

**THE LANKA HOSPITAL CORPORATION PLC [LHCL.N0000]****MAINTAIN SELL****MARGINS SHRINK AMIDST RISING COST PRESSURE****Fair Value [2018E]: LKR 39.0 [-9%]***Total loss with DPS 7% [AER -21%]*

LHCL's revenue grew marginally by +7%YoY in 2Q2018 to LKR 1.6Bn while 1H2018 grew by +10%YoY. GP margins impacted as a result of escalation of costs of services while increase in admin costs resulted in lower operating margins. LHCL fair value is at LKR 39.00 for 2018E providing an annualized negative return of 21%. MAINTAIN SELL.

| LKR (Mn) | 2Q2017 | 2Q2018 | YoY | 1H2017 | 1H2018 | YoY |
|--------------------------------|--------|--------|------|--------|--------|------|
| Earnings (LKR 'Mn) | | | | | | |
| Revenue | 1,563 | 1,677 | +7% | 3,071 | 3,379 | +10% |
| Gross Profit | 715 | 735 | +3% | 1,416 | 1,470 | +4% |
| EBIT | 193 | 172 | -11% | 375 | 344 | -8% |
| PBT | 238 | 243 | +2% | 478 | 483 | +1% |
| Net Profit | 206 | 191 | -7% | 418 | 385 | -8% |
| Balance Sheet (LKR 'Mn) | | | | | | |
| Shareholders' Equity | 6,039 | 6,182 | +2% | 6,039 | 6,182 | +2% |
| Borrowings | - | - | - | - | - | - |
| NAVPS | 26.99 | 27.63 | +2% | 27.0 | 27.63 | +2% |

Increased cost of services and admin expenses to affect margins

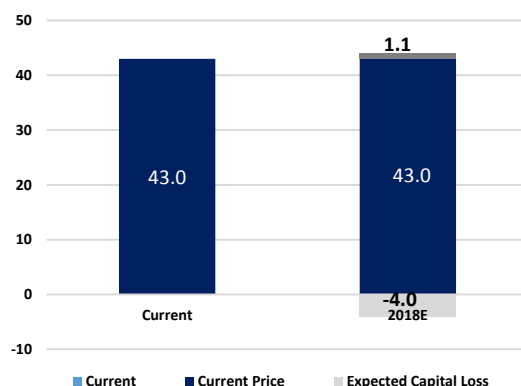
LHCL's earnings for the 2Q2018 recorded a decline of 7% midst of the marginal growth (+7%YoY) in top line and escalation in cost of services and admin expenses, resulting in both lower gross and operating margins. High costs associated with imports of input materials, due to the depreciation of the rupee, increased operational cost arising from obtaining 6th edition of the JCI accreditation (Joint Commission International) and regulatory pressure from increased income taxes from 12% to 28% on healthcare sector from 1st April 2018, further impacted on the bottom line of the company. We expect LHCL to see continued cost pressure rising from depreciation of LKR and shortage of skilled staff which compels the hospital to pay a premium price to recruit them. Restrictions by the government by means of Maximum Price Controls, can result in difficulties in pass through of costs to customer thus affecting the profitability in the near term.

Despite the long term drivers which favors the private health sector, LHCL's capacity addition is not high as that of competitors to leverage on the industry potential

Private health care sector in Sri Lanka is expected to poise for a strong growth trajectory in the mid to long term due to demand-supply gap in the public sector, high purchasing power in line with expected increase in per capita income, aging population, Non Communicable Diseases and prospects in the medical tourism industry which would act as catalysts in creating demand for private hospitals. LHCL's capex has been at a moderate level with an average capex of LKR 465Mn during last 4 years relative to its listed peers ASIR (which invested LKR 4.5Bn in a 175 bed facility hospital in Kandy, due for opening in 1QFY19) and NHL (initiated a new building of LKR 4.5 Bn with car parking and other facilities in 2017). Despite, LHCL's plans to invest in capacity addition during next 2-3 years including a 12 storied building and expand the regional presence, significant capex hasn't been budgeted yet to realize within the next couple of years. Accordingly, we believe LHCL to face possible competition from the other major players within the years to come.

