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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

MULTIDISCIPLINARY CASE STUDY EXAMINATION - MAY 2010

THE EXAMINATION QUESTION, INSTRUCTIONS AND ADDITIONAL (IMPACT) INFORMATION

Time allowed : 4 Hours **Marks :** 100 marks

Instructions

1. This question paper should be answered entirely in the **ENGLISH** Language and only in the **answer booklets** provided.

2. Any pre-prepared answers attached to your answer **will not** be marked.

3. It is advised to spend about 2 hours in writing the report.

4. After the instruction to stop writing at the end of the paper, five minutes will be given to assemble your answer.

THE PROPOSED MERGER OF

DERANA BANK & SAMPATH NATIONAL BANK

You are Dinesh Chandraratne, working as a final-year student for the Chartered Accountancy practice of Sanath Dayananda. You are currently working for Ms. Sandani Gamage, a senior manager working for Mr. Jon Lloyd- the UK representative and the head of the business advisory department of the firm.

Among your clients is Sampath National Bank PLC (SNB), which is a new client of ‘Vision Capital’, the business advisory department.

Requirement:

You are to prepare a report to the board of Sampath National Bank PLC, (SNB) as set out in the letter from Mr. Sampath Godage, the Chairman of SNB (Exhibit 4) and the memo from Ms Sandani Gamage (Exhibit 5).

State clearly any assumptions that you make.

Exhibit 4

SAMPATH NATIONAL BANK PLC

Colombo 02
www.sampathnb.c
om

t: +941302851,
f: +94 2 752620
enquire@snb.com

08 May 2010

Vision Capital Colombo
Sandani Gamage

Dear Sandani,

This is further to the discussions we had.

In early March 2010, I reviewed the proposed merger agreement between Derana Bank PLC and SNB. The executive teams of both firms endorsed the proposed merger. It remained to receive board approvals and go public with the news. On June 5, the boards of directors of DB and SNB are to meet to review the final terms and vote on whether to approve or reject the deal. If approved, the transaction would be announced on June 8. Approvals by regulators would take time. Therefore, it seemed unlikely that the transaction would be consummated early.

Analysts and investors would want to determine whether this deal made economic sense for shareholders of both firms. They would seek a sound rationale for the deal and some comfort that a transaction on this scale could be implemented effectively. And they would want to understand how this might change the fortunes of peers in the industry. Would this deal create value? Does it make strategic sense? How would the two organizations fit together?

Could you please study the proposals and get back to me.

I will table your findings at the next Board Meeting.

Thank you

SampthG

Exhibit 5

From: **Sandani**

Date: **19. May 2010**

To: **Dinesh Chandraratne**

Subject: **Derana SNB merger**

Dear Dinesh,

Mr. Sampath Godage was of the opinion that DB has an aggressive credit policy and the asset base of DB was not sufficiently diversified. Does DB possess any competitive advantages in any of these? I think we could compare with the industry and recommend the matter. Could anything have been done differently to avoid the crisis?

Mr. Sampath said; "our shareholders have authorised us to take some risks: if we do not take any risks, we are not enhancing shareholder value".

He also inquired about the merger method; whether the companies could add together the book values of their net assets without indicating which entity is the "purchaser". Would it be the best for investors to determine how to evaluate the transaction. Could you give the regulatory reference/s.

I have attached the documents prepared by SNB for your reference (Exhibits 6 and 7). According to Mr. Sampath the merger is financially strong; is it justifiable? Could you perform an analysis to determine the relative attractiveness of the industry? Please consider the qualitative factors applicable to the SNB and DB merger strategy. Mr. Sampath said that both DB and SNB would be liquidated and the new company would continue as DSNB.

Rgds

Sandani

Exhibit 6

The summarized proposal

Proposed Merger of SNB and DB

The merger discussions were motivated and shaped by political developments – it seemed to argue for the creation of greater institutional mass with which to handle the turbulent environment. The global financial crisis, deregulation, trends toward institutionalized saving and costly technological changes have added uncertainty to the turbulent banking industry. The financial services providers are repositioning themselves away from the commercial lending markets and toward the growth segments of investment banking, brokerage, and asset management, areas that would profit in the developmental economy.

