INDEPENDENT VALUATION OF SHARES

HNB FINANCE LIMITED

NEXIA MANAGEMENT SERVICES (PVT) LIMITED

NEXIA MANAGEMENT SERVICES (PVT) LTD.

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The Board of Directors,
HNB Finance Ltd,
No. 168, Nawala Road,
Nugegoda.

Dear Sirs,

VALUATION OF EQUITY SHARES – HNB FINANCE LIMITED

As requested by you, we have carried out a detailed analysis of the operations of HNB Finance Ltd (HNBF) to arrive at the fair value of HNBF's shares based on valuation methodologies considered as appropriate for the purpose of this valuation.

We believe that the information and explanations obtained from the management of HNBF were sufficient for us to arrive at an independent opinion on fair value of shares of HNBF.

Further, we confirm that Nexia Management Services (Pvt) Ltd is not a related party of HNBF nor has significant interest in or financial connection with the HNBF or any of its group companies.

The detailed valuation report is enclosed herewith for your reference.

Thanking you.

Yours faithfully,

S. Sendan

Director
NEXIA MANAGEMENT SERVICES (PVT) LTD.

Date 22/01/2020

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GLOSSARY

HNBF	HNB Finance
PER	Price-earnings Ratio
RI	Residual Income
IPO	Initial Public Offering
EBITDA	Earnings before Interest, Tax, Depreciation & Amortisation
EBIT	Earnings before Interest & Tax
TTM	Trailing Twelve Months
EPS	Earnings per Share
PAT	Profit after Tax
BV	Book Value
PV	Present Value
NI	Net Income
AWPLR	Average Weighted Primary Lending Rate
LKR	Sri Lankan Rupee

1. SUMMARY OF VALUATION RESULTS

We have carried out a detailed analysis of the business operations of HNBF to arrive at the fair value of HNBF's shares based on the three methodologies and the results have been summarized below.

Valuation Methodology	*Value Per Share (LKR)*
1. Peer Group PE	2.88
2. Residual Income	5.32
3. Discounted Future Earnings	8.16
Weighted Average Value Per Voting Share	6.13
Price per non-voting share (Range)	2.10 – 5.96

Based on the valuation results, we believe that HNBF shares (Ordinary Voting Shares) would have a fair value in the range of LKR 2.88 – LKR 8.16 per share, given the company's business fundamentals and the industry dynamics in Non-Bank Financial Institution Sector.

Considering healthy marketability of shares, we recommend base limit for share value of HNBF of LKR **6.13 per ordinary voting share** for the purpose of the IPO.

Based on the valuation results, we believe that HNBF shares (Ordinary Non-Voting Shares) would have a fair value in the range of LKR 2.10 – LKR 5.96 per share, given the company's business fundamentals and the industry dynamics in Non-Bank Financial Institution Sector.

Considering healthy marketability of shares, we recommend base limit for share value of HNBF of LKR **4.47 per ordinary non-voting share** for the purpose of the IPO.

2. TERMS OF REFERENCE

HNB Finance Limited, a subsidiary of Hatton National Bank PLC, is a Licensed Finance Company domiciled in Sri Lanka. The company commenced its operations in year 2000 with the main focus on women in rural areas and promoting financial inclusion through a hybrid model of the Grameen micro finance concept.

The company has achieved a rapid growth since its incorporation and the Board of Directors has now decided to list the company on Colombo Stock Exchange.

In compliance with listing regulations, the management has decided to obtain the services of an independent party for the purpose of justifying the IPO Offer Price. Accordingly, the management has requested Nexia Management Services (Pvt) Ltd to carry out an independent valuation of the company shares.

3. VALUATION METHODOLOGY

There are three basic ways of valuing a business.

1. Earnings based valuation
2. Market based valuation
3. Asset based valuation

A number of valuation techniques are available under each method. However, considering the industry & the business model of the HNBF, the valuation team determined Residual Income method, Peer PE method and Discounted Profit after Tax method as appropriate methods for valuing HNBF.

We did not consider Assets Based Valuation method since Net Asset Value may not be suitable for a company which operates as a going concern.

3.1 Residual Income Method

Residual income is net income less a charge (deduction) for common shareholders' opportunity cost in generating that income. Traditional financial statements are prepared to reflect earnings available to owners. Net income includes an expense to represent the cost of debt capital (interest expense). Dividends or other charges for equity capital are not deducted. Traditional accounting leaves to the owners the determination as to whether the resulting earnings are sufficient to meet the cost of equity capital. The economic concept of residual income, on the other hand, explicitly considers the cost of equity capital.

The Residual Income for a given year is determined as below;

$RI_t = E_t - (r \times B_{t-1})$

where,
RI_t = residual income in year t
E_t = expected earnings for year t
r = required return on equity
B_{t-1} = book value of equity in year t-1

In the Residual Income Model (RIM) of valuation, the intrinsic value of the firm has two components:

1. The current book value of equity, plus
2. The present value of future residual income

This can be expressed algebraically as:

$$P_0 = B_0 + \sum_{t=1}^{t-1} \left[\frac{RI_t}{(1+r)^t}\right] + TV_t$$

Where,

P_0 = intrinsic value in year 0
B_0 = book value of equity in year 0
RI_t = residual income in year t
r = required return on equity
TV_t = terminal value at year t

The Terminal Value at year t (TV_t) in a continuing residual income model is calculated using the following standard formula.

$$TV_t = \frac{RI_t}{(1+r-\omega)(1+r)^{t-1}}$$

Where,
TV_t = terminal value at year t
RI_t = residual income in year t
r = required return on equity
ω = persistence factor

The persistence factor determines the sustainability of excess net income over required rate of return. If the excess net income is expected to continue perpetually then the persistent factor is assumed as "1". Accordingly, if it is expected to diminish just after the initial forecast period persistent factor is assumed as "0". The persistence factor could be any value between "0" and "1" depending on the estimate on firm's ability to persist with its competitive advantage.

