

OPERATIONS REVIEW

MANAGEMENT DISCUSSION AND ANALYSIS

INTRODUCTION

This Review of Operations of the DFCC Group will deal with the core businesses of development and commercial banking that are delivered seamlessly through DFCC Bank (DFCC) and DFCC Vardhana Bank Limited (DVB) that will be collectively referred to as the DFCC Banking Business (DBB). This is followed by investment banking, which is largely channelled through our joint venture company, Acuity Partners (Pvt) Limited and its subsidiaries. The Review ends with a brief discussion on the activities of other companies within the DFCC Group. Consistent with the information presented elsewhere in the Annual Report, the year under review ('the year' or 'current year') for DFCC Vardhana Bank and Acuity Partners (Pvt) Limited is the financial year ended 31 December 2010, while the corresponding period for DFCC Bank and all other companies is the financial year ended 31 March 2011. Likewise, 'previous year' refers to the preceding financial year of the said entities.

DEVELOPMENT BANKING

PROJECT FINANCING FOR CORPORATE CLIENTS

A total of Rs18,071 million in credit and investment facilities, which was more than double the amount in the previous year, was approved by DFCC to finance investment projects of corporate clients. This was driven by favourable market factors, including a low interest rate regime and the continuing improvement in post-war investor confidence. Direct project loans accounted for the bulk of approvals, followed by indirect project loans to holding companies and financial intermediaries. Although there was a lag in disbursements, which is normal for large project loans, acceleration was seen in the fourth quarter. This helped to arrest the contraction of the project loan portfolio, which unlike revolving working capital loans, gets amortised. The total portfolio closed at Rs18,053 million as at 31 March 2011, around 5% below the Rs18,950 million at the beginning of the year.

An encouraging trend in the project financing pipeline was its increased diversity. Along with renewable energy, credit demand was also experienced from the manufacturing, construction, telecommunications, trade and financial services sectors. The year was also notable for the culmination of three landmark projects that demonstrated some aspects of DFCC's core competencies. In June 2010, the first private grid-connected wind power project in Sri Lanka was commissioned; DFCC's involvement with the project was not only as financier but also as a facilitator in the process of formulating the feed-in tariff for wind power plants. In February 2011, a Sri Lanka-led international consortium completed construction of the largest grid-connected small hydro power project to be developed in Uganda; DFCC carried out the initial financial feasibility study and planning for the project and facilitated its financing. In March 2011, the second Sri Lankan - developed

grid-connected small hydro power project in Uganda was completed; while the project was evaluated by DFCC, the funding was channelled through DVB due to exchange control related limitations applicable to DFCC, thereby highlighting the symbiotic relationship between development and commercial banking delivered seamlessly by DBB.

Asset quality of the corporate lending portfolio was maintained throughout, not only through diligent project appraisal and formulation at inception, but also by adopting a proactive strategy that included anticipatory and preventive action. This is borne out by a relatively low non-performing asset ratio of under 1% for corporate project loans as at 31 March 2011. Further, as shown below, the portfolio of project finance loans is well diversified, with four industry sectors, which include 12 manufacturing sub-sectors, accounting for about 75% of the credit exposure.

Sector	Exposure
Manufacturing	29%
Finance, Insurance & Real Estate	20%
Electricity, Gas & Water	13%
Community, Social, Education & Healthcare	12%

Looking ahead, project investment is gathering momentum with new demand for long-term funding as evidenced by the level of credit approved during the year. This also means a demand spill over for working capital and other short-term funding. In this context, DBB will look to capitalise on its unique identity as a strong development cum commercial banking operation.

