Hatton National Bank PLC

Company Update as at 3QFY11

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Hatton National Bank PLC

Hatton National Bank (HNB) is the second largest private Licensed Commercial Bank in Sri Lanka with an asset base of LKR379 bn as at end September 2011.

As per 3QFY11 the interest income has grown by 15% YoY (from 3QFY10 to 3QFY11) and 9% QoQ (from 2QFY11 to 3QFY11).

As per the 3QFY11 the interest expenses have grown by 22% YoY and 10% QoQ

During the period of 3QFY11, non interest income has dipped 5% YoY and 12% QoQ

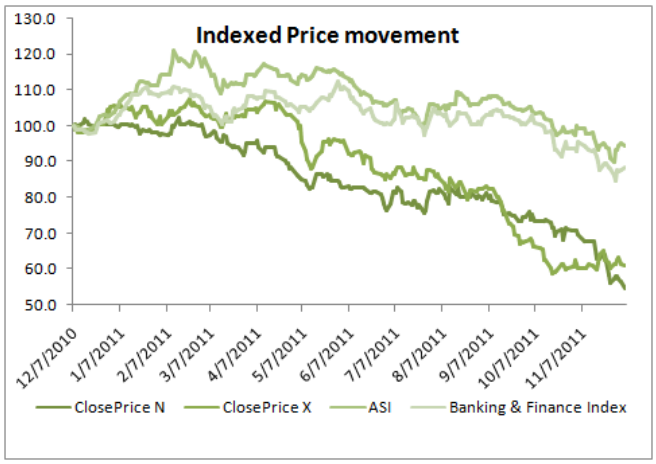
Based on 3QFY11, the growth in net profit is 32% YoY and 7% QoQ

As per 3QFY11, 5% of the total gross loans are non performing (gross non performing loan ratio) improving from 5.4% in 2QFY11 and 6.9% in 3QFY10

Liquid Assets Ratio of the bank stands at 22.14% (end FY10: 22.92%) and 29.31% (end FY10: 23.57%) respectively in Domestic Banking unit and Off-Shore Banking Unit, where the regulatory minimum is 20%.

As at end 3QFY11 the Core capital adequacy Ratio, as a percentage of Risk Weighted Assets stands at 11.84% from a previous 10.96% (end FY10) where as the minimum requirement is 5%. Similarly the Total capital adequacy ratio, as a percentage of Risk Weighted Assets is 13.80% in 3QFY11, improving from a 12.73% remained in end FY10 (minimum requirement is 10%).

In terms of earnings to price multiple; the Ordinary Voting share is attractively valued at 9.8x and 6.7x on FY11E and FY12E earnings respectively (based on a share price of LKR140.00). Similarly, the Ordinary Non Voting share is attractively valued at 5.6x and 3.8x on FY11E and FY12E earnings respectively (based on a share price of LKR79.90)



Major Shareholders as @ end September 2011	*% holding*
Voting	
Sri Lanka Insurance Corporation Ltd	**12.08**
Employees Provident Fund	7.67
Milford Exports (Ceylon) Limited	**6.53**
Stassen Exports Ltd	5.66
Brown & Company PLC	**5.61**
Non Voting	
Legalinc Trustee Services (Pvt) Ltd	**3.88**
Pershing LLC S/A Averbach Grauson & Co.	0.74
The Bank of New York Mellon SA/NV-CF Ruffer Total Return Fund	**0.64**
HINL-JPMCB-Butterfield Trust (Bermuda) LTD	0.49
The Bank of New York Mellon SA/NV-CF Ruffer Absolute Return Fund	**0.42**

Key financials			
Year ended 31st Dec	*FY2010*	*FY2011E*	*FY2012E*
Net interest income (LKR mn)	15,786.6	16,351.4	23,116.7
% change	*8%*	*4%*	*41%*
Net Profit (LKR mn)	4,786.8	5,223.4	8,068.3
% change	*7%*	*9%*	*54%*
EPS (LKR)	12.3	14.3	20.8
PE (voting)	11.4	9.8	6.7
PE (non voting)	6.5	5.6	3.8
DPS (LKR)	5.5	5.5	5.5
BVPS (LKR)	77.2	113.0	127.0
PBV (voting)	1.8	1.2	1.1
PBV (non voting)	1.0	0.7	0.6
ROE	17.0%	14.7%	17.8%

% Price movement			
	1m	**3m**	**12m**
Voting	**-22%**	**-33%**	**-45%**
Non Voting	1%	-26%	-38%

As at 31st March 2011	**Voting**	**Non voting**
Average daily turnover (LKR mn)	**22.0**	**9.5**
Shares in Issue (mn)	311.22	77.15
CDS quantity (mn)	**265.9**	**64.5**
Market Capitalization (LKR bn)	45	

Corporate Profile

Hatton National Bank (HNB) is the second largest private Licensed Commercial Bank in Sri Lanka with an asset base of LKR379 bn as at end September 2011. Bank, together with its subsidiaries, provides banking and related services in Sri Lanka and internationally.

The company's deposit products include non interest bearing deposits, savings deposits, term deposits, deposits redeemable at call, and certificates of deposit. Its loan portfolio comprises housing, personal, agricultural, animal produce, civil engineering, food processing, hotel and catering, light engineering, manufacturing, medical service, textile, trading, and transport loans.

The company's corporate banking services and products include working capital/operational finance, trade finance, project lending, lead financing for syndicate loans, standby letter of credit/bank guarantees, leasing, custodian services, and various forex/treasury products. Its activities also include offshore banking, mortgage financing, lease financing, corporate financing, dealing in government securities and quoted equities, pawn broking, stock broking, providing life and general insurance services, property development, credit card facilities, personal financial services, foreign currency operations, trade services, investment banking, development banking, rural finance, remittances and foreign currency related services, project finance, and other financial services.

As of end November 2011, the company is operating with 233 customer centers and 390 automated teller machines in Sri Lanka. Hatton National Bank PLC was founded in 1888 and is headquartered in Colombo, Sri Lanka.