TP is at LKR 39.00 – Maintain Sell

The current price of LHCL places the company at a trailing PER of 18.50x, which is at a premium than the average multiples of other listed peers (ASIR- 15.40x, AMSL- 10.10x and CHL -7.60x) in the health industry. We estimates LHCL's fair value at LKR 39.00 for 2018E, providing an annualized negative return of 21% at the current price. The price of LHCL has declined by 26% over the last 12 months where as ASPI dropped by 4%. Accordingly, considering the possible slowdown in the profitability growth, higher price multiples relative to other listed peers and low liquidity of the share we recommend a **SELL**.

**FIRST CAPITAL RESEARCH**

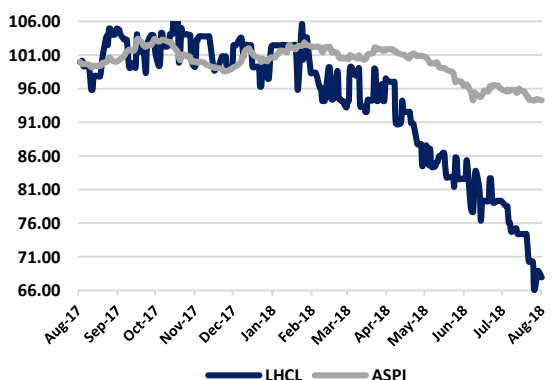
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KEY DATA

| | |
|-----------------------------------|------------|
| CSE Ticker | LHCL.N0000 |
| Bloomberg Ticker | LHCL SL |
| Share Price (LKR) | 43.00 |
| 52w High (LKR) | 65.00 |
| 52w Low (LKR) | 43.00 |
| Avg. Daily Volume (Shares) | 4,486 |
| Avg. Daily Turnover (LKR) | 260,749 |
| Issued Share Capital (Shares 'Mn) | 223.73 |
| Market Cap (LKR 'Mn) | 9,620 |
| Market Cap (USD 'Mn) | 59 |

*1 USD = LKR 162

| Price Performance | 1 mth | 3 mths | 12mths |
|-------------------|-------|--------|--------|
| LHCL | -2% | -14% | -26% |
| ASPI | 0% | -4% | -4% |



Source: CSE

Minimum Return for BUY:**Buy Below [AER of -17% with DPS]: LKR 38.17**

LHCL categorized as 'Grade B' counter (Refer page 08 for Recommendation criteria of Grade A, B & C Stocks)

Disclosure on Shareholding:

First Capital Group do not hold shares in LHCL and will not trade in this share for three trading days following the issue of this document.

Estimate Revision

| In LKR Mn | 2018E-O | 2018E-R | % Change | 2019E - O | 2019E - R | % Change |
|-------------------------------|--------------|--------------|----------|---------------|---------------|----------|
| Earnings Estimate | | | | | | |
| Revenue | 7,069 | 7,069 | 0% | 8,129 | 8,129 | 0% |
| Gross Profit | 3,110 | 3,110 | 0% | 3,577 | 3,577 | 0% |
| EBIT | 628 | 628 | 0% | 723 | 723 | 0% |
| Profit before Tax | 848 | 848 | 0% | 946 | 946 | 0% |
| Net Profit | 611 | 611 | 0% | 681 | 681 | 0% |
| Adjusted EPS | 2.73 | 2.73 | | 3.0 | 3.0 | |
| Growth YoY | 5.10% | 5.10% | | 11% | 11% | |
| Balance Sheet Estimate | | | | | | |
| Shareholders' Equity | 6,392 | 6,392 | 0% | 6,808 | 6,808 | 0% |
| Borrowings | 0 | 0 | 0% | 0 | 0 | 0% |
| NAVPS | 28.57 | 28.57 | | 30.43 | 30.43 | |
| Ratio Estimate | | | | | | |
| <i>ROE (%)</i> | <i>9.84%</i> | <i>9.84%</i> | | <i>10.31%</i> | <i>10.31%</i> | |
| <i>PER (x)</i> | <i>14.29</i> | <i>14.29</i> | | <i>12.82</i> | <i>12.82</i> | |
| <i>PBV (x)</i> | <i>1.36</i> | <i>1.36</i> | | <i>1.28</i> | <i>1.28</i> | |