FINANCING SMALL AND MEDIUM ENTERPRISES

The Small and Medium Enterprises (SME) sector was the one that was most adversely affected by the difficult global and local economic environment that prevailed in 2008 and 2009. The year commenced with positive signs of recovery of the SME sector following the restoration of peace, gradual recovery of regional economies and the low

interest rate and stable exchange rate environments. Project loan approvals to SME sector by DBB recorded a 95% growth to reach Rs35,167 million, compared to Rs18,060 million in the previous year. This included approvals of finance lease facilities that shot up four-fold following the reduction of import duty on vehicles and machinery in June 2010. SME approvals were mainly for the agriculture, food & beverage, healthcare, commercial transport, construction and trade sectors. Unlike in the corporate sector, the time lag between approval and drawdown of finance is relatively short in the case of SMEs. The total SME portfolio of DBB grew by 29% from Rs27,064 million to Rs34,991 million, with loans and leases accounting for about 80% of the portfolio, balance being financial leases.

A major portion of term loan facilities approved during the year were financed under credit schemes at concessionary rates of interest. Eight such credit schemes were utilised, namely Small & Medium Enterprises Regional Development Project (SMERDP), Southern Province Rural Economic Advancement Project, Agro Livestock Development Project, New Comprehensive Rural Credit Scheme, Awakening the North Credit Scheme, Resumption of Economic Activities in the Eastern Province Credit Scheme, KfW-DFCC Credit Scheme for SMEs in the Northern and Eastern Provinces and EIB Post-Tsunami Reconstruction Scheme. The ADB-funded SMERDP Credit Scheme was heavily utilised to finance 334 enterprises located outside the Western Province. Under this credit line DBB was the leading funder of such enterprises.

Although the non-performing advances ratio relating to SME finance provided by DBB was high at 11.8% at the beginning of the year, painstaking rehabilitation coupled at times with the orderly disposal of assets enabled the situation to be improved significantly by the end of the financial year. The non-performing loans advances and leases ratio relating to SME finance, excluding legacy loans under legal action for recovery,

was reduced to 6.5% with a significant reduction in the amount of such assets also being achieved.

DBB provides a comprehensive package of services to the SME sector. This included an ongoing programme of training and education of SME customers on important topics such as business management, entrepreneurship development, marketing and taxation. Several workshops were held during the year, in Colombo as well as the provinces, all of which were well attended.

SECTOR DEVELOPMENT AND CREDIT LINE MANAGEMENT

RENEWABLE ENERGY DEVELOPMENT

The World Bank and Global Environment Facility assisted Renewable Energy for Rural Economic Development (RERED) Project - Additional Financing credit line of USD40 million administered by DFCC was fully committed during the year, with 54% of the funds being disbursed by year end.

Since 1997, the three consecutive renewable energy credit lines administered by DFCC (namely: Energy Services Delivery Project, RERED Project and RERED Project-Additional Financing) have played a pivotal role in the private sector development of Non-Conventional Renewable Energy (NCRE) resources. By end-2010, the 168 MW of installed capacity funded by the three credit lines constituted 78% of the installed NCRE capacity in Sri Lanka.

An exciting development during the year was the commissioning of Sri Lanka's first privately owned on-grid wind power project. This 10 MW capacity project was implemented with financial and technical assistance from the RERED Project. Considering the potential for wind power in Sri Lanka's energy mix, DFCC, through the RERED Project, undertook a number of initiatives to facilitate its further development. The ongoing 'Sri Lanka Wind Integration Study' will determine the extent to which wind power could be integrated to the national grid. A working meeting on 'Advancing lender understanding of Wind Power Project Appraisal' was organised in association

with USAID - SARI Project for credit officers of RERED Participating Credit Institutions (PCIs). A study tour to China for PCIs to understand wind power and low head hydro power technologies and to Denmark for officials of the Ceylon Electricity Board and Ministry of Power and Energy to study wind projects and their integration to the grid were also organised as part of the capacity building initiatives.