Banking Sector Overview

The banking sector, being the most vital sector in the economy has concluded its year 2010, delivering an outstanding performance. The high performance was reflected through high rate of business growth, improved credit quality with favorable credit loss provision coverage, a high level of profitability and the maintenance of capital adequacy ratios well above the statutory limits.

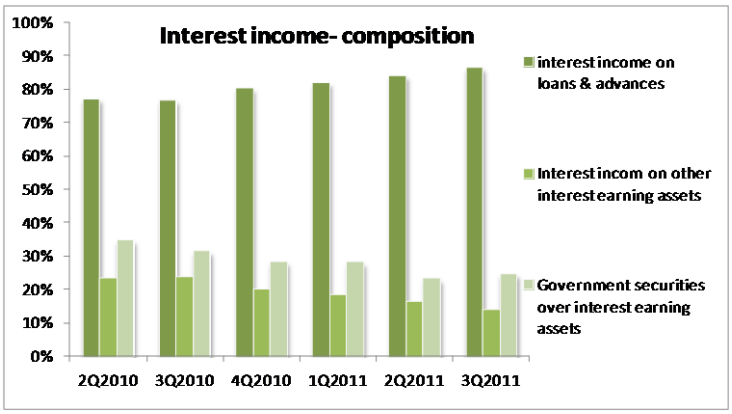
As at end of year 2010, the number of banks stood at 31, comprised of 22 licensed commercial banks and 9 specialized banks.

As per the latest available data for end June 2011, the total assets of Licensed Commercial banks approximate to LKR3, 255.6 bn an increase of 5% over 3 months where the assets position at the end of

March 2011 was LKR3, 095 bn. Similarly for end June 2011, total loans in the commercial banking system is LKR1,984 bn, an improvement of 8% over a 3 months period from a loan book of LKR1,838 bn during end March 2011. Signaling the improving loan quality in the economy, gross non performing loans in the commercial banking system have come down to LKR89 bn from a level of LKR93 bn prevailed prior to three months.

However the aforesaid growth in loans are achieved due to the relatively low interest rate environment, low unemployment, and brighter economic growth prospects. However a prolonged low interest rate regime would induce more credit demand and these will in turn lowered the quality of loans with rising non performing loans.

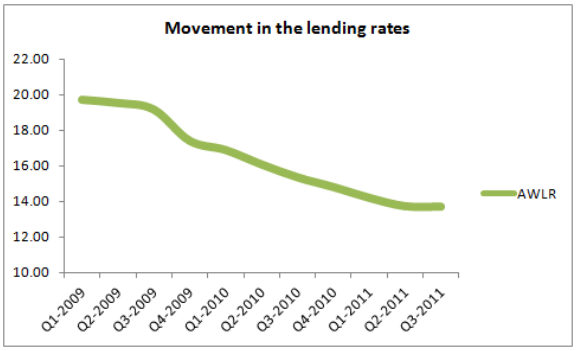
In addition, the growth in deposits within the commercial banking sector, have approximated to 5% over a 3 month period reaching a total deposit figure of LKR2, 323 bn. Moreover, the overall capital funds of the banking sector improved during the period, thus increasing the cushion available for absorbing risks.



Financial Performance

Interest income

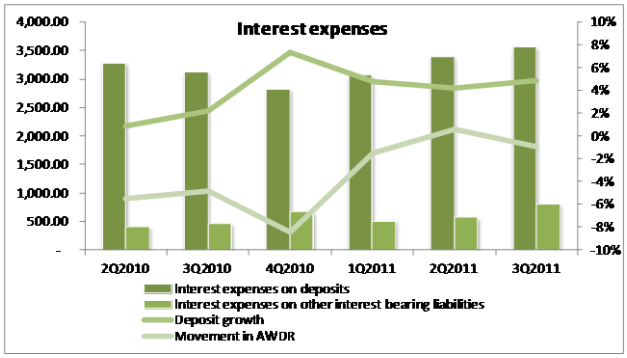
Interest income comprise of two major sources, interest income earned from loans and advances and interest income earned from other interest earnings assets including dealings in government securities, where a major contribution been given by earnings on loans and advances, which is in the range of 76%-86% on a quarterly basis. However, referring to historic quarterly result we can observe that contribution from other earning assets dipping. This was resultant from gradual decline in weight given on government securities in overall interest earning assets.



As per 3QFY11 the interest income has grown by 15% YoY (from 3QFY10 to 3QFY11) and 9% QoQ (from 2QFY11 to 3QFY11). The growth had been immensely supported by increasing earnings from loans and advances (30% YoY and 12% QoQ) in a situation where the interest earned from other earning assets showing a dip of 32% YoY and 7% QoQ and this type of behavior had been common in the overall banking sector. Interest income on loans and advances has shown a 30% YoY and 12% QoQ growth. More importantly this growth had been achieved in a period where the interest yields have

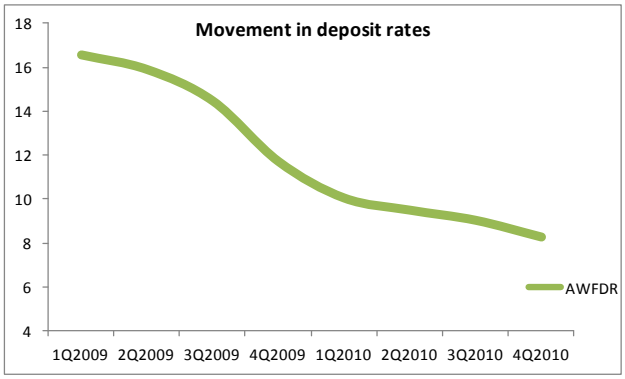
gone through tremendous pressure due to declining lending rates in the economy.

Referring to the previous full year FY2010, the interest income has shown a dip of 12% compared with FY2009. This is majorly due to the declining yields recorded in FY2010, where the interest yield has come down to 16% from a previously high of 20%. Yield has come down irrespective of a 23% increase in interest earning assets. Therefore declining yield is a result of diminishing lending rates in the economy. Nevertheless, over a time span of five years the bank has maintained a Compound Annual Growth Rate (CAGR) of 12% in interest income.