Valuation Table

| | 2014 | 2015 | 2016 | 2017 | 2018E | 2019E | 2020E |
|----------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Estimates (LKR 'Mn) | | | | | | | |
| Revenue | 4,754 | 5,514 | 5,886 | 6,382 | 7,069 | 8,129 | 8,985 |
| EBIT | 452 | 811 | 899 | 729 | 628 | 723 | 716 |
| Net Profit | 514 | 860 | 972 | 581 | 611 | 681 | 677 |
| EPS (LKR) | 2.30 | 3.84 | 4.35 | 2.60 | 2.73 | 3.04 | 3.02 |
| YoY % Growth | -25% | 67% | 13% | -40% | 5% | 11% | -1% |
| DPS (LKR) | 0.50 | 1.50 | 2.00 | 1.00 | 1.06 | 1.19 | 1.18 |
| Valuations | | | | | | | |
| <i>PER (x)</i> | <i>20.90</i> | <i>15.69</i> | <i>14.96</i> | <i>23.87</i> | <i>14.29</i> | <i>12.82</i> | <i>12.90</i> |
| <i>PBV (x)</i> | <i>2.40</i> | <i>2.70</i> | <i>2.49</i> | <i>2.30</i> | <i>1.36</i> | <i>1.28</i> | <i>1.21</i> |
| <i>DY(%)</i> | <i>1.04%</i> | <i>2.49%</i> | <i>3.08%</i> | <i>1.61%</i> | <i>2.73%</i> | <i>3.04%</i> | <i>3.02%</i> |
| NAVPS | 20.04 | 22.30 | 26.12 | 26.91 | 28.57 | 30.43 | 32.27 |
| Div Payout | 22% | 39% | 46% | 39% | 39% | 39% | 39% |

Valuation Summary

| Expected LHCL price for 2018E | |
|--|-------------|
| PER Valuation based target price | 40.9 |
| DCF Valuation based target price | 37.1 |
| Average Target Price | 39.0 |
| Target Price after Rounding off | 39.0 |

| Return | |
|------------------------------|-------------|
| Target Price | 39.0 |
| Current Price | 43.0 |
| Capital Gain (LKR) | -4.0 |
| Dividends 2018E (LKR) | 1.1 |
| Capital Gain (%) | -9% |
| Dividends Yield (%) | 2% |
| Total Return % | -7% |
| Annualized Return % | -21% |