The three renewable energy projects have also assisted in the electrification of over 138,200 off-grid households in rural Sri Lanka through solar home systems (SHS) and community-based village hydro schemes. Technical assistance activities carried out during the year included sustainability aspects, particularly in view of the rapidly expanding national grid. A study was launched to develop a mechanism for integrating existing village hydro schemes into the national grid. To assist the SHS industry, an independent study was undertaken to evaluate and improve loan recovery mechanisms employed by PCIs. Further, an eminent overseas consultant was engaged to formulate a future strategy for Sri Lankan SHS industry.

During the year, two separate teams from Ghana and Nepal visited Sri Lanka to study the RERED project, which is recognised internationally as a model renewable energy initiative.

PLANTATION DEVELOPMENT

The DFCC-managed credit component of the Plantation Development Project funded by the Asian Development Bank (which included a revolving fund set up by the Government of Sri Lanka) was successfully concluded in November 2010 with 100% disbursement of the JPY513 million and Rs2,000 million in loans. The Project assisted 14 regional plantation companies through 7 participating financial institutions in accessing long-term financing for their capital investment requirements.

SME DEVELOPMENT IN THE NORTH AND EAST

The EUR5 million KfW-assisted Small and Medium Enterprise Development Project in the North and the East is aimed at improving access to financial services through the banking sector for entrepreneurs in the two provinces, thereby increasing income and employment opportunities. As at 31 March 2011, refinance commitments and disbursements from five participating banks amounted to Rs242 million and Rs130 million, respectively. Most of the loans are small in value, typically less than Rs2 million each. The sectors funded were mainly agriculture, trading, construction and transport in the North and the East.

POST-TSUNAMI RECONSTRUCTION

The European Investment Bank-assisted Post-Tsunami Reconstruction Project provided assistance to revive the economies of 11 affected districts. At the close of the Project in December 2010, the total credit line of EUR60 million under the DFCC-administered scheme A (for directly and indirectly affected projects) was fully allocated and the 7 participating financial institutions had collectively disbursed Rs9,058 million (99.8% of the credit line). In addition to the economic development in tsunami affected areas, the assisted projects are estimated to provide over 3,000 employment opportunities in the leisure, health, manufacturing and service sectors.

LONG-TERM FUNDING

DFCC Bank's long-term funding base consists of credit lines obtained from multilateral and bilateral lending agencies as well as local long-term fund providers such as pension funds and savings banks. We continued to have access to drawdown on the European Investment Bank (EIB) Global II credit line. The objective is to borrow foreign currency denominated long-term financing for on-lending in either Sri Lankan Rupees or foreign currency to eligible borrowers who wish to avail of the benefits of the increased liberalisation of exchange control regulations in the country. The existing pool of funds consisted of foreign currency denominated borrowings, which when swapped into LKR contributed to managing the cost of funds. The exchange risk on swaps is managed within the risk limits framework of DBB.

The strong domestic credit ratings enjoyed by DFCC Bank and DVB stand them in good stead to access the local capital market to raise medium-term funding as well as attract customer deposits in the future. The management of cost of funds was a challenging exercise given declining rates and up to six months lag effect on benchmark indicators on borrowings and customer deposits.



Using RERED funds DFCC helped provide electricity to this community in Panamura Ella and also equipped them with a village computer center.

COMMERCIAL BANKING

CORPORATE BANKING

The corporate banking credit divisions of DFCC and DVB were operationally merged during the year. This has resulted in DBB delivering a wide range of development and commercial banking products and services through a dedicated distribution channel. In the integration process, the challenge of blending the development banking and commercial banking relationships without any deterioration in service quality or dilution of core competencies, was achieved successfully.

Surplus liquidity continued to be a feature of the market during the financial year. While credit demand remained skewed towards the short-term, the corporate portfolio utilisation (excluding Project Finance discussed earlier) grew by 80% to reach Rs5,490 million by the end of the year. The synergy realised from the merged operation was evident as this growth was achieved with virtually no change in DFCC's corporate banking organisation structure. Moreover, a considerable portion of this business was originated by cross selling commercial banking products to the corporate client base of DFCC.

