

CHAIRMAN'S MESSAGE



MANAGEMENT INFORMATION

It is my privilege and pleasure to present the Annual Report for the financial year ended 31 March 2011.

While two years have passed since the end of Sri Lanka's tortuously long conflict, 2010 represented an economic watershed for Sri Lanka as well as the world. For Sri Lanka it was the first full year of peace since the end of the conflict; for the world it was a period of recovery, albeit regionally uneven, from its deepest recession since the 1930s. Just as 2009 was adversely impacted by several negative developments, in 2010, the new found peace coincided with other positive factors, both internal and external, to create an environment conducive to realising Sri Lanka's true potential. The economy recorded an impressive growth rate of 8%, the highest for the past three decades and surpassing by far the 3.5% recorded in 2009. What is also encouraging is that the recovery took place across the board with all key sectors - Agriculture, Industry and Services - at least doubling their respective rate of growth. Another significant development was the recognition by the international financial community of Sri Lanka's consistent past economic performance and future

potential as reflected by the country's elevation to the status of a Middle Income Economy by the International Monetary Fund. This has had a salutary impact on Sri Lanka's global image and supported in no small measure the improvement in investor confidence, as demonstrated by the successful placement of the country's first 10-year sovereign bond last October amounting to US Dollars 1 billion.

The dawn of 2011 was full of promise. This was underpinned by moderate inflation, a low interest rate regime, foreign exchange stability, positive Government initiatives to reduce taxation and liberalise exchange control and a booming stock market. But as the early part of the year has witnessed, nothing can be taken for granted. The political unrest in the Middle East and the natural calamities in Japan, indicate that new situations can emerge virtually overnight with direct and indirect implications for Sri Lanka. Therefore, the challenge for Sri Lanka is twofold; to maintain the growth momentum achieved in 2010 while at the same time being prepared to face the impact of adverse internal or external shocks.

Diversification is a common strategy for managing risk. The Government's aim to transform Sri Lanka into an economic centre by developing five focused activity hubs is in harmony with such a strategy. While avoiding concentration risk, it also focuses on inherent strengths based on the country's geographic location, resources and needs. Nevertheless, it would be impractical for this strategy to be a stand-alone endeavour of the Government. The effort must be shared with the private sector with due engagement and partnership.

Public-private partnerships, on whatever scale, require an equitable risk-reward structure. It also requires that the outcome must represent value addition for all stakeholders, particularly the public. At the same time, such partnerships must not come to be regarded as the domain of a 'cartel' where opaqueness is the order of the day.



As such, openness and transparency are basic considerations, particularly when it comes to foreign direct investment. In this, the administration's efforts to ensure best practices and due process must continue with greater vigour.

I would like to move on to the financial sector. While the previous two years were periods of stress, 2010 witnessed an improved performance by the sector with strong balance sheet growth and increased profitability. Alongside this was the expansion of the delivery channels with a concerted effort in increasing the branch network in the Northern and Eastern provinces. During the year, the Central Bank of Sri Lanka, mindful of the events that took place in 2008 and 2009, reinforced its supervisory and regulatory framework. Some of its objectives were to strengthen the balance sheets and improve the robustness of risk management systems of financial institutions.

Key measures included the increase in the minimum capital requirement in stages by 2015 and a requirement for unlisted, locally incorporated, regulated financial institutions to obtain a listing on the Colombo Stock Exchange. These measures, laudable in their own right, have also opened the door for a consolidation of the industry. At the same time, the ongoing investment drive has increased the demands on the banking industry. Moreover, this demand has spilled over to the equity capital markets, which is a positive and long overdue development. On the other hand, cognisance must be taken of the fact that investment financing is essentially long-term in nature and that the domestic set up is still very much skewed to the shorter term in terms of funding. Addressing this structural deficiency will require a paradigm shift in the scale of domestic financial institutions and the depth of the local capital market. These are factors that

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would encourage the Regulators to look favourably towards the consolidation of the industry.

I now turn to the DFCC Group. Shareholders would know that a part of the voting shareholding of DFCC Bank (DFCC) in the former associate company - Commercial Bank of Ceylon PLC - was divested during the year reducing the total holding to 14% as directed by the Central Bank of Sri Lanka. DFCC will now drive its commercial banking business through its subsidiary, DFCC Vardhana Bank Limited (DVB) with even greater focus. DFCC recently increased its ownership in DVB to almost 98.9% from 95.6% as part of this strategy. In the current economic context, development banking and project financing has become even more relevant. But at the same time, the market dictates that these activities be complemented with commercial banking. Therefore the business

model for the Banking Business of the DFCC Group will comprise these two core activities carried out by two legal entities. DFCC will continue to concentrate on development finance while DVB will focus on commercial banking. This structure will retain the respective core skills and competencies under the two banks without any dilution. At the same time, both institutions will compete in the market as a fully integrated entity offering a full range of development banking and commercial banking products and services seamlessly through an integrated distribution channel.