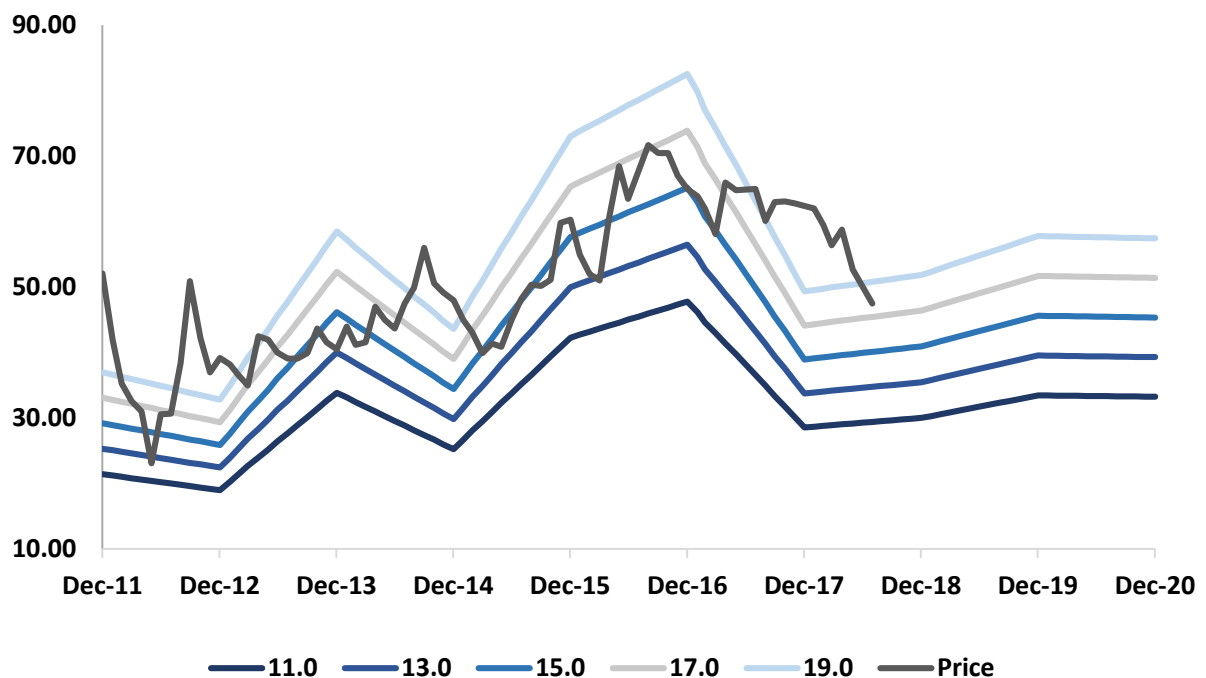
Discounted Cash flow Valuation

| DCF based Valuation | |
|-----------------------|-------|
| Enterprise Value | 7,073 |
| (-) Debt | - |
| (+) Cash | 1,216 |
| Total Value of Equity | 8,289 |
| No. of shares | 224 |
| Target Price | 37.1 |

| WACC | |
|---------------------|-------|
| K_e | 19% |
| K_d | 10% |
| D/E Assumption | 40/60 |
| Terminal Growth (%) | 3% |
| WACC | 15% |

| COE | |
|--------------------------------|-------|
| R_f | 9.5% |
| R_m | 17.5% |
| Growth % | 3.0% |
| β | 1.19 |
| Adjusted β | 1.19 |
| $K_e = R_f + \beta(R_m - R_f)$ | 19% |

PER Valuation



Source: CSE, Company Annual Reports and First Capital Research Estimates

| PER based Valuation | |
|-------------------------------|-------|
| 2018 Earnings (LKR 'Mn) | 611 |
| No. of Shares ('Mn) | 224 |
| 2018E EPS | 2.73 |
| Expected Average PER | 15.0x |
| Price at 15.0x 2018E Earnings | 40.9 |

Appendix I: Statement of Income and Expenses

| Income Statement (LKR Mn) Y/E 31st Dec | 2014 | 2015 | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Revenue | 4,754 | 5,514 | 5,886 | 6,382 | 7,069 | 8,129 | 8,985 |
| Cost of Sales | -2,647 | -2,973 | -3,099 | -3,519 | -3,959 | -4,552 | -5,121 |
| Gross Profit | 2,107 | 2,541 | 2,787 | 2,863 | 3,110 | 3,577 | 3,864 |
| Other Operating Income | 39 | 36 | 53 | 52 | 62 | 73 | 87 |
| Administrative and Other Op.Expenses | -1,694 | -1,766 | -1,941 | -2,186 | -2,545 | -2,927 | -3,235 |
| Operating Profit | 452 | 811 | 899 | 729 | 628 | 723 | 716 |
| Finance Cost | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Finance Income | 70 | 156 | 183 | 193 | 220 | 222 | 224 |
| Profit Before Tax | 522 | 967 | 1,082 | 922 | 848 | 946 | 940 |
| Income Tax Expenses | -8 | -107 | -109 | -341 | -238 | -265 | -263 |
| Profit for the Year | 514 | 860 | 972 | 581 | 611 | 681 | 677 |
| EPS | 2.30 | 3.84 | 4.35 | 2.60 | 2.73 | 3.04 | 3.02 |