Although a relatively new entrant in the sphere of international trade financing, DBB has made positive strides in this segment with strong growth recorded in both import and export related businesses. DBB is also continuing to expand its international correspondent banking relationships in regions with potential for more trade finance and remittance business.

BUSINESS BANKING

A new unit named Business Banking was set up within DBB during the year to serve the specific needs of the semi corporate end of the SME sector. This was identified as an under-served business segment. The Business

Banking hub office is in Colombo, with other designated offices and branches of DBB providing the required outreach. Credit facilities extended to Business Banking customers include asset financing loans and finance leases, working capital loans and advances, all types of trade finance and documentary collection services, construction finance, guarantee facilities, foreign exchange and payment services.

PERSONAL FINANCIAL SERVICES

PFS ASSETS

Personal Financial Services (PFS) and products are offered through the DVB network. These include overdrafts, personal loans, cash-backed advances, gold-pledged loans, housing loans and finance leases designed to cater to the diverse financial needs of individual customers. DBB's exposure to the PFS segment is still small, but it has been identified as a future growth sector. As a first step, positioning DVB as a PFS-oriented bank was undertaken by increasing the visibility among individuals through the 'DFCC Mindstar' quiz reality TV programme which has been a success in terms of viewer ratings. Considerable investment has been made in expanding the DVB footprint and developing a suite of products catering to various PFS segments.

Gold-pledged loans are a popular PFS product. The service standards hinge on providing a high level of privacy and speedy service to customers. Other popular PFS products include a cash-backed lending scheme branded Vardhana Cash-for-Cash for obtaining advances against fixed or savings deposits held with the Bank; a loan scheme designed for financing higher education named *Vardhana Nenasā*; and a housing loan scheme branded *Vardhana Sandella*.

An increasing number of customers avail of DVB's remittance services through the expanding domestic network. Steps are being taken to strengthen links with overseas money transfer companies, particularly in the Middle East, Europe, Far East and Australia mainly to cater to the needs of expatriate Sri Lankans.

RETAIL DEPOSIT MOBILISATION

The total customer deposit base of DBB stood at Rs27.2 billion. The deposit growth was static as DFCC's fund composition changed from deposits to other less costly sources of borrowings, which resulted in a decline in the deposit base, while DVB increased its deposit base by 6.6%. Retail deposits of DVB increased by 10.9% compared to the previous financial year. This growth rate is consistent with the average deposit growth rate in the banking sector during 2010. Given the high liquidity that prevailed throughout the year, DBB did not embark on mobilising wholesale deposits or aggressively seeking time deposits but focussed on increasing the proportion of low cost demand and savings deposits, which increased from 21% to 26% of total deposits, duly supported by an expanding branch network.

DELIVERY CHANNELS

Six branches were opened in Trincomalee, Jaffna, Vavuniya, Moratuwa, Embilipitiya and Pettah. In addition, 46 extension offices were opened at Post Office premises, many in rural areas, under an agreement with Sri Lanka Postal Department. With this expansion, DBB delivery channels increased to 49 branches and 75 extension offices, giving a total of 124 outlets by 31 March 2010. Priority was given to developing the footprint in the North and the East to support post-conflict economic revival of these Provinces, while the Uva and Southern Provinces will also be included in the coming year.

Channel management was streamlined across DBB and a regional management structure was introduced. Regional offices were established in Colombo, Kurunegala, Galle, Kandy and Kaduruwela.

TREASURY

DBB enjoyed comfortable liquidity through customer deposits, access to wholesale funding and internally generated funds. As such, there was no need to tap new wholesale funding during the year.

Customer related transactions of DVB generated significant income from both fixed income and foreign exchange related activities. Together with increased trade finance activity, Treasury was also able to profitably use the arbitrage opportunities that arose mainly in the US Dollar/LKR market.