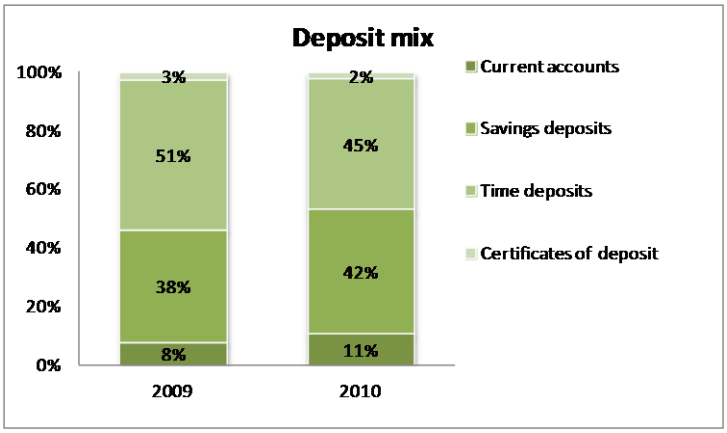


Interest Expenses

Interest expenses are dominated by expenses on deposits, where the deposits being the major funding base of the bank, constituting above 78% of the total funds. The rest of the interest expenses are born on other interest bearing liabilities, including borrowings and subordinated debenture. As per the 3QFY11 the interest expenses have grown by 22% YoY and 10% QoQ. Irrespective of a declining trend in deposit rates (AWDR) prevailed in the period, the interest expenses have grown due to the increasing volume of deposits. From 3QFY10 to 3QFY11, the deposits have increased by 23% similarly for a 3 month period from 2QFY11 to 3QFY11 the deposits have climbed by 5%. So that the increasing volume in funds utilized for lending purposes have caused the interest expenses to rise.



Further to that, the change in the low cost CASA (Current accounts & Savings accounts) mix from 3QFY10- 51% to 3QFY11- 49% has also given an upward pressure in interest expenses. The change is where during 3QFY11 savings deposits have grown by only 18% as oppose to a 28% growth in time deposits (in absolute terms the savings deposits have increased by LKR16 bn whilst time deposits increasing by LKR29 bn).



Referring to the previous full year FY2010, the interest expenses have shown a clear dip of 27%, which has been achieved together with a deposit growth of 11% and an improvement in CASA products from 46% in FY09 to 53% in FY10. However, as per 3QFY11, the CASA products out of total deposits have come down to 49% due to higher accumulation in time deposits. We believe that higher accumulation of time deposits made on a period of low interest rates would be beneficial for the bank, in an environment where we expect the

deposit rates to push up consequent to current macroeconomic changes taking place (ex: devaluation of rupee by 3%- budget 2012).

Net interest income

For 3QFY11 the Net interest income, difference between the interest income and interest expenses has recorded a growth of 9% YoY and 8% QoQ, the growth is a result of improving interest income over increasing interest expenses. As per the year ended 2010, the net interest income has shown a growth of 8% (from 2009 to 2010), compared with a growth of 16% (from 2008-2009) achieved over FY09. Even though the bank has achieved a dip of 27% in interest expenses during FY10, the growth in net interest income had been curtailed by the decline in interest income by 12%. Therefore the interest spread for FY10 stands at 10% slight lower from an 11% spread realized in FY09. And the net interest spread had remained at 8.4% level during both FY09 and FY10 relatively higher compared with net interest margins of 6.8% in FY07 and 7.3% in FY08.

Meanwhile, over a time span of five years the net interest income of the bank has grown at a compound rate of 17%.

Non- interest income

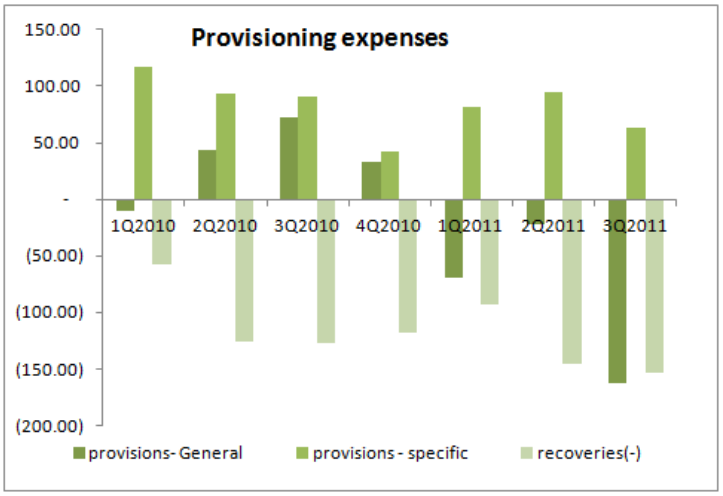
Non Interest income includes Foreign exchange profit, Fee and commission income and other income which include capital gains and recoveries. During the period of 3QFY11, non interest income has dipped 5% YoY and 12% QoQ. For the year ended FY10; the non interest income has increased by a 17%. Further, non interest income gives a contribution of 30% to the operating income.

Non Interest expenses (Operating Expenses)

Non- interest expenses include operational expenses incurred on staff, premises and equipment and other administrative expenses, where on average above 30% is personal cost. During 3QFY11, non-interest expenses have gone up by a 7% YoY, yet on a QoQ basis expenses have gone down by a mere 0.01%, more likely the cost base has remained stagnant. Referring to the year ended FY10; the operating expenses have gone up by 8% consequent to enhancing business volume. At the same time, operating expenses have taken a compound annual growth of 15% over a time span of five years.

Operating expenses (excluding loan loss provisions) measured relative to operating income would give a cost efficiency ratio (cost to income ratio) of 67% for the year ended FY10, which is in line with other commercial banks. However, the ratio has improved to 63% during 3QFY11.