The RI method was considered as an appropriate technique, taking into account the fact that it is an ongoing business, dealing primarily in financial assets.

3.2 Market Multiples Method

Value multiples such as Value to EBITDA or Value to EBIT cannot be easily adapted to value financial service firms, because neither value nor operating income can be easily estimated for these companies. Hence, for the valuation of shares we have used Market Multiples approach which takes into account the market multiples of listed peer companies. Price-earnings ratio (PER) and the Price-to-book value ratio (PBV) are commonly used market multiples in business valuation. The PBV was not considered since assets of HNBF was not utilized at optimal levels until recently. Therefore, we have used PER for the valuation purposes.

The two most common variations of PER based valuation are trailing 12-month price-earnings ratio and forward price-earnings ratio: The first is calculated by dividing the current price by the earnings per share for the trailing 12 months (TTM P/E), the second by dividing the current price by the estimated earnings per share for the next fiscal year (forward P/E). We have considered the forward P/E method for the valuation of HNBF shares.

We used forward P/E method as it considers future growth/earning potential of the company's operation. Which is the most suitable basis for investment decisions.

The share value under PER is calculated as follows:

$Share\ Price = Forward\ EPS$ for next year (Note-1) × $Peer\ group\ PER$ (Note-2)

(Note-1, forward EPS calculated here in is for 2019/20 financial year and this is given in page no. 26)

(Note-2 "peer group PER" calculated here in this report is based on the historical financial information of peer group companies and this figure is given in page no. 09)

Where,

EPS = earnings per share

PER = Price-to-Earnings ratio

3.3 Discounted Earnings After Tax

Estimating cash flows for finance companies is problematic since measuring reinvestment, i.e. net capital expenditure & working capital, in these firms is difficult. Hence, an alternative approach is required to estimate cash flows. For financial service firms, operating cash flows are not separately computed and Profit after Tax (PAT) is considered a close substitute to operating cash flows. Therefore, we have considered the discounted PAT as a suitable method for valuing equity of HNBF.

We have used discounted Profit After Tax in calculating share price of HNBF as banks and non-bank financial institution sectors are not mainly assets based operation. We did not consider EBITDA in determining share price as it is not a mainly considered figure in banking industry.

The first step in valuing equity shares under this method is to estimate the future earnings of the company. The future earnings are split into two stages, i.e. the earnings during the planning horizon and the terminal earnings. The perpetuity formula is used to estimate the terminal value of equity.

The projected earnings attributable to equity holders are then discounted at cost of equity of the firm. The share value is calculated as follows:

$$Share\ Value = \frac{(PV\ of\ earnings\ during\ planning\ Horizon + PV\ of\ terminal\ earnings)}{No\ of\ shares\ outstanding}$$

4. VALUATION RESULTS

4.1 Peer Group Price Earnings (PE) Method

Valuation of shares based on sector multiples may not be feasible if the companies are different in respect of size, products offered, profitability, etc. Therefore, in order to derive value based on market multiples, it would be more meaningful to consider closely related companies (peer group) with similar characteristics.

Based on our analysis, following five companies were selected as peer companies and their PER was computed based on EPS for the 12 months ended 31st March 2019 and share prices as at 24th July 2019 as published by Colombo Stock Exchange.

Company	EPS as at 31/03/2019	Closing market price as at 24/07/2019 (Rs)	PE Ratio
Commercial Credit & Finance PLC	6.54	29.50	4.5
Citizen Development Business Finance PLC	31.49	81.50	2.6
Nation Lanka Finance PLC	0.16	0.80	5.0
Arpico Finance Company PLC	50.10	145.00	2.9
Asia Asset Finance PLC	0.94	8.00	8.5
Mean PER			**4.70**

A discount rate of 10% has been applied for a lack of comparability and the size of the business. We have not factored the discount for the lack of marketability as HNBF will get listed in the near future.

HNBF EPS (forward) *Note - 1*	0.68
Mean PE of the peer group	4.7x
Discount for lack of comparability & size	10%
Post discount PE	4.2x
Value per share (LKR)	2.88

Note – 1: this is expected EPS for financial year 2019/20 as per forecasted financial statements of the HNBF (1,164,748,202/1,719,580,624 = 0.68).

4.2 Residual Income Method

(LKR)	2018/19 A	2019/20 F	2020/21 F	2021/22 F (a)
Net Income	830,595,822	1,164,748,202	1,519,850,549	2,162,753,701
Book Value of Common Equity	4,629,467,204	5,468,016,380	6,866,278,885	8,704,619,530
Beginning BV of Common Equity		4,629,467,204	5,468,016,380	6,866,278,885
(Beginning BV of Equity) X (Cost of Equity)		833,304,097	984,242,948	1,235,930,199
Residual Income		**331,444,105**	**535,607,600**	**926,823,501**
Discount Factor @ 18%		0.847	0.718	0.609
Present Value of Residual Income		**280,884,835**	**384,665,039**	**564,093,396**

Return on Common Equity:

Cost of Equity:	18%
Present Value of Equity Calculations:	
Current Value of Equity: (LKR)	4,629,467,204
Sum of PV of Residual Income: (LKR)	1,229,643,270
Terminal Growth Rate: (LKR) *(Please refer section 4.3)*	5.00%
Estimated Year 3 NI to Common: (LKR) **(a)**	2,162,753,701
Residual Income Terminal Value: (LKR)	5,415,845,156
PV of Res. Inc. Terminal Value: (LKR) **(b)**	3,296,250,563
Present Value of Equity: (LKR) **(c)**	9,155,361,038
Shares Outstanding	1,719,580,624
Implied Share Price (LKR)	**5.32**