As regards performance, I am pleased to report that the DFCC Group posted a consolidated profit after tax of Rs5,171 million. This is the highest ever in the history of the Group. Contributing to this profit was the one-off capital gain from the disposal of part of DFCC's shareholding in Commercial Bank of Ceylon PLC. Further details of the performance of the main business segments of the Group comprising of Banking Business delivered through DFCC and DVB and Investment Banking provided by Acuity Group, the equally owned joint venture with Hatton National Bank PLC, are given in the Chief Executive's Report and Management Discussion and Analysis.

I must also comment on the expansion of the distribution network of the DFCC Banking Business, where the focus was outside the Western Province. I am happy that headway has been made through the newly established branches in the North and East and that support to SMEs and entrepreneurs in these regions is gathering pace reflecting DFCC's role as Sri Lanka's premier development financial institution. The fact that our Banking Business has granted significantly more credit than raised deposits through the branches in the North and East is testimony to our continued commitment to support capital formation in all parts of the country.



The DFCC Group is on a sound launching pad for the next wave of growth. The financial resources are in place to be deployed in seizing gainful opportunities. The corporate structure encompassing DFCC and DVB in an operational merger is also in place and the unmatched capital market expertise and resources of the Acuity Group are at hand. We must therefore now look beyond the horizon.

What are the prospects? It was hinted in the mid 1990s that development banking the world over could soon be a sunset activity. Moreover, project financing was swallowed up or consigned as a peripheral business within universal banking operations, which often led to the dissipation of long-learned skills. However, DFCC remained steadfastly committed to its mission as Sri Lanka's pioneering and premier development bank and the opportunities are now there for this commitment to pay off. The project pipeline continues to strengthen and DFCC is not only a preferred financier, but is also regarded as a leading reference for project financing by the banking industry. At the same time, there is the symbiosis with DVB's commercial banking business. Besides operational and cost synergies, it is evident that a significant portion of future growth will be generated from cross selling development and commercial banking including the expansion of personal financial services. I am happy to report that approval of the Central Bank has been obtained for this business model to be continued and strengthened.

I thank my fellow Directors for their unstinted support and co-operation, and will continue to rely on their good counsel in meeting the challenges that lie ahead. I also wish to make reference to those Directors who left the Board;

Mr A M De S Jayaratne retired in April 2010 on reaching the mandatory retirement age while Mr T Caglayan retired in June 2010. Mr D S Weerakkody and Mrs Damitha de Zoysa (Government Director) resigned in July 2010. I thank them all for their valuable contributions. I welcome to the Board Mr R B Thambiyah and Mr C R Jansz, both of who joined in July and Mrs H M N S Gunawardana (Government Director) and Ms. S R Thambiyah (Alternate Director for Mr Thambiyah) who joined in August and October respectively. I also welcome Mr T K Bandaranayake (the former Alternate Director to Mr T Caglayan), who was appointed a Director in June 2010.

Mr C P R Perera, who is retiring from the Board by rotation has decided not to seek re-election at the Annual General Meeting. The Board will miss his valuable input. I thank him for the contribution he has made since 2005 and wish him well in his future endeavours.

Mr Nihal Fonseka, the Chief Executive Officer, has demonstrated yet again a high degree of leadership that continues to bring out the best in the DFCC team to deliver another successful year. Employees at all levels showed great commitment and I remain confident of their continued efforts in taking DFCC forward.

We regard all our clients as valued partners. Their success underpins the success of DFCC and we value each relationship. I thank them for their patronage and look forward to a long-term 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's endeavours,

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both in its development banking role and in its transition into a financial services group. I thank them and look forward to their continued support and co-operation in the future.

I, together with my colleagues on the DFCC Board, value the trust and confidence that you, our shareholders, have placed in our abilities to guide and direct DFCC. We thank you for giving us this privilege. In recognition of the good performance of the DFCC Group during the year, the Board has decided to recommend a final dividend of Rs3 per share. This, together with the interim dividend of Rs7 per share declared

earlier, represents a payout of Rs10.00 per share, or Rs20.00 per share prior to the dilution arising from the 1 for 1 bonus issue in November 2010.

The total dividend pay out amounts to Rs2,649 million and is a measure of the Bank's commitment to its shareholders. Going forward, we wish to assure you that we will continue to remain committed to increasing the value of your equity.



J M S Brito
Chairman

30 May 2011