Provision for loan losses



Similar to what we observed in most of the banks the provisioning is seen a negative LKR253 mn during 3QFY11 in HNB. One of the reasons being the write back in over provisions in general reserves in the light of adhering to the Central Bank directive requiring commercial banks to reduce the Statutory General Provision rate by 0.1 percent each quarter to 0.5 percent by the end of 2011 . Therefore during 3QFY11 the reversal had been LKR162 mn. Secondly, there had been recoveries amounting to LKR153.5 mn in loans which the bank has previously categorized as non performing. Also there had been recoveries in prior quarters too, owing to improving credit quality in the bank as well as in the economy. In addition to the above bank has made a specific provision of LKR63 mn to set aside to cover identified non-performing loans. The specific provisioning made for the quarter is a dip of 31% YoY and 33% QoQ.

As per the year ended FY10, the overall provision burden has shown a dip of 32% compared with FY09, and the compound annual growth in provision expenses is a negative 15% (for 5 year period) indicating that provision expenses are taking a declining trend due to improving loan quality.

Net profit (Profit attributable to equity holders)

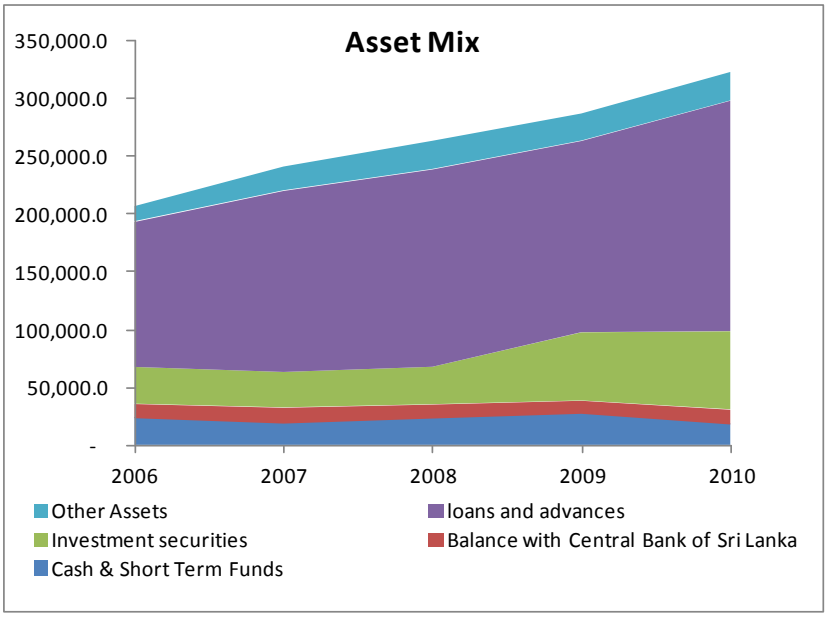
Net profits had taken a CAGR growth of 21% over a period of 5 years. Simultaneously, as per the year ended FY10, the YoY growth in net profit was 7%, and based on 3QFY11, the growth in net profit is 32% YoY and 7% QoQ ,where the current growth (growth in 3QFY11) has been achieved through a significant growth of 9% (YoY) and 8% (QoQ) in net interest income, 4% YoY 1% QoQ growth in operating income and a lower growth of 7% YoY in total operating expenses. And the other positives are the decline in tax rates (35% to 28%).

LKR Millions	3Q2010	2Q2011	3Q2011	YoY	QoQ
Interest income	**7,529**	**7,938**	**8,669**	**15%**	**9%**
-Int income on loans & advances	5,757	6,655	7,470	30%	12%
-Int income on other int earning assets	**1,771**	**1,283**	**1,198**	**-32%**	**-7%**
(-)Interest expenses	3,596	3,980	4,386	22%	10%
-Int expenses on deposits	**3,127**	**3,398**	**3,577**	**14%**	**5%**
-Int exp on other int bearing liab	469	582	809	72%	39%
Net interest income	**3,933**	**3,958**	**4,283**	**9%**	**8%**
Non interest income	2,014	2,168	1,911	-5%	-12%
(-)Non interest expenses	**3,689**	**3,942**	**3,942**	**7%**	**-0.01%**
(-) prov for bad & doubt debts & loan written off	37	(73)	(253)	-793%	246%
(-)Tax	**607**	**576**	**688**	**13%**	**20%**
Net profit attributable to equity holders	1,048	1,293	1,381	32%	7%

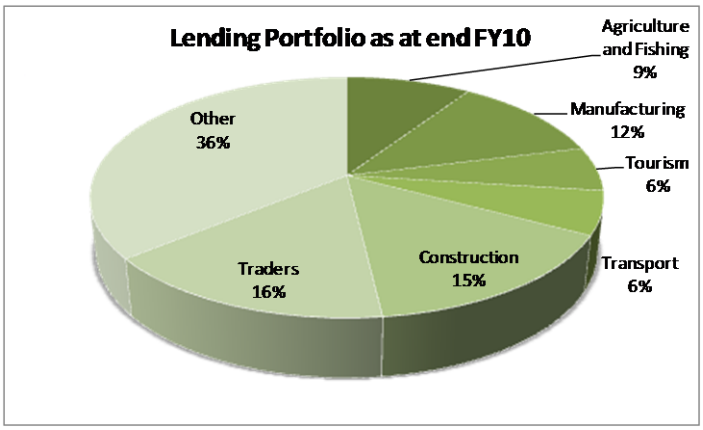
Asset Quality

HNB's asset base is dominated by loan disbursements, as at end FY10, the loans have accounted for 62% of the total assets whereas this has increased to 68% during 3QFY11. Therefore, loans' being the major income generating asset for the bank, quality of the loan portfolio is important.

