

Management Information

Chairman's Message

It is with great pleasure that I present the Annual Report of DFCC Bank for the financial year ended 31 March 2010.

There is no doubt that it was a defining period for Sri Lanka. The shackles of conflict were finally undone and the long awaited 'light at the end of the tunnel' was sighted. The country now has the epochal prospect of attaining its full potential. As expectations are high, the new elected Government under the leadership of His Excellency the President Mahinda Rajapakse will no doubt grasp this opportunity and deliver on the mandate awarded by the people.

I would like to look back briefly on the past year. Sri Lanka's economy had to bear the full brunt of the global recession and therefore weakened during the first half of 2009. However, positive internal and external developments towards the latter part of the year enabled the economy to recover strongly from the lacklustre start. While the catalyst was the ending of the long running terrorist violence, the country's economic situation was also aided by the continuing recovery in world markets. The containment of inflation and the decline in interest rates were also important factors that helped to regain business and investor confidence.

Going forward, the prospects for Sri Lanka arising from the post conflict situation and the eventual recovery of world markets are good. Even so, the country has to embark on the long and arduous task of nation building with vigour where sound strategic actions have to prevail in order for the peace dividend to materialise. While the onward path is full of promise, there are potential hazards that need to be cleared right at the very outset. There are three immediate and perennial issues; politics, governance and the fiscal deficit.

Firstly, the legacy of the defeated terrorist movement will not be dispelled overnight. Therefore, while the military 'coup de grace' has been administered, focus must continue on the rehabilitation and resettlement process, and the economic development of all the affected regions. In this context, it is encouraging that the development thrust that is gathering pace particularly in the South is also gaining momentum in the North and East and achieving tangible results on the ground.

The second issue is the question of governance. In this regard, a top down approach based on meritocracy is the best strategy. Such action requires determination and a strong and politically

unfettered will. It is my belief that this combination of factors now exists as evidenced by the early efforts at streamlining a top heavy administration. Such efforts however, must build up momentum.

The third issue is the recurring fiscal deficit and large losses of several state-owned enterprises. The resultant build up of public sector debt is casting a shadow over the future development of the country. This needs to be aggressively addressed sooner rather than later with the same intensity and attention that enabled the defeat of terrorism. The environment is now conducive for such action and what is required is the political will to capitalise on the 'feel good' factor and push through the more sensitive measures such as factor liberalisation and revenue reform.

Also, while the Government will spearhead the development of infrastructure and other areas, there is the need to increase the role of the private sector in this activity particularly through public-private partnerships and other transparent structures. In the context of investing in a post conflict

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Im S. Pinto



Sri Lanka, I do not believe that the financing of such projects would be a constraint provided that transparency prevails. Most long-term financial institutions have a pragmatic attitude particularly when it comes to project finance. However, ethical investing and best practices, especially after the global banking crisis, are overriding considerations meaning that any opaqueness will stall a transaction.

I would like to move on to the banking sector itself. Globally, the image of the industry has suffered. Depositors and investors lost much due to endemic moral hazard while taxpayers had to foot huge bills for the bailouts of those institutions deemed 'too Big to Fail'. In the United States alone, 140 banks went under in 2009 and a further 41 failed during January to March 2010. However, following concerted policy actions that helped stabilise the system, there was some recovery beginning in the latter part of 2009. Even so, confidence in the industry needs to be quickly rebuilt particularly through the implementation of reform and regulatory tightening on a global scale. In contrast, the domestic financial system remained stable due in no small part to proactive regulatory action taken by the Central Bank of Sri Lanka. At the same time, the year was challenging as a result of the slowdown in the local economy towards the end of 2008, which carried through to the first part of 2009. This slowdown took its toll on portfolio growth and quality. The industry-wide credit portfolio contracted by almost 5% as against the growth exhibited in previous years. As regards quality, total non-performing advances went up by 21% contributing to an industry-wide non-performing loan ratio of 8% as at March 2010. Although the

domestic banking industry continued to be profitable, the performance of the core business of intermediation was weak. However, there are welcome signs of revival that have emerged in the last few months.

Looking ahead, there is widespread acceptance that the financial system has to undergo a fundamental structural transformation. The domestic banking space is too fragmented and this will require the players to attain a critical mass, particularly given the credit demand prospects and the emerging regulatory scenario. The need for corporate consolidation to achieve scale economy and operational homogeneity and thereby cost rationalisation and profitability enhancement has thus been voiced many a time. The need for an equitable tax rate to incentivise the raising of equity capital has also been articulated repeatedly. In all this, there is a unity of opinion and I therefore hope that the policy makers and the authorities concerned will give due heed to the industry situation and address the issues raised.

