

# FINANCIAL REVIEW

## MANAGEMENT DISCUSSION AND ANALYSIS

### INTRODUCTION

The profit after tax of DFCC Group in the financial year under review (referred to in this Review as 'current year') was Rs5,171 million, an increase of 193% over Rs2,684 million in the previous financial year (referred to as 'previous year'). This includes an exceptional profit of Rs3,001 million arising from the reduction of voting ordinary shares in Commercial Bank of Ceylon PLC (CBC) to 15% from 26.8% during the period June to August 2010. Since investment in CBC is carried at cost in the balance sheet of DFCC Bank, the profit on sale is the difference between the net sale price and the cost of acquisition of shares sold. In the consolidated balance sheet of the Group however, the investment is equity accounted and consequently the consolidated profit is the excess of net sale price over the equity accounted cost, i.e., although DFCC Bank's income statements report a higher profit on which financial services VAT is paid, the consolidated profit of the Group is lower.

The Income statements of the DFCC Group on page 85 include consolidated profit arising from the sale of CBC in the current year as well as the sale of Lanka Ventures PLC (LVL) to Acuity Partners (Pvt) Limited, a joint venture company of DFCC Bank, in the previous year.

Furthermore, it also includes the equity accounted profit of CBC for April and May 2010 in the current year and the full year in the previous year. These financial statements, while providing information in accordance with statutory requirements, makes year on year review of the performance difficult.

Therefore, for purposes of review we have provided supplementary financial information of the consolidated banking business comprising DFCC Bank and DFCC Vardhana Bank Limited (DVB) with adjustments. This supplementary financial information is on pages 76 to 80 and has been audited by KPMG Ford, Rhodes, Thornton & Co. The adjustments for purposes of review segregate the exceptional profit on sale of CBC in the current year and sale of LVL in the previous year and treats the investment in CBC as if it ceased to be an associate company on 1 April 2009 instead of 2 June 2010 with consequential adjustments to the current and previous years.

The predominant business of the Group is the banking business of DFCC Bank and DVB, referred to as DFCC Banking Business (DBB) and the investment banking and related services delivered through the joint venture company, Acuity Partners (Pvt) Limited and its subsidiaries.

### PROFITABILITY OF DBB

This Review based on the supplementary financial information referred to therefore firstly deals with DBB and thereafter contributions to group profit attributable to equity holders of DFCC Bank made by other members of the Group.

## DBB INCOME STATEMENT

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The adjusted profit after tax of DBB in the current year was Rs1,996 million, a 15.1% increase over Rs1,734 million in the previous year. DBB's profit drivers are net interest income of the credit portfolio derived from portfolio growth and interest margin, dividend income, gains from sale of non-affiliated share investments, fee and foreign exchange income and management of non-interest cost. Maintenance of credit portfolio quality is imperative to preserve the profit contribution from these profit drivers.

## NET INTEREST INCOME (NII) OF DBB

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NII was Rs5,031 million in the current year, a 6% increase over Rs4,745 million in the previous year. The current financial year was characterised by a low interest rate regime and intense competition for supply of credit in the context of the very high level of liquidity in the banking system. Thus the interest income of DBB was 18% lower in the current year despite the credit portfolio growth of 15% that was complemented by the improvement to the portfolio quality. Part of the reason for the relatively low growth in NII was that these positive developments were in the latter part of the current year and therefore the full benefit was not available in the current year.

The interest expense of DBB was 34% lower in the current year reflecting the lower interest paid on liabilities. Some of the higher-cost customer deposit liabilities were paid off without renewal with the sale proceeds of CBC shares. The pressure on interest margin was greater on DVB since it pursued a strategy of expanding its customer

base by attracting several high quality corporate customers, thus sacrificing short-term interest margin for long-term benefit that arise from such relationships. Expected benefits include greater trade finance opportunities that contribute to non-interest income from fees and foreign exchange transactions, and providing access to their employees to expand personal financial services.