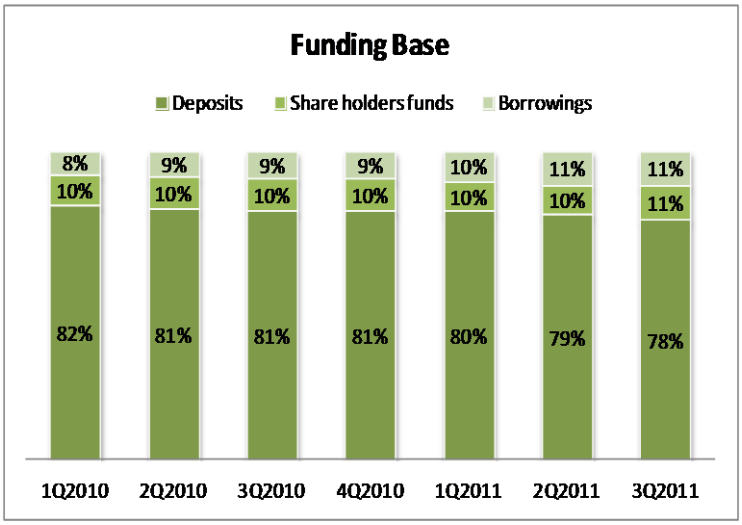
As per 3QFY11, 5% of the total gross loans are non performing (gross non performing loan ratio) improving from 5.4% in 2QFY11 and 6.9% in 3QFY10, being similar to the sector. Total non- performing loans as at end September 2011 has recorded a dip of 1% YoY (LKR151 mn) and 3% QoQ (LKR465 mn) to reach LKR12.9 bn whilst total performing loans growing at a massive 39% YoY (LKR68.7 bn) and 5% QoQ (LKR11.1 bn) to reach LKR244 bn.



Net NPL ratio (Non performing loans for in which provisions are not made) of the bank stands at 2.5% as at end September 2011 which has also improved from 2.7% in 2QFY11 and 3.1% in 3QFY10 (sector average for 2011 is 2.9%), affirming that asset quality of HNB is high and they are maintaining adequate provisions as to absorb potential risk arising from the loan book.



Apart from the above, in order to mitigate the overall credit risk, the bank is maintaining a well diversified lending portfolio covering all of the growth sectors in the economy. Whereas out of total loans 15.9% been given to the traders, 15.3% given to construction, 11.7% to manufacturing, 9% to Agriculture and fishing etc…

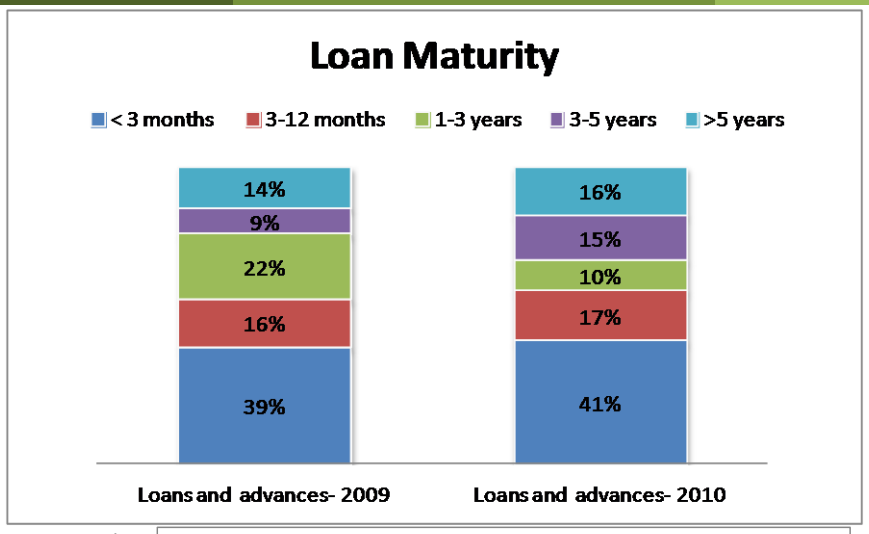


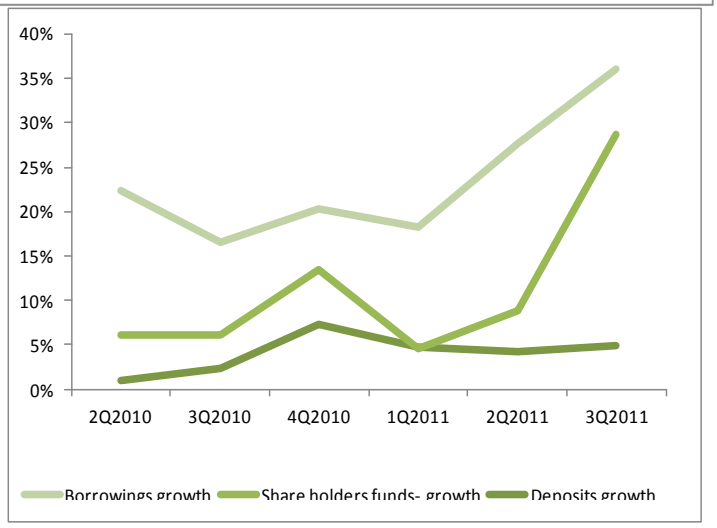
Funding and Liquidity

HNB's funding base is dominated by deposits of 78%, followed by 11% Share holder's funds and 11% borrowings (as per 3QFY11). During 3QFY11 the funding composition has slightly changed owing to the recently concluded Rights issue collecting LKR6.1 bn.

Bank's total deposits of LKR271 constitutes of demand deposits (8%) savings deposits (41%) time deposits (49%) margin deposits (1%) as at end September 2011. During 3QFY11, the overall growth in deposits had been 23% YoY (increasing by LKR50.6 bn) and 5% QoQ (increasing by LKR12.7 bn). And the deposits have grown at a compound annual growth rate of 12% over FY06 to FY10. In terms of composition of the deposits, 51% constitute of CASA deposits as at 3QFY10, but the weight on CASA products in total deposits has taken a down ward trend during 3QFY11 to 49%. Share holders' funds include stated capital and reserves. During 3QFY11, stated capital increased by LKR 6.1 bn to reach LKR11 bn, consequent to the proceeds from the rights issue, realizing a growth of 113% in stated capital. This has resulted in an overall growth of 37% YoY and 24% QoQ in total shareholders' funds.