I now turn to the performance of DFCC Bank. Weak credit demand and declining interest rates left their mark on the lending portfolio and interest income at both the Bank and Group level. In the environment that prevailed the main business line of DFCC Bank, which involves providing debt capital for projects suffered disproportionately when compared with banks that funded working capital. The contraction in the top line meant that efforts had to be focussed strongly on managing

delinquent assets and all aspects of cost in order to achieve a respectable growth in the bottom line. Bearing in mind its responsibility as a development finance institution, the Bank took a conscious decision to provide liquidity either by restructuring or providing new funding to many viable businesses in sectors that experienced stress. These endeavours enabled the Bank and the Group to record growths of 26% and 30% respectively in profits after tax for the financial year ended 31 March 2010. I am also pleased to inform that, at the Group level, the investment in the distribution network of DFCC Vardhana Bank Limited (DVB) began to bear fruit as expected. DVB has now expanded its distribution network to all the provinces. Despite the inherent difficulties that a small commercial bank has to face in difficult economic conditions, DVB more than doubled its contribution to Group profit. It is clear that the Bank requires to expand its franchise in the commercial banking space to enable it to effectively deliver on its development banking mandate. Accordingly, we are in the process of developing a model under which both these businesses can continue. The future of the Bank's shareholding in Commercial Bank of Ceylon PLC, presently an associate company is being re-examined as part of this exercise. The Group is committed to play its development role in the North and East and has opened the first three branches in the region. We will expand our activities in these provinces in the coming years.

Although experiencing a challenging year, Commercial Bank of Ceylon PLC maintained its substantial contribution to the Group. Significant contributions to Group profit also came from Lanka Industrial Estates Limited and the investment banking joint venture, Acuity Partners (Pvt) Limited. The Bank meanwhile divested its controlling stake in Lanka Ventures PLC at a profit to Acuity Partners (Pvt) Limited in early 2010. The Bank has committed new capital of up to Rs500 million to Acuity Partners to finance this acquisition and for business expansion of the Acuity Group. This has brought all the non core financial businesses of the Bank under one umbrella and will enable Acuity Partners to position itself as Sri Lanka's premier universal investment bank. The information technology subsidiary Synapsys Limited has built up capacity to move to the next level of implementing business solutions overseas. To further its growth, the Bank plans to infuse Rs50 million in new capital to this business in stages.

From a business perspective, there is cause for optimism. The upturn was manifest in the last quarter of the financial year and the newly found confidence was marked by the unprecedented surge in equity prices on the Colombo Stock Exchange. At the same time, DFCC's project finance pipeline has strengthened considerably across the board in sectors such as manufacturing, food & beverage, tourism and telecommunication. This is encouraging as it indicates the breadth of the recovery. Also, the build up of investment momentum augurs well for DFCC's core business of capital asset

financing and DVB's commercial banking business. In this scenario, the Group will adopt proactive strategies for portfolio growth focussing on those sectors with potential as well as resilience to internal and external shocks.

My fellow Directors were unstinting in their support and cooperation.

I thank them and will continue to rely on their good counsel. Mrs. Sujatha Cooray resigned from the Board in December 2009. I thank her for the valued contribution and support.

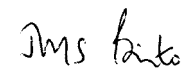
Mr. Ajith Jayaratne, Senior Director and Chairman of the Board Audit Sub-committee, retired from the Board on reaching the age of 70. I thank him for his valued guidance and backing during his tenure on the Board and wish him well. I welcome Dr. Mrs Damitha de Zoysa who was appointed Government Director in December 2009. I also welcome Messrs Asoka Abeyewardene, Tissa Bandaranayake (Alternate Director to Mr Turan Caglayan) and Gomin Dayasri who were appointed in August 2009, October 2009 and March 2010 respectively.

DFCC is founded on its employees. Mr. Nihal Fonseka, the Chief Executive, continues to bring out the best in the DFCC team and together, their performance has again delivered value. Their work ethic is exemplary and I remain confident of their continued commitment in powering DFCC forward. I thank all, and will bank on their future efforts.

At DFCC, we regard all our clients as valued partners and treat each relationship as special. Their patronage has enabled our success in no small way and I thank them all for their choice of DFCC as financier. As we continue onwards, we will rely on a partnership of mutual support and benefit.

Officials of the Ministry of Finance and the Central Bank of Sri Lanka have long been supportive of DFCC Bank's endeavours. I thank them for the help and support extended in the past and will continue to rely on their facilitation in the future.

Dear shareholders, I, together with my fellow Directors, value the trust you have placed in our abilities and we thank you for giving us the privilege of directing the course of DFCC Bank. In recognition of your support, and the 25% increase in earnings per share to Rs12.97, the Board has decided to recommend that the dividend be increased to Rs6 per share from the Rs5 per share paid last year. Going forward, while there is optimism, there will also be challenges to be faced. Whatever these challenges, be assured it is your interest in DFCC Bank that will receive our utmost attention.



J M S Brito
Chairman

26 May 2010