The net interest income of Treasury arises out of investments in Treasury Bills & Bonds and money market operations. The Treasury continued to benefit by mismatches in maturities in assets and liabilities through higher yielding Treasury Bills and Bonds funded by money market borrowings and swaps. Treasury contributed a total gross interest income of Rs2,536 million, 26% of total gross interest income of DBB.

An integrated automated system to better manage and control DBB's trading activities in foreign exchange and fixed income securities was implemented during the year, thereby enhancing trading capacity with greater control over market and operational risks.

CAPITAL MARKETS AND INVESTMENT BANKING

The Colombo stock market continued with the previous year's bull-run and achieved new milestones in the process. The All Share Price Index crossed the 7,000 mark and reached a record high of 7,812 points in February 2011. The index gained 94% from 3,725 points to 7,226 points during the year ended

31 March 2011 compared to 125% the previous year. Liquidity levels increased significantly with average daily turnover rising from Rs892 million to Rs2,809 million during this period. Market valuations as measured by the Price Earnings Ratio increased from 18.4 times to 25.7 times. While this was driven by expectations of strong growth in corporate earnings and surplus liquidity, there was also an element of speculation.

Given the buoyant market conditions, DFCC adopted an active buy strategy based on fundamentals during the year. DFCC's investment portfolio, comprising quoted and unquoted equity and unit trusts, was increased from Rs818 million to Rs1,595 million (excluding the residual holding in Commercial Bank of Ceylon PLC). As at 31 March 2011, the market value of the quoted investment portfolio and unit trust holdings was Rs2,901 million, of which the unrealised capital gain was Rs1,379 million. Capital gains of Rs53 million were realised from sales of mature quoted and unquoted equity holdings. DFCC also has a small 'trading portfolio', that is a regulation-based, rather than an intentional classification, which recorded a marked to market gain of Rs29 million.

DFCC's Investment banking businesses are clustered as an investment banking group under Acuity Partners (Pvt) Limited, the equally owned Joint Venture with Hatton National Bank PLC. The favourable market conditions enabled all members of the Acuity Group and especially Acuity Stockbrokers (Pvt) Limited to turn in strong performances. The Acuity Group also executed several notable transactions and stands out among investment banks as offering the broadest range of financial services.

Acuity Group was involved in raising over Rs11,500 million in private and public equity, which included the largest private placement and the most successful Initial Public Offering, in terms of over-subscription on the Colombo Stock Exchange. It was also active in the debt capital market and was involved in several loan syndications.

OTHER GROUP BUSINESSES

Commercial Bank of Ceylon PLC ceased to be an associate company in June 2010 when DFCC reduced its equity holding. With this divestment, DFCC complied with a Direction issued by the Central Bank of Sri Lanka and the long drawn out litigation involving many parties relating to this shareholding was concluded.

Lanka Industrial Estates Limited, which owns and operates the industrial park at Sapugaskanda, recorded a steady performance with a profit after tax of Rs98 million. The Company is now exploring ways and means of diversifying its revenue base.

Synapsys Limited, the information and communication technology subsidiary, which provides all IT related services to DBB, reported a turnaround with a profit after tax of Rs7 million. A key product developed and launched by Synapsys was M-BANX. This is a mobile transaction platform that delivers asset and liability products to the customer's doorstep, as well as processing routine transactions. The platform has been successfully deployed in DVB and in a financial institution in the Maldives. DFCC invested a further Rs33 million in new capital in the Company. Several business models are under consideration to facilitate Synapsys to expand its reach overseas.

DFCC Consulting (Pvt) Limited undertook assignments that were mainly in the area of evaluating and financing of projects in the renewable energy sector. While the Company posted a small profit, it is now poised to take on some challenging overseas assignments.

National Asset Management Limited (NAMAL), the fund management associate, recorded an improved performance with a profit after tax of Rs22 million. The Company's ownership changed when a consortium led by Union Bank PLC acquired the 70% stake held by Milford Holdings (Pvt) Limited.