Total Borrowings figure of LKR39 bn include funds obtained through Central Bank of Sri Lanka (CBSL) (4%), borrowings from banks & financial institutions in Sri Lanka (31%) and abroad (17%), securities sold under repurchase agreement, (35%) subordinated term debenture (12%) as at end September 2011. The growth in borrowings during 3QFY11 is 55% YoY and 7% QoQ. However for the period of 2006-2010 the compound growth is a negative 4%. Therefore we see that bank has been demanding for more credit in recent quarters to get the benefits of prevailed low interest rates. Further, these borrowings are more short term falling to less than three months bucket.





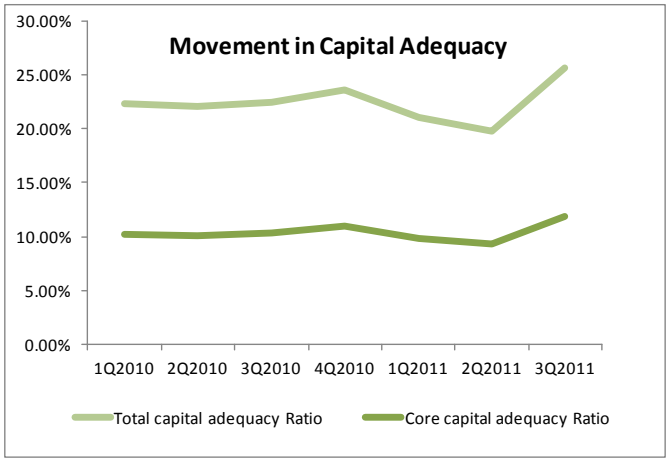
HNB's Asset Liability Maturity Mismatch (ALMM) in the "less than 1 year bucket" widened from a negative gap of LKR27, 420mn as at end FY2009 to a negative gap of LKR41, 373mn as at end 2010. This negative gap amounts to a 34% of interest earning assets as at the same date. The widening of the gap was primarily due to an increase in short term customer deposits during FY2010. Similarly, the positive gaps prevailed during FY09 in 3-5 years and beyond five years buckets further widened during FY10 as a result of bank's loan grants taking longer maturities. Therefore, during FY09 out of total loans, 9% were in 3-5 year bucket and 14% in above five year bucket, where as this composition had changed to 15% and 16% respectively in 3-5 year bucket above five year bucket during FY10.

LKR millions- FY2009	< 3 months	3-12 months	1-3 years	3-5 years	>5 years
Interest earning assets	**112,891**	**48,365**	**45,852**	**15,394**	**22,388**
Interest bearing liabilities	140,311	48,878	10,589	4,612	10,393
Gap	**(27,420)**	**(513)**	**35,263**	**10,782**	**11,995**
Cumulative gap		(27,933)	7,330	18,112	30,107

LKR millions- FY2010	< 3 months	3-12 months	1-3 years	3-5 years	>5 years
Interest earning assets	121,557	55,600	36,142	33,701	30,833
Interest bearing liabilities	162,930	50,146	13,228	5,188	4,484
Gap	(41,373)	5,453	22,914	28,513	26,349
Cumulative gap		(35,920)	(13,006)	15,507	41,856

The loan to deposit ratio (loans/ deposits) measuring the ability to cover withdrawals made by its customers of the bank is currently at 95% as at 3QFY11, compared with a ratio of 82% during 3QFY11. This indicates two situations. One is that the bank's liquidity position is lowering down and secondly it suggests that bank is relying more on borrowed funds for disbursements. However a higher loan to deposit ratio doesn't necessarily indicate that the liquidity position is curtailed. Referring to the latest available 3QFY10 data, the Statutory Liquid Assets Ratio of the bank stands at 22.14% (end FY10: 22.92%) and 29.31% (end FY10: 23.57%) respectively in Domestic Banking unit and Off-Shore Banking Unit, where the regulatory minimum is 20%.

Meanwhile, it is important to note that recent high loan to deposit ratio is a result of 55% YoY (3QFY10-3QFY11) growth in borrowings, where the bank has taken the advantage of low interest environment to expand the loan book volume at a state of higher demand for credit in the economy.



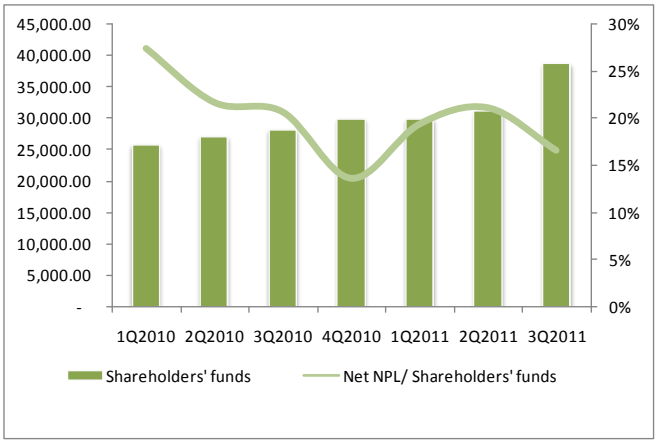
Capital adequacy

Capital adequacy is a measure of a bank's capital. This ratio is used to protect depositors and promote the stability and efficiency of the financial system. As at end 3QFY11 the Core capital adequacy Ratio, as a percentage of Risk Weighted Assets stands at 11.84% from a previous 10.96% (end FY10) where as the minimum requirement is 5%. Similarly the Total capital adequacy ratio, as a percentage of Risk Weighted Assets is 13.80% in 3QFY11, improving from a 12.73% remained in end FY10 (minimum requirement is 10%).

The major reason for the improvement in the capital adequacy is the capital infusion took place via a rights issue, during 3QFY11 to raise LKR6.1 bn stated capital. However prior to the rights issue the capital adequacy ratios were relatively low at 9.25% Core capital adequacy Ratio and 10.58% total capital adequacy Ratio. Similarly, the increase in subordinated term debenture during 3QFY11 by 77% YoY and 74% QoQ coupled with modest earnings retention (retention of 62% for FY2010) has further strengthen the capital adequacy.