Note: Estimated year 3 NI to common equity, PV of residual income terminal value and present value of equity were calculated as follows;

(a.) *Estimated year 3 NI to common equity*

Forecasted Net Income (Profit) in 2021/22 financial year. This Rs. 2,162,753,701 /=

(b.) *PV of residual income terminal value*

PV of residual income terminal value = RI terminal value / (1+COE) ^3
= 5,415,845,156 / (1+0.18) ^3
= 3,296,250,563

(c.) *Present value of equity*

Present value of Equity = Current Value of common equity + sum of PV of RI + PV of RI terminal value
= 4,629,467,204 + 1,229,643,270 + 3,296,250,563
= 9,155,361,038

4.3 Discounted Future Earnings Method

(LKR)	2019/20	2020/21	2021/22
Earnings attributable to equity holders	1,164,748,202	1,519,850,549	2,162,753,701
Discount factor	0.847	0.718	0.609
Discounted Earnings	987,074,747	1,091,533,000	1,316,318,672

Discount factor (cost of equity)	18%
Terminal growth rate	5%
No of shares	1,719,580,624
Total PV of earnings (LKR) **(a)**	3,394,926,419
Terminal value (LKR) **(b)**	17,468,395,275
PV of terminal value (LKR) **(c)= (b x 0.609)**	10,631,804,660
Equity value (LKR) **(d)=(a + c)**	14,026,731,079
Implied Share Price (LKR)	**8.16**

Note: Terminal Value, PV of Terminal Value and Equity Value were calculated as follows;

(b.) *Terminal Value (LKR)*

Terminal Value = Net Income in year 2021/22 (1+K) / (K – g)
= 2,162,753,701 x (1+0.18) / (0.18 - 0.05)
= 17,468,395,275

(c.) *PV of Terminal Value (LKR)*

PV of Terminal Value = Terminal Value x discount factor in 2021/22 at 18%
= 17,468,395,275 x 0.609
= 10,631,804,660

(d.) *Equity Value (LKR)*

Equity Value = Total PV of PAT + PV terminal value
= 3,394,926,419 + 10,631,804,660
= 14,026,731,079

Non-bank financial institutions sector is generally considered to be positively correlated with the GDP growth. Sri Lanka achieved a GDP growth in excess of 5% for last ten years and it is expected to grow at 4.8% by 2024 as per the IMF report issued in May 2019. We are of the view that the industry growth would coincide with the GDP growth rate during next five years and hence the industry would, at a minimum, be able to maintain a 5% growth rate.
(Source: https://www.imf.org › media › Files › Publications)

4.4 The Weighted- Average Share Price

The weight for the share value derived from each method is determined according to the relative suitability of the valuation method for a finance company.

Valuation Method	Share Price (LKR)	Weight	Weighted Price (LKR)
Residual Income	5.32	25%	1.33
Peer Group PER	2.88	25%	0.72
Discounted Future Earnings	8.16	50%	4.08
Weighted Average Share Price			**6.13**

4.5 Valuation of Non-Voting Shares

A company's voting shares and non-voting shares are often identical except for the difference in voting rights granted to each class of shares. Hence, a discount for lack of voting rights (DLVR) is often applied to the value of voting equity in order to derive the value of non-voting equity.

One way to estimate the DLVR is to analyze the trading price of the shares of publicly traded companies. As at 23rd September 2019, 21 listed companies had non-voting shares according to Colombo Stock Exchange. We have analyzed the share price difference between voting & non-voting shares of these companies for trailing 6 months in order to arrive at the average trading discount for non-voting shares. Accordingly, the average discount for lack of voting rights was estimated at 27% per share ***(Note)*** and the value per non-voting share of HNBF is as follows.

Valuation method	Peer Group	Residual Income	Discounted future earnings
Price per voting share (LKR)	2.88	5.32	8.16
Discount for lack of voting rights @ 27%	(0.78)	(1.44)	(2.20)
Price per non-voting share	**2.10**	**3.88**	**5.96**

(Source: Nexia analysis based on trading data retrieved from www.cse.lk)

Note: Discount for Lack of Voting Right (DLVR) was calculated as follows;

S/N	*Company Name*	*Average price in last 06 months*		*Lack of voting right*
		Voting Shares	*Non-Voting shares*	
1	Blue Diamonds Jewellery Worldwide PLC	0.59	0.27	54%
2	Ceylon Hospitals PLC	75.43	70.28	7%
3	CIC Holdings PLC	46.22	34.26	26%
4	Citizens Development Business Finance PLC	82.86	63.90	23%
5	Commercial Bank of Ceylon PLC	98.04	84.60	14%
6	Hatton National Bank PLC	157.39	135.35	14%
7	Laufs Gas PLC	16.72	13.20	21%
8	Maleatte Valley Plantations PLC	6.56	4.20	36%
9	Renuka Holdings PLC	15.27	10.53	31%
10	SMB Leasing PLC	0.44	0.25	44%
11	Seylan Bank PLC	58.64	34.65	41%
12	Toyota Cement Company (Lanka) PLC	25.74	21.35	17%
13	Celinco Insurance PLC	1,920.64	802.97	58%
14	Lucky Lanka Milk Processing Company PLC	1.26	0.79	38%
15	Renuka Foods PLC	15.76	10.19	35%
16	Morision PLC	728.53	578.67	21%
17	Nations Trust Bank PLC	83.55	80.23	4%
18	Serendib Hotels PLC	17.35	13.12	24%
19	Tess Agro PLC	0.47	0.41	11%
20	The Finance Company PLC	No trading in last 06 months		-
21	Agstar PLC	No trading in last 06 months (Non-V)		-
	Average lack of Voting Rights			**27%**

5. FORECASTING METHODOLOGY & ASSUMPTIONS

5.1 Forecasting Methodology

The Residual Income & Free Cash Flows based valuation methods discussed in the foregoing section of this report require forecasting of financial statements in order to obtain necessary input data for the valuation. The management of HNBF has prepared forecasted financial data for three years as part of their ***Strategic Business Plan (2019 -2022).***

We have analyzed these projections with the supporting computations and underlying assumptions used by the management to determine whether said projections are appropriate for the valuation purposes. We satisfy with the underlying assumptions and projections made by the management in Section 5.2 of this report.

