

Operating and Financial Review

The objective of this Review, prepared by management, is to provide a balanced analysis of the main trends and factors that influenced the development and performance of the business of the Group during 2004 and its position at the end of the year. The likely impact of those factors on the future development, performance and position of the Group will be discussed. This Review is not required by any standard or regulation binding in any country in which the Group operates. It was prepared as a guide to assist shareholders and other stakeholders in understanding the business of the Group and in making their own assessment.

During the year, the Board and Management relied on Key Performance Indicators (KPI) in the subsidiaries to monitor their progress and to determine the Group's position. These KPI were evaluated against pre-set budgets, prior year results and in some cases, industry and international benchmarks. The viability of the Group and its ability to sustain itself as sound financial institution depends mainly on effective risk and yield management, growth in the incremental profitability of growth in assets and maintenance of high levels of operational efficiency. Specialisation and decentralisation works best for the Group in achieving these objectives and in making corporate governance, especially internal control, more effective and productive at Board and management levels. The most effective KPI for evaluating performance are described below.

The Net Interest Margin on loans

This ratio reflects the effectiveness of the asset and liability management processes and the productivity of the loan portfolios. It is determined mainly by management's ability to suitably identify risk and apply appropriate pricing, by the effect of our international credit rating on the cost of borrowings and by the rate of success in positioning loan products in the market. This ratio can be affected significantly by the effects of country risk and by volatility in market interest rates. Although the gross yield on total assets fell from 7.7% in 2003 to 7.5% in 2004, and income from loans and investments increased only by 1.1%, the Net Interest Margin increased from 3.13% to 4.08% of average total assets. This accounted for over 55% of the increase in the Net Profit in 2004. The improvement was due entirely to the re-pricing of listed bonds in the local market and to the issue of new bonds and short-term notes at lower rates. Higher cost debt was retired in 2002 and in 2003. The average cost of borrowings from the EIB, CDB, IIC and the MIF now equates with or exceeds market rates reflecting the net effect of the additional risk pricing inherent in the investments made with these funds and a subsidy component. All EIB loans, except one loan at an average rate of 7.0%, have a fixed rate and a variable rate based on profit-sharing.

The earnings rate on un-listed investments

Income from un-listed investments increased by 34% in 2004 mainly because of realisations ("exits") and a net yield after expenses, made up of cash income and valuation gains, of 15.7% on investments made in 2003 and 2004. The private equity and

venture capital business requires a great deal of expertise and experience because the portfolio is spread over a large number of investments in various sectors and countries.

The overhead cost efficiency ratios in terms of both income and assets and earnings

Overhead cost was 2.4% of average total assets 48% of Net Interest Income plus fees compared with 2.1% and 64% respectively in 2003. The Group's overhead cost efficiency ratios are well within local and international standards. In DFL itself, these ratios were 1.5% and 42% in 2004. However, in the microfinance subsidiary, overhead cost was 22% of average total assets. In 2004, the average for a sample of 32 of the best institutions in Latin America was 21% with the lowest at 10.6%. We need to be less than 15% which would have required a 50% increase in assets. In the microfinance subsidiary, overhead cost was 139% of Net Interest Income plus fees. This was heavily affected by low yields and low productivity in St Lucia where the ratio was 463% compared with 201% in Grenada which was affected by income losses due to hurricane damage.

Effective execution of Group strategies

The basic strategies open to management were (a) expand the volume of assets or limit increases in overhead costs or (b) increase the yield on assets or reduce the cost of liabilities. The critical components of these strategies are:

- Market positioning in terms of co-ordination of income yields and interest costs
- Efficient deployment of staff and improvements in systems productivity
- Managing investment processes and recovery services to preserve asset quality
- Deal structuring and pricing measures to control the volatility of earnings-at-risk

Changes in the many variables underlying these components can occur quickly and sometimes, simultaneously. This creates a high degree of complexity especially for a relatively small financial institution which has very little influence on market dynamics and practices. It is for that reason that our specialisation, decentralisation and sound governance practices are essential for sustainability and value creation. Embedded in the organisation of the Group is a system of wide-spread controls which we describe as Assurance, Business process improvement and Compliance (ABC) as explained in the Corporate Governance disclosure statement. Costs related to the ABC functions accounted for xx% of total overhead cost in 2004. The effectiveness of the ABC functions is a significant factor affecting the sustained performance of the Group. This cost will increase because the Group expects that the Caribbean business environment will become even more dynamic, competitive and volatile and because we will expand the business of the Group in 2005. The reports generated from the ABC functions are reviewed closely by the Board and form a substantial portion of the work of the full Board. It is the business of the Group to effectively manage a relatively high level of risk concentrations in industrial, tourism and other business sectors rather than diversify across the full range of financial services. This specialisation provides focus and operating synergies but reduces scope for diversification of risk and sources of earnings. This specialisation, and the capabilities that support our Mission, places the Group in a

unique strategic position in the Caribbean financial system as a whole. This provides value to our diverse range of shareholders and stakeholders.