Millions	1Q2010	2Q2010	3Q2010	4Q2010	1Q2011	2Q2011	3Q2011
Net non performing loans (Net NPL)	7,099.85	5,893.43	5,836.42	4,065.65	5,795.53	6,609.15	6,412.03
Shareholders' funds	25,847.13	27,178.67	28,245.11	29,978.11	29,931.40	31,293.48	38,743.61
Net NPL/ Shareholders' funds	27%	22%	21%	14%	19%	21%	17%

In terms of net NPL to shareholders' funds ratio of 17% as at end 3QFY11 remains one of the best among its peers, indicating adequate capitalization levels. This ratio measures the ability to bear the losses that may arise from non performing loans where for these loans bank has not made any provisions. Historically, the ratio has been maintained at lower levels and currently it has further eased down to 17% from a previous 21%, where the improvement is majorly due to the new capital infusion.



DuPont Analysis

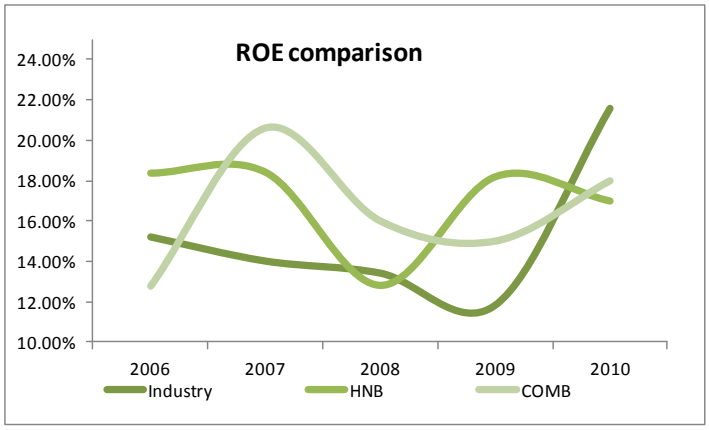
DuPont analysis is a methodology by which the ROE of a company can be broken down in to its constituent parts. ROE is a measure of how successfully the management of a company has deployed the equity to generate a return for its shareholders.

The ROE can be shown as a product of Earnings on assets and equity multiplier. The ratio of assets as a percentage of equity is known as equity multiplier.

With respect to HNB, the ROE for FY2010 is 17% (ROE in FY09 is 18%) which is derived through Earnings On assets of 1.60% and an Equity Multiplier of 10.83. However, the decline in ROE is a result of both declining earnings on assets from 1.65% in FY09 to 1.60% in FY10 and drop in equity multiplier from 11.17 in FY09 to 10.83 in FY10. Equity multiplier has come down due to the higher growth of 14% in average total equity whilst total average assets increasing by a lesser 11%. The slight decline in earnings on assets from 1.65% to 1.60% is a matter of slower growth in net interest income during FY10 where the slow growth in interest income is due to a 12% dip in interest income.

Net interest income/ Average Assets = Net interest margin * Earnings asset ratio

As mentioned above, there are two possible ways to improve the ratio of net interest income/ average assets. Firstly it is by improving net interest margin (Net interest income/average earnings assets), and secondly it is through increasing the ratio of interest earning assets to total assets (Earnings asset ratio).



During FY2010, the net interest income as a percentage of total assets has declined to 5.2% from a previous level of 5.3%. The reason for the dip can be analyzed using two basic ratios, including Net interest net interest margin and Earnings asset ratio. However, during FY2010, the Net interest margin has remained almost static, but the earnings asset ratio has slightly changed from 63% in FY09 to 62% in FY10.

DuPont Analysis		2007	2008	2009	2010
ROE	***a=b * c***	19%	13%	18%	17%
Earnings on Assets	b	1.43%	1.14%	1.65%	1.60%
Equity multiplier	c	13.08	11.41	11.17	10.83
Earnings on Assets	***b = d+e-f-g+h-i***	1.43%	1.14%	1.66%	1.60%
Net interest income/Average assets	d	4.9%	5.0%	5.3%	5.2%
Non interest income/Average assets	e	2%	2%	2%	2%
Operating costs/Average assets	f	5%	5%	5%	5%
Loan loss charges/Average assets	g	0.41%	0.46%	0.26%	0.16%
Share of associate comp profit/ Average assets	h	0.01%	0.00%	0.00%	0.00%
Tax/Average assets	i	1%	1%	1%	1%
Net interest income/Average assets	***d= j*k***	4.9%	5.0%	5.3%	5.2%
Net interest income/Average Earnings assets	j	6.8%	7.3%	8.4%	8.4%
Earnings asset ratio	k	73%	68%	63%	62%

Risk Management

Risk management is a fundamental part of HNB's business activities. To keep risk management at the centre of the executive agenda, it is embedded in the everyday management of the business.

Credit Risk

Credit risk is defined as the potential for loss arising from the failure of a counter party to perform according to its contractual arrangement with the bank. It includes failure in repayment of capital or interest in full within the agreed time period. HNB has a well diversified credit portfolio in terms of concentration, business segments and industry representing a major source of income and over 2/3rd of its asset base, consequently safeguarding portfolio quality is of paramount importance.

The credit approval structure broadly sets out banks' credit strategy and discretionary lending. Also bank operates a sound credit granting process adopting a committee based approval structure, where all approval signatories carry equal responsibility for credit risk. Further, in order to mitigate the risk of default in loan grants, bank is maintaining an appropriate credit administration, measurement and monitoring process.

Liquidity and Interest Rate Risk

At a portfolio level the banks' loan book is comfortably financed by retail deposits, therefore reliance on wholesale deposits and interbank market is minimal. As mentioned earlier, the non existence of long term borrowing instruments at affordable cost results in some maturity miss match in the asset book (borrow short and lend long). However, this is considerably mitigated by a large stable and growing low cost deposit base.

Conceptually the bank is exposed to interest rate risk arising from a predominantly fixed rate liability book (especially in deposits, because majority of the borrowings are short term) where reprising is significantly slower than the largely fixed rate lending portfolio in a reducing interest rate scenario. However empirical results indicate ability to protect its net interest margins despite declining rates.