We have used following sources of information & methodology to analyze the financial projections of the management:

1. The Audited Financial Statements were analyzed in order to review the historical performance of HNBF and to identify possible trends and key performance indicators.

2. The projected financial statements were assessed in light of the future outlook of Non-bank Finance Sector.

3. The key growth strategies included in the Strategic Business Plan (2019 – 2022) of the company was discussed with the management to determine the feasibility of these strategies.

4. The underlying assumptions and the resultant financial projections were discussed with the management, analyzed with data collected independently, and modified where necessary to ensure projections remain relevant & appropriate for the purpose of this valuation.

Key excerpts from the above analysis are set out in the next section of this report together with main assumptions used by the management in projecting financial statements.

5.2 Review of underlying forecast assumptions based on industry/company analysis

5.2.1 Industry Analysis

Overview

The Non- Bank Financial Institutions (NBFI) sector comprised of 43 Licensed Finance Companies (LFCs) and 5 Specialized Leasing Companies (SLCs) by the end of 2018. At end 2018, there were 1,373 branches and 658 other outlets of the LFCs and SLCs sector, out of which 927 branches (68 per cent) were concentrated outside the Western Province. *(source: www.cbsl.lk annual report 2018).*

The recent performance of Non-Bank Finance Institutions (NBFI) sector was not impressive with low credit growth, reducing profits, and increase in non-performing loans. This moderate growth was mainly due to fiscal & macro-prudential policy measures introduced by the government to curtail importation of motor vehicles, moderate economic growth, and natural hazards such as floods & drought prevailed during recent times.

However, the key performance indicators of the NBFI sector in respect of capital, liquidity & profitability remained positive.

We have used information published by CBSL up to December 2018 (CBSL Annual Report-2018) for industry analysis. Assuming no significant changes in 1st quarter of 2019 financial year (Jan-Mar 2019) in Non-Bank Financial Institution sector, forecast for financial year 2019/20 was analyzed.

Profitability

The net interest income of the Non-Bank Financial Institution sector (NBFI) increased at a slower rate than in 2017, recording a growth of 6% with aggregate net interest income recorded at Rs. 108.8 billion in 2018. *(source: www.cbsl.lk annual report 2018)*

The slowdown of net income growth rate can be attributed to rising interest rates. Rising interest rates result in finance companies' deposit base re-pricing faster than its assets as bulk of the assets continue to be in leasing where interest rates are fixed for an average 5 years while over 90% of the deposits are 1 Year which re-price at a faster pace. Several of the Finance companies have successfully moved to loans and advances, however still around 50% of the portfolio is concentrated in leasing and hire purchase (Chart -2).

Non-interest income of the sector increased by 11.9 per cent mainly due to the increase in default charges and other service charges, while non-interest expenses also increased by 1.5 per cent, affecting adversely towards sector profitability, mainly due to the increase in staff costs. *(source: www.cbsl.lk annual report 2018)*

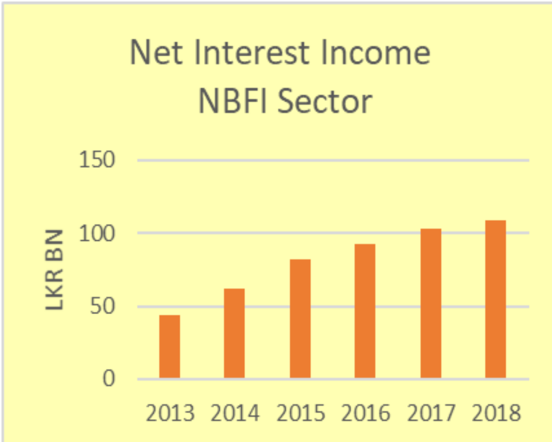

Chart -1
(Source: Central Bank annual reports 2013-18)

Chart -2
(Source: Central Bank annual report 2018)

Assets

The total asset base of the NBFI sector at the end of 2018 was Rs. 1,431.3 Mn. Out of the total assets, Loans & Advances accounted for 79.4% (Rs. 1,136.4 Mn). As Indicated by chart -3, the loans & advances portfolio has expanded at a slower rate than in 2017. Given the monetary tightening measures, new LTV (loan-to-value) rules and the currency depreciation, vehicle leasing segment is likely to register a slowdown while loans and advances segment record the bulk of the growth. *(source: www.cbsl.lk annual report 2018)*

Due to the increase in duty on vehicles, the new registrations of vehicles have dropped significantly (chart -4). Further, revision of the LTV ratio of Motor Vehicles upwards to 25% for three wheelers and 50% for Cars also negatively affect the growth in leasing and Hire Purchase for new vehicles. *(source: www.cbsl.lk annual report 2018)*