In 2005, the Group will be re-structured to retain this specialisation, especially within Development Finance Ltd, while allowing subsidiaries more flexibility to provide a wider range of financial and management services. The objective is to carry out the Mission of the Group within a wider perspective that caters to the varied needs of micro, small and medium-sized enterprises. The Group will also participate in the widening and deepening of financial sectors by using its industry knowledge and risk management skills to arrange multi-bank financing transactions involving both funded and risk participations. The specialised software and organisational capability to do this is supported by a strong internal control system that includes experienced accountants and loan operations managers. Directors and Management believe that this brings a unique capability to the field of development finance in the Caribbean.

In support of our diversification and regional expansion plan, CDN Management Services Ltd (CDN) has been expanded with new capital, management and professional staff. This subsidiary will build on its success in offering fee-based support to various enterprise development and private sector development programmes in the Caribbean. It will also expand its management development programmes outside of Trinidad and Tobago using dedicated facilities and working closely with highly reputable and competent partners. CDN will also provide project management services to the Group eventually extending this to include MIS/IT and financial reporting services. CDN's contribution to the Group's profitability in 2004 was \$ 168,824.

The Microfinance group to be known in 2005 as Microfin Caribbean Holdings Ltd generated a loss of \$ 3.91 Million after amortisation of pre-operating expenses of \$ 216,680, depreciation cost of \$ 330,533 and loan loss provisions of \$ 2.59 Million. 75% of the loan loss provision was booked in the microfinance subsidiary in Trinidad and Tobago in the first quarter of 2004. Since then, there was significant strengthening of the credit culture. Repayment trends have returned to normal following a sudden reversal in the third quarter of 2002 when a new microfinance lender began operations. Loan loss provisions in Grenada were due to prolonged disruptions caused by severe damage from Hurricane Ivan in September. In St Lucia, loan loss provisions were due to a sharp, sustained economic downturn that also curtailed portfolio growth. The economy has stabilised and the portfolio was expanded in the last quarter. However, growth was insufficient to offset the combination of high overhead costs and low productivity.

Microfinance operations in small economies, such as St Lucia and Grenada, are highly vulnerable to prolonged disruptions caused by disasters and sharp down-turns. During these times, controlled external support is required to ensure continuity as a sustainable microfinance institution. The effectiveness of such support was illustrated by USAID and DFID in 2004 in Grenada immediately after Hurricane Ivan. There was no such support in St Lucia following the simultaneous shocks to the banana and tourism industries. Our St Lucia microfinance operation will not be viable until 2006 and requires external support in 2005 or downsizing. We expect operations in Trinidad & Tobago and

Grenada to improve substantially. As a result, Microfin Caribbean Holdings Ltd will be profitable in 2005.

Caribbean Development Capital Ltd (DEVCAP) became an operational subsidiary in 2004 and contributed significantly to Group profitability. DEVCAP is a high-risk operation as it invests in equity instruments in un-listed, small and medium-sized enterprises. It is subject to market price risk that can make its net profit sensitive to changes in market interest rates.

The Consolidated Net Profit of the Group was \$ 11.08 Million after taking into account the interests of minority shareholders. We recorded \$ 4.375 Million from one-time “Fair Value” gains, adjustments of accruals and foreign exchange gains. These one-time gains were partially offset by loan loss provisions of \$ 3.6 Million in DFL which are not expected to re-occur in 2005.

Improvements made in 2004 will support enhanced performance in 2005. These include substantial reduction of non-interest bearing assets, increases in the volume of new business, improvements in operational efficiency and business volume, especially in the microfinance subsidiaries. We have therefore budgeted an improvement in Net Profit in 2005 although we expect to incur one-time cost in our Business Expansion Plan. In 2005, DFLSA Incorporated will be operational in Guyana and in Suriname as a specialist lender and service provider to Small and Medium-sized enterprises.