Operational Risk

Operational risk is the risk of direct or indirect losses resulting from human factors, external events, and inadequate or failed internal process systems. Operational risks in the bank are managed through a comprehensive internal control framework.

Market Risk

Market risk is the possibility of loss in "on and off balance sheet positions arising from changes in the value of financial instruments due to movements in market variables such as interest rates, exchange rates equity, and commodity prices.

A comprehensive Board approved Treasury Policy is in place and is regularly updated to reflect regulatory and developments.

Future Outlook

In the short term, the launch of the new SME product in 2011 will energize the Bank's operations in the sector, sharpening the focus, and increasing the scope and scale of SME services. It is expected that in the medium term, SME will contribute significantly to the bank's overall business performance whilst acting as a catalyst in the economic performance of the nation.

In the medium term, the bank envisages opportunity to further strengthen the development finance sector in the Northern and Eastern Provinces. The bank will continue to work in close partnership with the Central Bank of Sri Lanka with the objective of achieving national priorities.

In the medium term bank will follow a strategy of expansion with focus on growing strategic alliances and partnerships to harness inward remittances. The bank is evaluating new markets for inward remittances and these include Israel and Australia.

The bank views relationships as the key to future business sustainability especially in the area of treasury operations. It looks to utilize the synergies and linkages from the bank's other operational sectors for business development and will direct its synergies towards rigorous management of assets and liabilities, trading in fixed income and forex as well as the introduction of new products going forward.

Increasing competition and fragmentation of the market place will call for greater focus on marketing in the year ahead. Whilst maintenance of loyalty and consolidation of existing customer base will remain critical for the bank, consumer relevant advertising incorporating the bank's ethical beliefs and shaping of promotional activity will lead the approach towards customer retention.

Valuations & Recommendation

Being benefited from prevailing favorable macroeconomic fundamentals supported by expected growth of 8.2% in GDP for 2012 and Interest rates expected to hover around repo rate of 7% next year due to uncertain global conditions and the need to maintain growth and Improved growth outlook elevated through sovereign rating upgrade and capital infusion of LKR6.1 bn during 3QFY11, we believe HNB would achieve a growth of 32% in earnings assets together with an elevation of 46% in the loan book by the end of 2011. Already the bank has achieved a growth of 24% in the loan book for a nine months period. These would result in a net profit of LKR5,223.4 mn for 2011E and a further LKR8, 068.3 mn for FY12E.

Valuation dashboard				
HNB (N) : 140.00 (X) : 79.90	**2010**	**2011E**	**2012E**	**2013E**
Interest income ***mn***	30,563.8	32,668.5	40,378.8	46,140.2
Growth	***-12%***	***7%***	***24%***	***14%***
Interest expenses ***mn***	14,777.2	16,317.1	17,262.1	18,988.0
GRowth	***-27%***	***10%***	***6%***	***10%***
Net interest inome ***mn***	15,786.6	16,351.4	23,116.7	27,152.2
Growth	***8%***	***4%***	***41%***	***17%***
Operating expenses ***mn***	16,073.4	16,368.6	22,189.9	26,340.3
Growth	***8%***	***2%***	***36%***	***19%***
Net Profit ***mn***	4,786.8	5,223.4	8,068.3	9,365.7
Growth	***7%***	***9%***	***54%***	***16%***
EPS	12.3	14.3	20.8	24.1
DPS (N), (X)	5.5	5.5	5.5	5.5
PE (N)	11.4	9.8	6.7	5.8
PE (X)	6.5	5.6	3.8	3.3
ROE	17.0%	14.7%	17.8%	17.1%
BVPS	77.19	112.98	127.03	155.66
PBV (N)	1.81	1.24	1.10	0.90
PBV (X)	1.04	0.71	0.63	0.51
Sector PE	11.7			
Sector ROE	15.4%			
Sector PBV	1.80			
Market PE	14.3			
Market ROE	15.7%			
Market PBV	2.24			

However, due to tense competition posed through other finance institutions (both government and private) including LCB's RFC's, LSB's the market share of HNB would remain saturated yet dominating as a key player in the banking sector. Therefore, we believe the interest spreads would squeeze in medium to long term, from a current level of 8% to a long term average of 7%-9%.

Similarly, HNB with a credit rating of AA- (lka) would be in a favorable position in terms of attracting funds to fuel its lending. We believe a deposit growth of 29% for FY11E and 7% for FY12E, where bank has already achieved a growth of 13% for a nine month period.

In terms of earnings to price multiple; the Ordinary Voting share is attractively valued at 9.8x and 6.7x on FY11E and FY12E earnings respectively (based on a share price of LKR140.00). Similarly, the Ordinary Non Voting share is attractively valued at 5.6x and 3.8x on FY11E and FY12E earnings respectively (based on a share price of LKR79.90)

Based on an analysis of a historic 52-week price movement of HNB (Voting), we derived a price movement of +/-31.5 on a mean of LKR225.9 hence the flux is approximately +/-14%. Furthermore, if it is assumed that the same upside price movement is seen pushing the price to LKR171.50 (from a current level of LKR140.00), and the forward PE multiples would be 12x for FY2011E and 8.3x for FY2012E.

Simultaneously, based on an analysis of a historic 52-week price movement of HNB (X) we derived a price movement of +/-20.8 on a mean of LKR120.4 hence the flux is approximately +/-17%. Adding further, if it is assumed that the same upside price movement is seen pushing the price to LKR100.7 (from a current level of LKR79.90), and the forward PE multiples would be 7.1x for FY2011E and 4.9x for FY2012E.

Price assimilation - Non Voting				
	FY11E	***FY11E****	***FY12E***	***FY12E****
	100.74	**146.33**	**100.74**	**146.33**
PE	7.05	10.23	4.85	7.04
PBV	0.95	1.38	0.79	1.15
**the maximum price recorded within a period of 1 year*				

Price assimilation - Voting				
	FY11E	***FY11E****	***FY12E***	***FY12E****
	171.50	**272.53**	**171.50**	**272.53**
PE	11.99	19.06	8.26	13.12
PBV	1.61	2.56	1.35	2.15
**the maximum price recorded within a period of 1 year*				

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