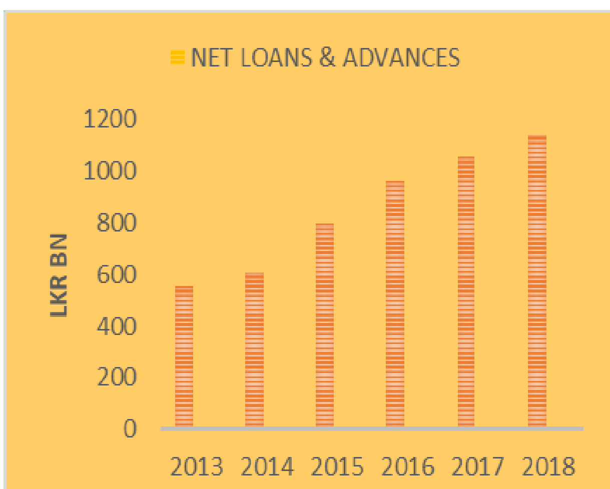

Chart -3
(Source: Central Bank Annual Reports 2013-18)

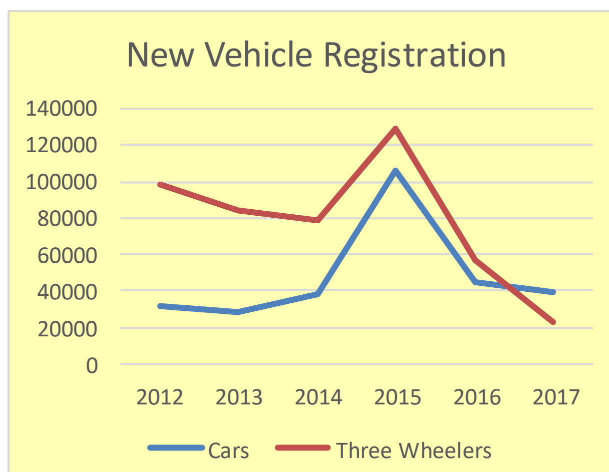

Chart -4
(Source: www.transport.gov.lk/statistics)

Liabilities

Customer deposits accounted for 50.1% of the total liabilities of NBFI sector in 2018. As indicated by chart -5, the deposits grew at a slower rate in 2018 compared to the growth rate in 2017. Time deposits accounted for 95% of the total deposits. *(source: www.cbsl.lk annual report 2018)*

The second largest constituent of the sector liabilities was the borrowings which accounted for 29.2% of total liabilities. Borrowings recorded a growth of 17.1 per cent (Rs. 67.8 billion) in 2018, a shift from the negative growth recorded in the year 2017. Deposit growth slowed down to 4.4 per cent, compared with the growth of 29.4 per cent recorded in the corresponding period of 2017. *(source: www.cbsl.lk annual report 2018)*

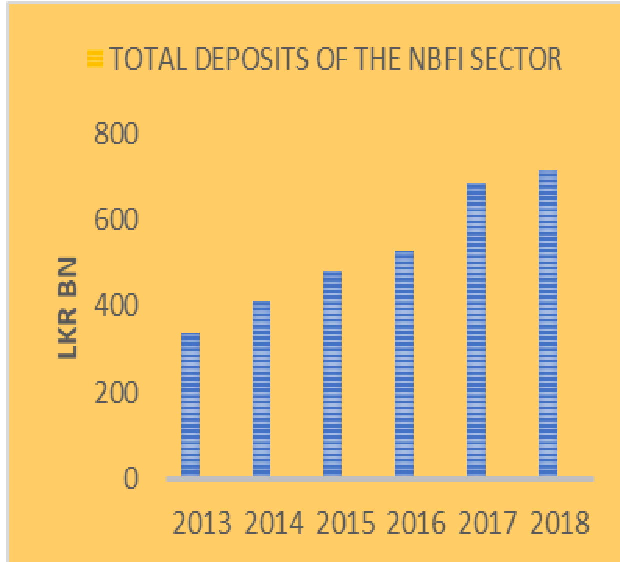

Chart -5

(Source: Central Bank Annual Reports 2013-18)

5.2.2 Review of Key Assumptions

Next three years forecast is prepared by the HNBF management based on the following assumptions. We did not use any assumption and we analyzed the assumptions made by the management based on the future strategic plans and historical data provided by HNBF.

Net Interest Income

According to the Strategic Business Plan for 2020-2022, the management expects to introduce new financial products (Trade finance, housing loans, personal loans, gold loan, Islamic loan etc) and move into new sectors (hardware & construction, fisheries, etc). The income expected from these initiatives have been factored into the projections. For existing products, current growth rates are assumed to be continued into the future.

Management further expects that the industry will be turnaround during 2020-2022, thereby, they have increased the loan targets as per below table. In order to counter act to the government macro & prudential measures in the recent past, company had introduced new products such as Gold Loans and also increase the dependence on the SME sector whilst taking steps to rationalize exiting product portfolio. Management's expected future disbursement from leasing is focus on the existing vehicle market & moreover micro leasing to be promoted. Hence, curtailment of the government action to shrink the vehicle importation may have not impacted in a significant manner.

Projected product wise loan disbursements

Product	2020	2021	2022
Loan - Diriya	22,262,380,000	25,539,567,373	28,189,850,507
Loan - Sahana	2,571,000,000	2,688,846,850	2,716,653,250
Loan -Divisaru	3,168,650,000	3,802,380,000	4,334,850,450
Loan - EZY	3,410,751,249	3,772,172,833	4,502,270,800
Loan -Abhilasha	2,502,400,000	2,681,113,425	3,292,098,558
Loan -Swashakthi	838,175,000	927,935,261	1,077,602,238
Loan - SME Saviya	2,015,000,000	2,620,800,000	3,276,000,000
Loan - Cooperate Relax	162,000,000	162,000,000	362,000,000
Loan - Housing Niwahana	930,000,000	1,209,600,000	1,209,600,000
Disbursment - Leasing	10,661,000,000	14,040,000,000	16,800,000,000
Gold Loan	944,200,000	2,280,960,000	2,509,056,000
Total	**49,465,556,249**	**59,725,375,742**	**68,269,981,803**

Further, the management expects to earn future interest income from their existing product portfolio and from the new products as disclosed below.

