

FINANCIAL ANALYSIS

A. Overview

1. Nations Trust Banks (NTB), has experienced strong growth due to rising demand for financial services as the economy of Sri Lanka has recovered from a civil war that ended in 2009. NTB is a universal bank offering multiple products. It concentrates on serving small and medium-sized enterprises (SMEs) as part of a strategy to support demand in this segment, which is a large contributor to gross domestic product and employment. Total assets increased from SLRs49.8 billion in 2007 to SLRs100.8 billion in 2011, which represented a compound annual growth rate (CAGR) of 19.3%. Gross customer loans grew from SLRs29.9 billion in 2007 to SLRs60.8 billion in 2011 (CAGR: 19.3%). Total customer deposits also grew at a robust CAGR of 23.5% over the same period from SLRs28.0 billion to SLRs66.5 billion. As of 30 June 2012, total assets were SLRs118.4 billion, gross customer loans were SLRs71.6 billion, and total customer deposits were SLRs81.4 billion.¹

B. Capital Adequacy

2. NTB is well-capitalized with a Tier 1 ratio of 12.5% and total capital adequacy ratio (CAR) of 16.6% at the end of 2011. As of 30 June 2012, the Tier 1 ratio was 10.4% and total CAR was 13.6%.² NTB compares well with the average Tier 1 capital ratio of 12.7% in the country's banking sector and total CAR average of 14.3% at the end of 2011. NTB also exceeds the local regulatory minimum ratios of 5% and 10% and the Bank of International Settlements standards of 4.5% and 8% for Tier 1 capital ratio and total CAR, respectively.³ The bank's CAR improved 1.7% in 2011 over 2010 due to capital infusion through subordinated debentures of SLRs2 billion, retained earnings from net income of SLRs1.3 billion, and the conversion of warrants amounting to SLRs733 million. To date, all warrants have been exercised.

3. Due to demand across Sri Lanka and increased loan growth, NTB continues to invest in capital expenditure. The increase in capital will cover the majority of these expenditures. A continuous upgrading of infrastructure and the integration of Northern and Eastern provinces into the mainstream economy has increased the country's productive capacity. As a result, NTB increased its network from 40 branches in 2010 to 48 at the end of 2011. As of June 2012, NTB had 61 ATMs, 53 branches (primarily in Western Province), one leasing center, and seven personal banking centers. NTB has established four regional SME centers outside Colombo.

4. NTB is continually developing internet banking and is the sole franchisee of American Express credit cards in Sri Lanka. The bank in 2012 launched an International Finance Corporation (IFC) toolkit on its website and an SME portal is to be launched 2013 as an additional way to channel customer education and advisory services. Information systems were upgraded in 2011 in several key areas to enable the bank to serve its customers more efficiently and support future growth in its business.

5. The payment of dividends by the bank is restricted to the maximum of retained earnings. The final dividend for 2011, distributed in 2012, was SLRs484.2 million. In December 2011, NTB distributed SLRs461.2 million in dividends to its shareholders.

C. Asset Quality

6. **Loan portfolio.** NTB's loan portfolio grew from SLRs34.5 billion in 2009 to SLRs60.8 billion in 2011. This represented a CAGR of 32.7%, compared with the average banking sector

¹ Examples of the fluctuating US dollar–Sri Lanka rupee exchange rate during these periods include \$1 = SLRs133.26 (30 June 2012); \$1 = SLRs115.40 (31 December 2011); and \$1 = SLRs108.68 (31 Dec 2007).

² CAR is based on Basel II standards.

³ Central Bank of Sri Lanka. 2012. *Annual Report 2011*. Colombo. The end of 2011 figures are provisional.

CAGR of 18.6% over the same period. As of 30 June 2012, NTB's gross loan portfolio amounted to SLRs71.6 billion. The loan growth was due to (i) pent-up demand that had accumulated during the civil war which began in 1983 and ended in 2009; (ii) expansion of the bank's branch network outside of Western Province; (iii) growth of retail business from new market segments, such as auto loans; (iv) a strategic emphasis on growth of the bank's SME and leasing businesses through entry into new market segments, such as the commercial, agriculture, and machinery sectors; and (v) effective cross-selling of products and services within the bank.

7. **Small and medium-sized enterprise loan portfolio**The SME loans are used for business expansion; capital leases; manufacturing, assembling, and distribution; and working capital. SME overdrafts and term loans were both secured and unsecured. Primary demand for SME term loans came from agriculture and manufacturing industries and from the Western Province. However, as the northern and eastern regions continue to recover, the bank is projecting increased demand from these areas.