Serious consideration on the SNB side of a merger with DB began with a discussion between CEO s during December 2009. The SNB Executive Committee met on January 2-3, 2010 to explore various merger alternatives. The alternatives ranged across various strategic dimensions. During January and February 2010, the CEO of DB met with the President of SNB to discuss mandates and leadership of the new firm. They agreed to begin formal negotiations. The initial discussion covered a range of topics, including strategy, term sheets, and governance issues. A proposal was advanced that would create a CEO with a deputy, a Chairmen with a Vice- Chairman, one each from the former banks. Negotiations continued in March 2010; by the end of the month, a term sheet was drawn up that designated Mr. Sampath Godage as Chairman.

Objectives of the Merger

The general motives for the merger translated into five specific objectives:

1. Attain leadership in lines of business: private banking, institutional asset management, investment banking, and private equity.
2. Develop the leading edge in Sri Lankan consumer and corporate banking.
3. Create substantial shareholder value, targeting return on equity in the range of 15 to 20 percent, improving financing with the aim of reducing cost of capital, and improving transparency and disclosure.
4. Exploit an excellent cultural fit between the two firms. Both firms have a Sri Lankan heritage.
5. Create a sustainable position for a leading Sri Lankan financial institution, improving capital adequacy.
6. Create the scale and capital base that would allow a next step to establish a meaningful position in Asian investment banking.

Terms of the Proposed Transaction

Exhibit 7 outlines the terms of the proposed deal. Exchange ratios would be based on market value of the firms (however, DB opts for book values for transaction). This exhibit shows that shareholders of each bank would exchange their shares for shares in a new firm. The make-up of the board of directors and management team of the new company, is given in the Exhibit. Headcount reductions of about 700 would be “carefully managed with strong social responsibility and fairness.” At the same time, management aspired toward a “meritocracy in selection of and rewards for management and employees.”

The key managerial positions would be filled on the basis of merit rather than 'power sharing' between the two organizations. Management compensation would be structured to align with the interests of employees and shareholders. The negotiators affirmed a common vision for the new firm:

- To be the preferred choice of the clients we wish to serve.
- To be a highly attractive place in which to work.
- To offer a superior source of value creation for our shareholders. The targeted return on equity was in the range of 15 to 20 percent, while maintaining strong credit ratings.

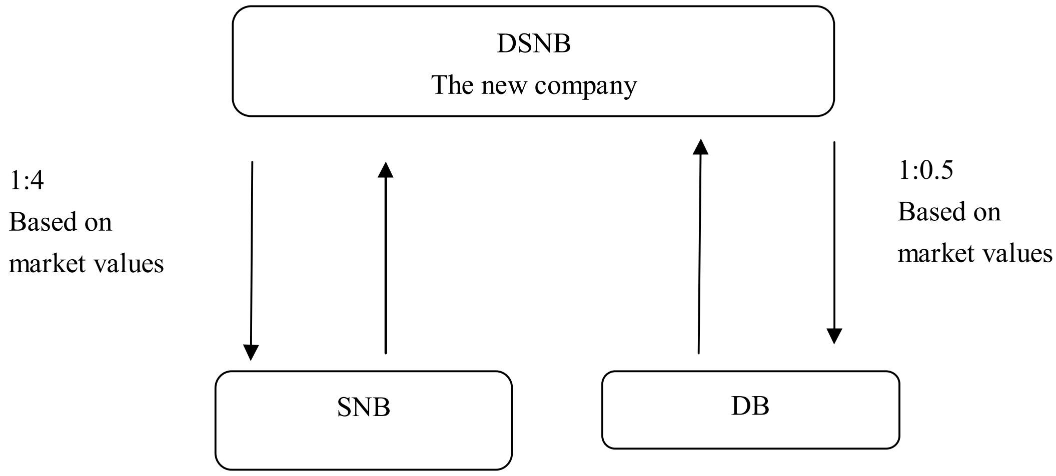
Outlook

If the boards of DB and SNB approved the deal, CEO s would announce it to the public and begin the process of obtaining approvals from shareholders and banking regulators. This might take five or six months. In parallel, the two organizations would begin planning the details of their post-merger integration. Already, the executives had targeted the following goals by business lines:

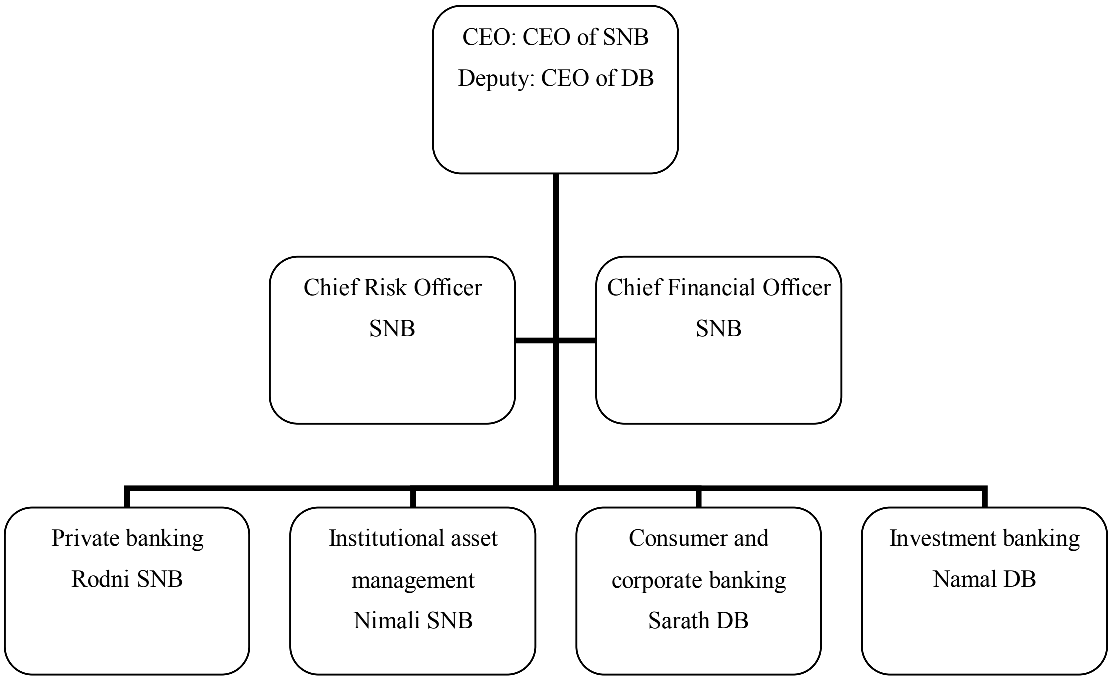
- Combine private banking operations and focus on both domestic and international expansion.
- Integrate the investment banking operations within 12 months.
- Restructure and consolidate the Consumer and Corporate Banking activities within one to two years.

Exhibit 7

Diagram of the Merger



Management Structure



DSNB

Table 1: Board of Directors

Members	Appointment	Formerly on the Board of
Sampath Godage	Chairman	SNB
Milton Meegoda	Vice Chairman	DB
H Fernando	Member	SNB
P S Mutugala	Member	SNB
D Karyawasam	Member	SNB
R Manmohan	Member	DB
Dilini Taraka	Member	DB

DSNB

Table 2: Headcount reduction plan

	Combined workforce	Estimated headcount reduction
Private banking & institutional asset management	1000	90
Consumer and corporate	2500	500
Investment banking	1900	80
Corporate center	200	30
	5600	700

Table 3: DSNB - Projections

Rs. Billions

	2011	2012	2013	2014	2015	2016 through 2025
Revenue (interest net & other income)	21	22	24	26	30	35-40
Cost (including tax)	18	18.5	19	20	21	24-28
Profit	3	3.5	5	6	9	11-12
Equity	20	22	29	36	44	Rs. 150 billion by 2025
ROE	15%	16%	17%	17%	20%	20%-25%

Table 4: Summary term sheet for the merger

Form of payment	Stock
Exchange ratio SNB	4 DSNB for each share
Exchange ratio DB	Not yet finalized Non-voting shares would be repurchased at Rs. 14 and settled by DB before the merger.
Number of DSNB shares to be issued	Not yet finalized
Effective ownership of DSNB	60% < for SNB shareholders
SNB market price of a share at end, 2009	Rs. 212
DB market price of a share at end, 2010 April	Rs. 26.5
DB market price of a non-voting share at end, 2010 April	Rs. 13
Expectations	Annual cost savings of Rs. 1.5 billion realizable within 2-3 years Revenue growth more than 10% p.a. Redeployment of excess capital