<u>Interest income from Existing Product</u>

Product	2020	2021	2022
Interest Income - DIRIYA	4,220,277,988	4,552,618,583	5,125,077,423
Interest Income - SAHANA	232,207,500	239,607,848	244,498,793
Interest Income - EASY	600,772,187	634,994,570	767,514,592
Interest Income - Abhilasha	516,240,533	523,502,447	615,789,860
Interest Income - Swashakthi	150,550,340	179,472,344	210,095,223
Interest Income -SME Saviya	340,858,429	667,086,389	989,394,868
Interest Income Cooperate - Relax	76,759,112	87,808,039	102,115,780
Interest Income - Housing Niwahana	170,090,384	335,115,726	472,814,328
Interest Income Loan - Against Deposit	6,693,780	7,289,935	7,290,079
Interest Income - Personal Loan	71,222,963	73,345,944	74,966,914
	6,385,673,215	**7,300,841,826**	**8,609,557,860**

Interest income from recently implemented and new Product

Product	2020	2021	2022
Interest Income - Leasing	2,317,989,163	4,166,292,850	5,956,699,640
Interest Income - Divisaru	401,386,144	682,251,535	823,298,681
Interest Income - Gold Loan	87,834,000	490,905,600	1,063,426,560
	2,807,209,307	**5,339,449,985**	**7,843,424,882**

Interest Income from Investments

Investment	2020	2021	2022
Interest Income -Treasury Bill	139,889,278	318,639,278	484,013,088
Interest Income - Treasury Bonds	2,496,268	2,496,268	2,408,245
Interest Income - Debenture	16,875,000	16,875,000	15,468,750
Interest Income - Fixed Deposit	23,000,000	23,000,000	21,083,333
Interest Income - Saving	72,000,000	72,000,000	72,000,000
	254,260,546	**433,010,546**	**594,973,417**
Total	**9,447,143,068**	**13,073,302,357**	**17,047,956,158**

Interest Income on Gold Loans

As of March 2019, the company has started gold loan product within 26 branches. The management is expecting to expand this product to other branches also. According to company's plan, by end of 2019/20 Financial Year, this product will be introduced to 24 new branches and by end of 2020/21 Financial Year, total braches will be 69.

In addition to the above the company is expecting to open up Gold Loan Centers in following areas by end of 2020/21 financial year.

Piliyandala, Wellawatte, Kotahena, Kiribathgoda, Sea Street, Aluthgama, Grandpass, Battaramulla, Kandana.

Leasing

Management has started Leasing in 2016 and the ground work for a massive expansion is expected to be materialized from 2020-22 financial years. Following specific strategies will be executed to increase the volume.

- will increase the sales force of Leasing staff adequately in high potential areas to exploit opportunities to enhance volume of sales.
- Plan to have more strategic alliances with the major vehicle dealers in key provinces.
- The Document Management System will be introduced to reduce the lead time and increase efficiency in approvals process.
- Plan to introduce new incentive systems for dealers and marketing staff.
- Identify new needs of micro level customers in untapped markets by using our micro finance experience.
- New targets will be set to the entire branch network by giving a high weightage to improve the leasing sales.
- Existing Sales staff are screened and evaluated to identify any special training requirements to enhance their efficiency.
- Plans to introduce new incentive scheme to recruitment partners to head hunt high caliber talents /staff.

Divisaru

So far management has conducted microfinance product based on the group concept method. Demographical changes in the recent past required critically evaluate the group concept method. Hence, they have introduced Divisaru where microfinance customers do not require to participate for the group meeting but, it will be promoted as a new personalized loan product from 2020.

Existing meeting centers totaling 10,200 will be rationalized, reshuffled and reduced to 6,500 to be more efficient and effective. We will also approach new customers by introducing new Divisaru product. Current existing field offices will be scientifically and methodically deployed in appropriate geographical areas also using GPS /Google mapping to ensure that we harness full potential of staff as well as business in key locations.

The management also expects to change the funding mix by increasing more saving deposits with low interest cost. By doing this, the management expects to minimize the interest costs and increase the net income. For interest expenses projections, following rates were assumed.

Fixed deposits mobilizing rate – 15.33% for 5 year FD
Borrowing rate – IRR rate for Loan:13.50%

Moving to the bank loan from fixed deposits since it is assumed that cost on bank loan is beneficial to income statement than fixed deposits (based on current situation).

Interest Expenses on Funding

Funding Type	2020	2021	2022
Fixed Deposit Interest Expenses	2,726,817,454	4,119,360,366	5,210,674,610
Debenture Interest	270,161,458	286,862,500	286,862,500
Interest Expenses – Saving	262,025,568	532,175,333	823,204,891
Interest Expenses on Borrowing	452,451,903	1,295,771,926	1,826,429,921
	3,711,456,383	**6,234,170,125**	**8,147,171,921**

Net Fee & Commission Income

The management assumed that fee & commission income will be earned at rates consistent with existing rates.

The fee & commission expenses comprised of commission paid for introducing fixed deposits. The management expects to pay commission at 0.75%.

Further, recent imposition of interest rate cap by CBSL resulted in the reduction in the effective interest rate from 47% to 35% where HNBF had to increase their volume of the loans to compensate the margins reduced due to the interest rate. For example, documents charges considered as Fee Income thereby increase in Fee Income. In addition, Divisaru new products also plan to increase in volume which would attract new fee base income.

Newly introduced utility bill payments facility also will help in increasing the Fee Based Income.

Other Operating Income

This includes interest income from investment in financial instruments, rent income, commissions, etc. The investment in financial assets is expected to maintain in par with the liquidity levels required by central bank regulations. Following interest rates are used for forecasting interest on financial assets.