8. **Asset quality.** NTB uses the Central Bank of Sri Lanka (CBSL) standard loan classification specification. The nonperforming loan (NPL) ratio peaked at 8.5% in 2009 due to the impact of the 2008–2009 global financial crisis and the civil war, which ended only in May 2009. NTB's asset quality began a significant rise in 2010 and continued to improve in 2011. This reflected better political and economic conditions and the government's post-war recovery efforts. It was also due to NTB's use of improved risk management tools, such as statistical score cards for personal loans and credit card underwriting.⁴ SMEs are particularly sensitive to interest rates and susceptible to global economic slowdowns.

9. **Loan loss coverage.** Using the CBSL standard loan classification scheme. This was lower than the sector average of 57% over the same period due to the behavior of its loan portfolio and a concentration on leases.⁵ The bank classifies leases and credit card and consumer loans as nonperforming as soon as they become overdue and makes provisions according to its provisioning policy. These leases and loans remain classified as NPLs until all the arrears are settled, which results in such customers being classified as NPLs. NTB is compliant with central bank provisioning requirements and, according to Fitch, has more stringent requirements than minimum regulatory requirements.⁶

D. Liquidity and Funding

10. **Funding structure.** NTB's main funding source is its customer deposits. NTB has relationships with several IFIs, existing credit lines with Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden, and trade finance facilities with ADB and the IFC. NTB will continue to develop relationships with local and international commercial banks.

11. **Liquidity.** Most short-term deposits are rolled over. The short-term nature of deposits, robust loan growth, and the need for foreign funding due to the shallow capital markets will make ADB's funding under the project beneficial to NTB.

12. **Currency gap analysis.** NTB hedges open positions with regard to foreign exchange exposure. Hedging is done via local commercial banks or the CBSL.

⁴ ADB. 2012. *Trade Finance Program (TFP)—Nations Trust Bank Annual Review*. Manila.

⁵ Nations Trust Bank annual reports for 2009–2011; CBSL. 2012. *Selected Financial Performance Indicators for the Banking Industry*. Colombo.

⁶ Fitch Ratings. 2011. *Nations Trust Bank Full Rating Report*. Colombo (19 December). SME and retail, leasing, and factoring loans accounted for 66% of loans in 2011 and 61% in 2010.

13. **Earnings and profitability.** Net income grew from SLRs501.8 million in 2009 to SLRs1.4 billion in 2011, representing a CAGR of 67%, which was higher than the sector net income CAGR of 55% over the same period. Percentage wise, net income grew by 36.8% in 2011 (2010: 99.7%), which was faster than the sector average of 10.4% in 2011 (2010: 117.4%). Net income growth was mainly generated by net interest income, as well as by income from fees and commissions. The growth in net income in 2011 was given a strong boost by asset recoveries, which led to a large reversal of loan loss provisions.⁷ NTB's net income was SLRs1.7 billion as of 30 June 2012.

14. NTB's audited financial statements are prepared according to Sri Lanka Accounting Standards and audited by Ernst & Young Colombo. The table below shows the bank's financial highlights. The audited income and financial statements are in supplementary documents 10 and 11.

Nations Trust Bank Financial Highlights

Item	2009	2010	2011	June 2012 ^b
Total assets	69,978,230	82,416,846	100,821,640	118,376,587
Gross customer loans	34,539,757	43,631,157	60,794,418	71,619,582
Total deposits from customers	44,218,855	48,348,306	66,497,627	81,420,875
Total shareholder equity	4,186,187	6,131,519	7,774,970	8,116,297
Net income	501,801	1,001,937	1,370,928	1,651,204
Net interest margin	5.85%	6.27%	4.97%	4.62%
Cost-income ratio	64.09%	67.86%	72.59%	66.93%
Gross NPL ratio (>90 days), per NTB	8.50%	4.80%	2.83%	2.92%
Return on average equity	12.36%	19.42%	19.72%	20.78%
Return on average total assets	0.74%	1.31%	1.50%	1.51%
Capital adequacy ratio (%)	15.14%	14.91%	16.62%	13.57%
US dollar-Sri Lanka rupee average exchange rate (SLRs)	114.35	110.95	115.40	133.26

> = greater than, ADB = Asian Development Bank, NTB = Nations Trust Bank, NPL = nonperforming loan, US = United States.

^a Includes loans on non-accrual status for which full payment is doubtful, based on the assessment of management, and restructured loans that would otherwise be past due or impaired.

^b Unaudited

Sources: Nations Trust Bank and ADB.

⁷ NTB's income statement showed a positive loan loss provision of SLRs218.9 million in 2011 and negative SLRs209.1 million in 2010, representing a decrease of 204.7%. The loan loss provision for the banking industry was SLRs5.4 billion in 2011 and SLRs2.4 billion in 2010, representing an increase of 127.5%.