to South Asia. However, the Treasury successfully negotiated a cross border credit line, for which the agreement is in the process of being finalised. Negotiations are under

Management of Credit Lines

The Project Management Department manages four credit programmes of the Government of Sri Lanka.

way with another foreign long-term lender for a further medium-term credit line to be obtained during 2009. Although the declining rates of interest in the global financial markets have contributed to reduced benchmark interest rates on such borrowings, margins have increased to reflect the global liquidity constraints and higher risk premia expected by lenders. The Bank will ensure that any foreign exchange exposures arising from such borrowings are actively managed with natural or market-based hedges where appropriate.

In December 2008, the Bank redeemed the Floating Rate Notes (FRNs) of USD65 million issued in 1998 utilising assets in a sinking fund built up over the life of the instrument. As such there was no strain on the Bank's liquidity. The repayment however led to a contraction in the balance sheet.

The Bank also proactively managed the wholesale customer deposit portfolio which is an important source of funding for the Bank. The deposits and other market based borrowings accounted for 42% of the total borrowings of DFCC as at 31 March 2009. The possibility of issuing medium-term debt was explored but not undertaken due to the high interest rate environment and low demand for project finance.

The World Bank and Global Environment Facility (GEF) assisted Renewable Energy for Rural Economic Development (RERED) Project aims to (i) improve the quality of rural life by utilising off-grid renewable energy technologies to bring electricity to remote communities and (ii) promote private sector power generation from renewable energy sources for the main grid. Now in its third iteration - RERED (Additional Financing) - these credit lines and associated grant programmes have supported the addition of 137 MW of grid-connected capacity and electrification of 132,434 off-grid households through community-based projects and Solar Home Systems (SHS). Hydro and solar technologies are now well established in Sri Lanka and the Project intends to promote other renewable energy technologies including biomass and wind.

The credit component of the Plantation Development Project, funded by the Asian Development Bank and a revolving fund set up by the Government of Sri Lanka, focuses on the transformation of Regional Plantation Companies (RPCs) from primary producers into agribusiness entities. As at 31 March

2009, seven participating financial institutions have collectively disbursed Rs1,410 million to 14 eligible RPCs. These funds have been used for field development, crop and non-crop diversification, factory consolidation and process automation, and marketing ventures.

The European Investment Bank (EIB)-assisted Post-Tsunami Reconstruction Project provides assistance to revive the economies of 11 affected districts in the Eastern, Northern, Southern and Western provinces. Over 80% of the cumulative fund allocated for both directly and indirectly affected components is committed for development projects in leisure, health, manufacturing and service sectors.

The KfW-assisted Small and Medium Enterprise Development Project in the North and the East focuses on improving access to financial services for entrepreneurs. The credit line is geared to cater to the SME sector in the two provinces which is expected to develop with a new vigor along with the on-going and proposed large-scale development projects in the North and the East.