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Hatton National Bank's Capital Increase Is Credit Positive

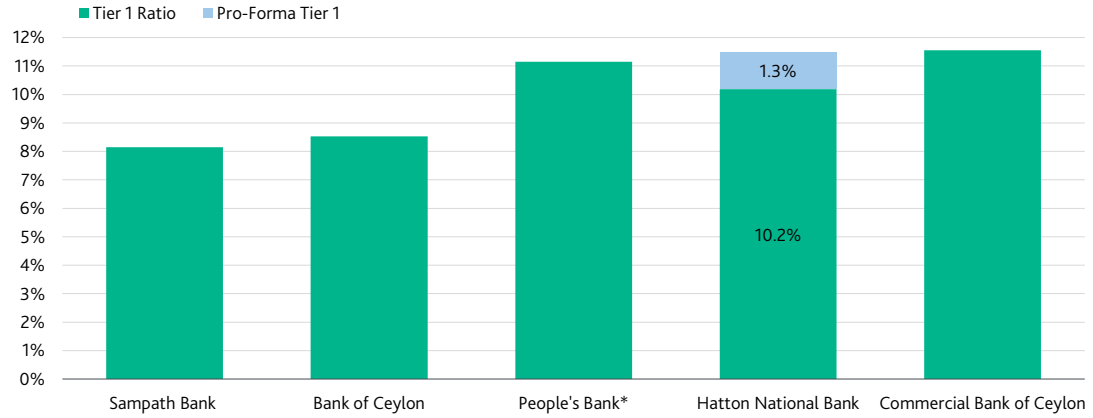
Last Wednesday, the Sri Lanka-based Hatton National Bank Ltd. (HNB, B1 negative, b1[8]) announced its decision to issue approximately $50 million of common voting shares to the Asian Development Bank (ADB, Aaa stable), which will hold approximately 10% of HNB's voting shares post issuance. The capital infusion will increase HNB's capital buffer and support its credit growth strategy, a credit positive. We expect the transaction's completion in the fourth quarter of this year, after receiving approval from the Colombo Stock Exchange and HNB's shareholders.

We estimate that the capital raise will increase HNB's Tier 1 capital ratio to 11.5% from 10.2% as of 30 June 2016. As Exhibit 1 shows, HNB will become one of the better capitalized banks in Sri Lanka, with a Tier 1 capital ratio comparable to the Commercial Bank of Ceylon (unrated) and higher than the ratios of Sampath Bank Plc (B1 Negative, b1), Bank of Ceylon (B1 Negative, b1), and People's Bank (unrated).

EXHIBIT 1

Hatton National Bank's Pro Forma and Select Sri Lankan Banks' Tier 1 Capital Ratios at 30 June 2016

HNB is set to become one of the better capitalized banks in Sri Lanka.



Note: *As of end-March 2016.

Sources: The Banks and Moody's Investors Service

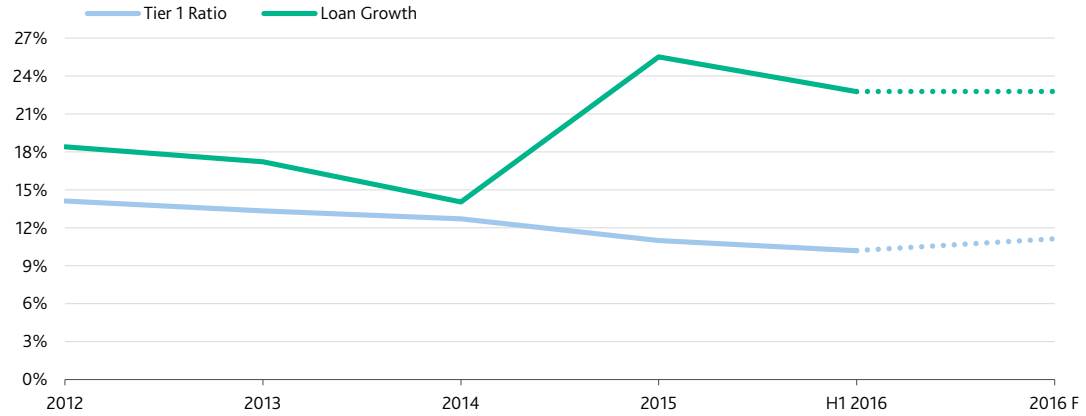
The increase in the Tier 1 ratio will support HNB's loan growth, which had increased 23% year on year as of 30 June. Exhibit 2 shows that the bank's Tier 1 ratio had steadily declined with the pickup of loan growth from 2014 onward.

[8] The bank ratings shown in this report are the bank's deposit rating and baseline credit assessment.

EXHIBIT 2

Hatton National Bank's Year-over-Year Loan Growth and Tier 1 Ratio

HNB's loan growth has been eroding its capital ratio.



Note: For our full-year 2016 forecast, we annualized loan growth and net income from the first half of 2016.

Sources: The bank and Moody's Investors Service

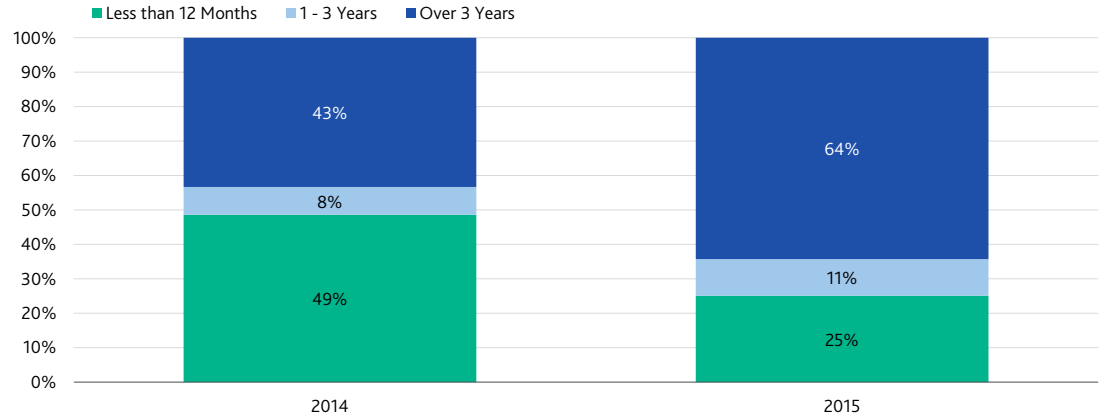
The issuance also increases HNB's loss-absorption buffer. Its ratio of nonperforming loans to total shareholders' equity and loan loss reserves will decrease to 12.5% after the capital raise from 13.4% at end-June 2016. This provides an additional buffer in the event of asset quality deterioration on the back of HNB's rapid loan growth.

The tie-up with ADB, the first for a Sri Lankan bank, will likely further improve the maturity profile of HNB's market borrowings by facilitating market access for longer-tenor funds. Separately in a transaction not related to the share issuance, the ADB had already provided a $100 million seven-year loan to HNB in 2015, and we expect that additional long-term funds could become available to HNB from international investors. HNB has increasingly relied on market funding because of rapid lending growth. Its market funds were 14.4% of its assets as of 30 June 2016, up from 10.6% as year-end 2014. Exhibit 3 shows that the structure of HNB's borrowings nevertheless improved last year because of the 2015 ADB loan.

EXHIBIT 3

Hatton National Bank's Market Funds Term Structure

HNB's market funds term structure had improved with the 2015 ADB Loan.



Sources: The Bank and Moody's Investors Service