Annual interest rate on T- Bill investment	7.50%
Annual interest rate on T-Bond Investment	6.50%
Annual interest rate on debenture investment	11.25%
Annual interest rate on Money market savings	7.50%
Annual interest rate on fixed deposits	11.00%

Personnel Cost

The estimated number of staff and their pay rates are available in the Human Resource budget of the company.

The annual pay increment is assumed to be 15%. It includes 7% increment to compensate for inflation and 8% premium.

Reduction in manpower through effective digitization & operational excellence will reduce the payroll cost for new recruitments by 2022.

Other Operating Expenses

Other operating expenses are expected to increase in line with the general inflation rate plus the expenditure required to support the projected growth. By 2022, management is expecting to decline the expenses growth due to the operational excellence efficiencies and digitalization efforts of the company.

Loans and Advances

The management plans to increase collateral based lending to meet 50% component of such products in the total portfolio of the company by 2021. The Micro products will continue at current growth rates. According to the strategic business plan, the leasing portfolio is expected to grow at higher rates during the period 2019-2021 to bring the leasing portfolio to 50% of total portfolio by 2021. Accordingly flowing growth rates are used in forecasting the leasing portfolio:

1st year growth rate - 129%
2nd year growth rate - 70%
3rd year growth rate is - 21%

Impairment gain / (loss) on Loan Portfolio

The impairment provision on loan portfolio is expected to decrease gradually as collateral based lending increases. Accordingly, the management expects impairment at 2% in first year of forecast and 1.75% in the second year and 1.5% thereafter.

Financial investments, Held - to- Maturity (HTM)

This category includes investment in treasury bonds & debentures and the management expects to invest in these instruments only to meet the regulatory requirements of liquid assets. Hence the investment portfolio for this category will not change in future years.

Financial investments, Available- for- Sale (AFS)

The ASF category includes investment in unquoted shares. The management expects no additional investment or disposals during projected period.

Investment properties and Property Plant & Equipment (PPE)

The PPE purchases are forecasted as per capital expenditure budget of the company. The management has no plans to acquire investment properties during next three years. Current depreciation rates will not change neither PPE nor investment properties will be revalued during projected period.

Borrowings

Management has planned to issue a debenture amounting to Rs. 2 Bn from 2020 to 2021. This is purely to meet regulatory capital requirements.

Cost of Equity

We have used the Capital Assets Pricing Model (CAPM) to determine the cost of equity.

$$K_e = R_f + \beta \, (R_m - R_f)$$

Where,
Ke, is the cost of equity
Rf, is the risk free rate
β , is the equity beta
(Rm –Rf), is the equity market risk premium

- Latest ten-years Treasury Bond rate was considered as the risk free rate. This rate as of 24th July 2019 was 10.15% according to the Central Bank of Sri Lanka.
  (Source: www.cbsl.lk.)

- Since company's shares are currently not publicly traded, we have considered the average beta of following companies closely related and categorized as peers of HNBF.

Company	Beta
Commercial Credit & Finance PLC	0.71
Citizen Development Business Finance PLC	0.12
Nation Lanka Finance PLC	3.25
Arpico Finance Company PLC	0.07
Asia Asset Finance PLC	-0.16
Average beta	0.80

(Source: www.cse.lk, beta against S&P SL 20 as of 2nd quarter of 2019)

This average beta was then adjusted to remove company specific financing side risk and readjusted to reflect the gearing level of the HNBF.

Adjusted Beta – 0.67

- Equity risk premium (rm – rf) in the most developed economy in the USA is 5.96% (January 2019). It represents the difference between total market rate and risk free rate. Rating agencies set long term rating of each country for investors. It represents the portion of a risk connected to the investment in given area. Sri Lanka was given a rating of B2 – by rating agency Moody's. It represents the extra premium for the risk of Sri Lanka of 6.25% as of January 2019.

  (Source: Stern School of Business, New York University publications available at www.stern.nyu.edu)

  To convert country equity risk premiums to corporate equity risk premiums, one of the three approaches described below can be used.

  Approach 1: Assume that every company in the country is equally exposed to country risk.

  Approach 2: Assume that a company's exposure to country risk is similar to its exposure to other market risks.

  Approach 3: Treat country risk as a separate risk factor & allow firms to have different risk exposures to country risk (e.g. based on the proportion of their revenue come from non-domestic sales).

  We have used the approach 2 to determine the cost of equity of HNBF. Accordingly, the cost of equity is:

  Ke = Rf + β (US premium + Country premium)
  Ke = 10.15% + 0.67 (5.96% + 6.25%)
  Ke = 18%

6. FORECASTED FINANCIAL STATEMENTS

Income Statement

	2019/20 Rs.	2020/21 Rs.	2021/22 Rs.
Interest Income	9,447,143,068	13,073,302,357	17,047,956,158
Interest Expenses	(3,712,706,098)	(6,242,418,413)	(8,153,921,921)
Net Interest Income	**5,734,436,970**	**6,830,883,944**	**8,894,034,237**
Fee and commission Income	1,114,296,794	1,350,300,895	1,630,830,007
Net Interest Income ,fee and commission income	**6,848,733,764**	**8,181,184,839**	**10,524,864,243**
Other Operating Income	334,527,967	353,762,656	373,149,738
Total Operating Income	**7,183,261,731**	**8,534,947,496**	**10,898,013,981**
Impairment gain / (loss) on loans and receivables	(594,000,000)	(709,600,000)	(849,600,000)
Net operating Income	**6,589,261,731**	**7,825,347,496**	**10,048,413,981**
Less - Operation Expenses	(3,606,197,085)	(4,115,325,567)	(4,447,880,317)
Operating profit/ (loss) before Value Added Tax (VAT)	**2,983,064,646**	**3,710,021,929**	**5,600,533,665**
VAT & NBT Financial Service , Debt Repayment Levy	(886,108,742)	(1,030,789,527)	(1,687,613,194)
Operating profit/ (loss) after Value Added Tax (VAT)	**2,096,955,904**	**2,679,232,402**	**3,912,920,471**
Provision For Income Tax	(932,207,702)	(1,159,381,853)	(1,750,166,770)
Profit / (Loss)	**1,164,748,202**	**1,519,850,549**	**2,162,753,701**
Earnings Per Share	**0.68**	**0.88**	**1.26**

