Management Discussion and Analysis

Financial Review

Overview

Profitability

The Group profit after tax of the Bank in the financial year under review (referred to in this report as current year) was Rs2,684 million an increase of 30% over Rs2,068 million in the previous financial year (referred to as previous year). The unconsolidated profit after tax of the Bank in the current year was Rs1,713 million a 26% increase over Rs1,360 million the previous year. Thus, the performance in the current year is a significant improvement compared to the results one year ago which recorded a 8% decrease in the Group profit after tax and a modest 3% increase in the unconsolidated profit after tax of the Bank.

Unless otherwise stated, this review relates to unconsolidated results of the Bank.

Calendar year 2009 was characterised by a domestic economic slow down due to the global financial and economic crisis and the challenging domestic business environment. Thus the credit demand for Bank's core business of financing new business enterprises, capacity expansion or modernisation of existing business enterprises was significantly reduced.

The Bank however, anticipated the emerging difficult business environment at the beginning of the financial year and took specific steps to improve the profitability of the Bank. These measures included the following:

i. Maintenance of Net Interest Income Margin

Interest income of Rs7,416 million in the current year was 13% lower than Rs8,529 million in the previous year, in line with the contraction of loan and lease portfolios. Interest expense of Rs4,224 million in the current year was however 25% lower than Rs5,624 million in the previous year. Correspondingly net interest income was 43% of the interest income in the current year, significantly higher than 34% in the previous year. However, this increase is in part due to funding swaps. The currency swap cost is not included under net interest income but charged against foreign exchange profit as prescribed by the currently applicable reporting requirements. Thus the foreign exchange loss shown under other income would be a profit and net interest income correspondingly reduced if the currency swap cost is shown as an interest expense. Concurrent with the funding swap the Bank entered into forward exchange contracts to close the foreign exchange positions and therefore these transactions have not resulted in open foreign exchange positions of any significance.

The improvement in net interest income margin was achieved despite significant reductions in on-lending rates for advances in the second half of the financial year as a result of the reduction of domestic interest rates. The Bank acquired significant amounts of Government Securities for its held-to-maturity portfolio in the early part of the year thereby locking in the income at the high interest rates that prevailed and was also able to use funds amounting to Rs3,230 generated by the declining credit portfolio to shed expensive customer deposits. These factors contributed to the increase in the interest margin.

ii. Containment of Personnel Cost

The increase in personnel cost to Rs575 million in the current year was a modest 6% increase over the previous year. The pension cost reduced from Rs103 million in the previous year to Rs72 million in the current year primarily due to better returns on pension fund assets.

iii. Containment of other Operating Expenses

The establishment and other overhead expenses in the current year was Rs488 million, a marginal increase from Rs483 million in the previous year. The Bank uses internal costing methods to encourage cost savings in energy, transportation and cost of consumables. The Bank was able to achieve this cost efficiency despite additional operating costs incurred in the opening of new branches in Galle, Batticaloa and Ampara.

The Value Added Tax on financial services and income tax expense in the current year was Rs1,348 million which is 44% of the operating profit before these taxes. In the previous year these taxes accounted for 47% of the operating profit before these taxes. These taxes collectively exceed the non-interest expenses incurred by the Bank to generate revenue (i.e. personnel cost, establishment and overhead expenses).

Loan Quality

The gross non-performing loans (NPL) and finance leases was Rs3,768 million on 31 March 2010, a marginal decrease from Rs3,783 million a year ago. However, the infected exposure net of provisions and the realisable value of tangible collateral was only Rs217 million on 31 March 2010. As a percentage of the equity on 31 March 2010, this was 1.4%.

Loans constitute 85% of the non-performing credit portfolio.

The composition of NPL by age of arrears indicates that Rs1,416 million (44% of the total gross non-performing loans of Rs3,194 million) was over 18 months on 31 March 2010, an increase from 37% in the previous year's non-performing loans in the same arrears category.

The consolidated results include the profits of subsidiaries and associate companies and their performance review is given individually.

Combined Operations of the Bank and its Commercial Banking Subsidiary DFCC Vardhana Bank Limited (DVB)

DVB is a 96% owned subsidiary of the Bank with an investment of Rs2,286 million. The credit quality of DVB too was affected by the economic downturn.

The combined non-interest expense to operating income ratio of the Bank and its commercial banking arm DVB, (the cost income ratio) was 32% in the current year compared to 33% in the previous year.

DVB too allocated substantial resources in the early part of the year to investments in Government Securities to be held to maturity thereby benefiting when interest rates declined sharply later on in the year. It did not pursue loan growth but concentrated on arresting any further decline in the quality of its existing portfolio and managing the cost of its customer liability base. As a result, the net interest income in the current year which reached Rs1,751 million, was 41% of the interest income, increased from 37% in the previous year.

Investment in Lanka Ventures PLC

On 18 January 2010, Bank sold its entire shareholding in Lanka Ventures PLC (LVL) to Acuity Partners (Pvt) Limited, a joint venture company equally owned by DFCC Bank and Hatton National Bank PLC. This transaction yielded a profit of Rs284 million. Although this profit is liable to 20% financial services VAT, being a capital gain, there is no income tax liability. The contribution to consolidated profit after tax was Rs142 million.

The results of LVL for the period 18 January up to 31 March 2010 are consolidated with Acuity Partners (Pvt) Limited. The Consolidated Financial Statements of the Bank do not include these results since the results of Acuity Partners (Pvt) Limited whose financial year ended on 31 December 2009 are consolidated with a three month gap.

Investment in Commercial Bank of Ceylon PLC

The voting rights of the Bank are currently restricted to 10%. However, two nominee Directors continued to serve on the Board of Directors right through the current year and consequently Commercial Bank of Ceylon PLC is classified as an associate company in the consolidated financial statements. The Bank's income includes a dividend of Rs423 million in the current year, 27% higher than Rs333 million in the previous year. The increase being due to timing differences in the payment. The consolidated profit includes (after elimination of dividend) a post tax profit of Rs656 million in the current year and is less than Rs728 million in the previous year. The market value of this investment on 31 March 2010 was Rs13,536 million compared to the cost of investment of Rs3,152 million. This is a significant increase compared to the market value of Rs5,049 million one year ago.

Other Subsidiaries, Associate Company (National Asset Management Limited) and Joint Venture (Acuity Partners Pvt Limited)

The collective contribution to profit after tax was Rs77 million in the current year compared to Rs50 million in the previous year. The Bank intends to progressively increase its investment in Synapsys Limited by Rs50 million to enable Synapsys Limited to expand its activities outside Sri Lanka.

Dividend Distribution

The Directors have recommended a first and final dividend of Rs6 per ordinary share, which will amount to a payment of Rs794 million. The total dividend pay out as a percentage of Bank's own profit after tax for the year ended 31 March 2010 is 46%. The total payout represents a 20% increase over the previous year.

Capital and Liability Structure

The Total equity of the Bank was Rs15,722 million on 31 March 2010.

Total interest bearing liabilities was Rs38,654 million with a gearing of 75% debt to 25% equity which is similar to the gearing in the previous year. The capital adequacy ratio on consolidated basis was 23.2% on 31 March 2010 (19.9% on 31 March 2009).