## OTHER INCOME

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Other income of DBB was Rs1,720 million in the current year, an increase of 13% over Rs1,518 million in the previous year excluding the exceptional gains on part disposal of CBC shares in the current year and disposal of LVL in the previous year. Dividend income received by DFCC Bank made a significant contribution to the other income of the combined banking business (DBB) while the contribution from DVB also increased in the current year due to the success of strategies to increase trade finance business.

Due to the weakening of the US Dollar, there was a significant drop in the foreign exchange income in the current year. This was Rs28 million in the current year compared to Rs159 million in the previous year after adjusting for the US Dollar/LKR funding swap cost which is treated as an interest expense for the purposes of this review. The potential to benefit from foreign exchange fluctuation is limited for DVB due to its relatively small size restricting proprietary trading.

## OPERATING EXPENSES

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Non-interest expense in relation to operating income was 37.5% in the current year, an increase over the 34.1% recorded in the previous year. The increase is largely attributable to investments in

expanding the distribution network with concomitant head count increase in DVB and investments in technology to achieve a higher degree of automation. The pay back from these initiatives will be realised in the medium term.

## SPECIFIC PROVISIONS

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The gross specific provision of Rs1,225 million in the current year is 11% higher than Rs1,100 million in the previous year. However, due to concerted recovery action, the reduction in provisions through recoveries was Rs772 million in the current year, a 43% increase over the Rs541 million reduction achieved in the previous year.

## TAXES

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The financial services tax reduction from 20% to 12% was effective from 1 January 2011. It benefited only DFCC Bank in the current year, as a financial year ended 31 December 2010 is used for DVB for the consolidation.

## LOAN QUALITY

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The gross non-performing credit portfolio (NPL) comprising loans & advances, finance lease & Bills of Exchange of DBB was Rs4,475 million on 31 March 2011, a decrease of 21% from Rs5,683 million an year ago. As explained in Note No. 61 on page 142 the basis of classification of NPL on 31 March 2011 is more stringent compared to the basis on 31 March 2010. This was a significant achievement in reduction of NPL, particularly in the latter part of the financial year and augurs well for the future profitability of an expanded credit portfolio. The NPL ratio was 6.6% on 31 March 2011

reduced from 10.2% one year ago. While paying attention to recoveries of impaired credit portfolio, the specific provision coverage on NPL increased to 56.5% on 31 March 2011 from 37.7% one year ago.

## CONTRIBUTION TO PROFIT BY ACUITY PARTNERS (PVT) LIMITED

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Acuity Partners (Pvt) Limited, an equally owned joint venture between DFCC Bank and Hatton National Bank PLC, together with its subsidiaries constitutes a Group (APG) that provides a full range of investment banking services. During the current year, it made a significant contribution of Rs129 million to the profit after tax (PAT) of the DFCC Group, a four-fold increase over the Rs31 million in the previous year. Amount included in the Group PAT is the share of total PAT of APG attributable to equity holders of DFCC Bank.

## CONTRIBUTIONS TO PROFIT BY OTHER MEMBERS OF THE GROUP

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This comprises the profit contribution from Lanka Industrial Estates Limited, Synapsys Limited, DFCC Consulting (Pvt) Limited and National Asset Management Limited. The collective contribution to Group profit after tax by these entities was Rs65 million in the current year.

## DIVIDEND DISTRIBUTION

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In addition to an interim dividend of Rs7 per share, the Directors have recommended a final dividend of Rs3 per share, which will amount to an aggregate payment of Rs2,649 million. The total dividend payout as a percentage of DFCC Bank's own profit after tax for year to 31 March 2011 is 37%. The total payout represents a 233% increase over the previous year due to the exceptional one-off gain during the current year.

## REGULATORY CAPITAL

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This was significantly boosted by the part sale of the investment in CBC. While affording a sizeable equity cushion to the depositors and lenders, this tends to dampen the rate of return to equity shareholders until asset growth is financed through gearing.

## IMPENDING CHANGES TO ACCOUNTING STANDARDS

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These have been explained in Note No. 9 on page 103. The key component is the Standards on Financial Instruments regarding Recognition, Measurement and Disclosures.