Statement of Financial Position

	2019/20	2020/21	2021/22
	Rs.	**Rs.**	**Rs.**
Assets			
Cash and Cash Equivalents	242,211,776	417,630,236	324,837,724
Loans and advance	40,605,705,586	55,776,456,695	70,326,428,691
Financial investment - Loan & Receivable	307,112,771	307,112,771	307,112,771
Financial investments- available-for- sale	12,430,283	12,430,283	12,430,283
Financial investments- held - to-maturity	3,006,030,529	7,226,590,529	8,597,150,529
Other Receivables	68,803,491	83,803,491	92,703,491
Other Assets / Prepayments	256,281,605	241,281,605	232,381,605
Investment Properties	1,295,000,000	1,295,000,000	1,295,000,000
Intangible Assets	381,994,082	313,108,866	225,173,650
Property Plant and Equipment	1,847,645,154	1,659,485,412	1,452,194,909
Total Assets	**48,023,215,275**	**67,332,899,887**	**82,865,413,651**
Liabilities			
Bank Overdraft	202,390,579	377,390,579	349,590,579
Due to customers	31,367,434,676	42,960,523,224	55,587,509,420
Other Borrowings	8,806,572,803	14,881,978,179	15,632,898,216
Taxation	184,747,768	138,947,768	120,997,368
Other Liabilities	1,748,583,818	1,822,712,001	2,137,809,287
Retiring Benefit Obligation	229,353,511	268,953,511	315,873,511
Differed Tax Liabilities	16,115,738	16,115,738	16,115,738
Total Liabilities	**42,555,198,894**	**60,466,621,001**	**74,160,794,120**
Shareholders' funds			
Stated Capital	223,545,481	223,545,481	223,545,481
General Reserve	82,897,989	82,897,989	82,897,989
Statutory Reserve Fund	638,519,637	638,519,637	638,519,637
Revaluation Reserves	589,484,031	589,484,031	589,484,031
Accumulated Profit / Losses	3,933,569,242	5,331,831,747	7,170,172,392
Total Shareholders' funds	**5,468,016,380**	**6,866,278,885**	**8,704,619,530**
Total Liabilities & Shareholders' funds	**48,023,215,275**	**67,332,899,887**	**82,865,413,651**

7. VALUATION TEAM

Sanjaya Bandara – Director

Mr. S. M. S .S. Bandara FCA, MBA, B.sc (Acc), is specialized in all technical matters relating to Accounting, especially IFRS's. Ha has vast experience in financial consulting and business valuation. Sanjaya is a council member of the Institute of Chartered Accountants of Sri Lanka. He has an honors degree in Accountancy from the University of Sri Jayewardenepura and a MBA from the University of Colombo.

Tharindu Dananjaya - Manager

Mr. Tharindu Dananjaya B.sc (Acc) Sp., counts over eight (08) years of experience in financial risk management, business valuation and auditing. He has an honors degree in Accountancy from the University of Sri Jayewardenepura.

The valuation team/personal possesses required qualifications, experience and the exposure in preparing valuation reports for similar nature in compliance with the CSE listing rules.

8. LIMITING CONDITIONS & DISCLAIMER

8.1 The conclusion of value as reported herein this report is valid only for the specific purpose as of the date of the valuation.

8.2 We have relied on the financial forecasts and other related information provided by HNB Finance Ltd or its representatives, in the course of our valuation process, as fully and correctly reflecting the enterprise's business conditions and operating results for the respective periods, except as specifically noted herein. ***We have not audited, reviewed, or verified the correctness of the financial information provided to us and, accordingly, we express no opinion or any other form of assurance on this information.***

8.3 Public information and industry and statistical information have been obtained from sources we believe to be reliable. However, we make no representation as to the accuracy or completeness of such information and have performed no procedures to corroborate the information.

8.4 The conclusion of value arrived at herein is based on the assumption that the current level of management expertise and effectiveness would continue to be maintained, and that the character and integrity of the enterprise through any sale, reorganization, exchange, or diminution of the owners' participation would not be materially or significantly changed.

8.5 Neither all nor any part of the contents of this report (especially the conclusion of value), should be disseminated to the public through any means of communication without our prior written consent and approval.

8.6 No change of any item in this appraisal report shall be made by anyone other than us and we shall have no responsibility for any such unauthorized change.

8.7 Unless otherwise stated, no effort has been made to determine the possible effect, if any, on the subject business due to future change in state, or local legislation.

8.8 The valuation contemplates facts and conditions existing as of the valuation date. Events and conditions occurring after that date have not been considered, and we have no obligation to update our report or calculation of value for such events, happenings, and conditions. Also, we have no obligation to update the report or the calculation of value for information that comes to our attention after the date of the valuation report.

8.9 Due to inherent uncertainties and unforeseen factors affecting a share valuation, we do not accept responsibility or liability for any loss or damage whatsoever which may arise as a result of the contents of this report. All responsibility and liability is expressly disclaimed by Nexia Management Services (Pvt) Ltd.

8.10 The valuation report is valid for a period of three months (03) from the date of approval of the CSE.

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