Source : Company Annual Reports and First Capital Research Estimates

Appendix II: Statement of Financial Position

| Balance Sheet (LKR Mn) | 2014 | 2015 | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|--------------|--------------|--------------|--------------|--------------|--------------|---------------|
| As at 31st December | | | | | | | |
| Non-current Assets | | | | | | | |
| Property, Plant and Equipment | 3,660 | 3,650 | 4,083 | 4,520 | 4,315 | 4,098 | 3,868 |
| Intangible assets | 32 | 61 | 60 | 96 | 96 | 96 | 96 |
| Advance lease premium | 162 | 175 | 189 | 203 | 217 | 231 | 245 |
| | 3,854 | 3,886 | 4,333 | 4,819 | 4,628 | 4,424 | 4,209 |
| Current Assets | | | | | | | |
| Inventories | 307 | 272 | 319 | 295 | 396 | 455 | 512 |
| Trade and other receivables | 472 | 426 | 499 | 551 | 566 | 650 | 719 |
| Amounts due from related companies | 6 | 5 | 4 | 7 | 7 | 7 | 7 |
| Economic service charge recoverable | 34 | 8 | 4 | 3 | 3 | 3 | 3 |
| Other financial assets – fixed deposits | 905 | 1,531 | 2,029 | 2,226 | 2,226 | 2,226 | 2,226 |
| Cash and cash equivalents | 95 | 215 | 166 | 249 | 1,216 | 1,869 | 2,543 |
| | 1,819 | 2,458 | 3,020 | 3,331 | 4,414 | 5,211 | 6,010 |
| Total Assets | 5,673 | 6,344 | 7,352 | 8,150 | 9,042 | 9,635 | 10,219 |
| Equity and Liabilities | | | | | | | |
| Stated Capital | 2,672 | 2,672 | 2,672 | 2,672 | 2,672 | 2,672 | 2,672 |
| Reserves | 1,028 | 994 | 1,285 | 1,066 | 1,066 | 1,066 | 1,066 |
| Retained Earnings | 783 | 1,324 | 1,888 | 2,282 | 2,655 | 3,070 | 3,483 |
| Total Equity | 4,483 | 4,990 | 5,844 | 6,020 | 6,392 | 6,808 | 7,220 |
| Non-Current Liabilities | | | | | | | |
| Retirement benefit obligations | 105 | 118 | 134 | 167 | 167 | 167 | 167 |
| Deferred tax liabilities | 314 | 347 | 427 | 998 | 998 | 998 | 998 |
| | 419 | 465 | 560 | 1,165 | 1,165 | 1,165 | 1,165 |
| Current Liabilities | | | | | | | |
| Interest bearing borrowings | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Amounts due to related companies | 13 | 28 | 24 | 23 | 23 | 23 | 23 |
| Trade and other payables | 560 | 660 | 654 | 670 | 1,188 | 1,366 | 1,536 |
| Income tax payable | 0 | 20 | 36 | 38 | 41 | 41 | 41 |
| Bank overdraft | 198 | 179 | 234 | 233 | 233 | 233 | 233 |
| | 770 | 888 | 948 | 965 | 1,485 | 1,663 | 1,833 |
| Total Equity and Liabilities | 5,673 | 6,344 | 7,352 | 8,150 | 9,042 | 9,635 | 10,219 |
| NAVPS | 20.0 | 22.3 | 26.1 | 26.9 | 28.6 | 30.4 | 32.3 |

Source : Company Annual Reports and First Capital Research Estimates

Appendix III: Statement of Cash flow

| Cashflow Statement (LKR Mn) Y/E 31st Dec | 2014 | 2015 | 2016 | 2017 | 2018E | 2019E | 2020E |
|---|-------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Cash Flows from Operating Activities | | | | | | | |
| Profit Before Taxation | 522 | 967 | 1,082 | 922 | 848 | 946 | 940 |
| Adjustments for, | | | | | | | |
| Interest income | -65 | -62 | -121 | -149 | -220 | -222 | -224 |
| Depreciation on property, plant and equipment | 242 | 271 | 292 | 363 | 405 | 417 | 429 |
| Amortisation of intangible assets | 3 | 8 | 11 | 13 | 0 | 0 | 0 |
| Amortisation of advance lease premium | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| Provision for retiring gratuity | 33 | 29 | 30 | 38 | 0 | 0 | 0 |
| Impairment loss on inventory | 3 | 2 | 2 | -4 | 0 | 0 | 0 |
| Impairment loss on trade receivables | 7 | 5 | 0 | 7 | 0 | 0 | 0 |
| Write-off of capital work-in-progress | 3 | - | 0 | 0 | 0 | 0 | 0 |
| Gain/Loss on disposal of property, plant and ec | 4 | 0 | -5 | -2 | 0 | 0 | 0 |
| Operating Profit Before Working Capital Change | 758 | 1,224 | 1,297 | 1,192 | 1,038 | 1,145 | 1,150 |
| (Increase)/decrease in inventories | -135 | 33 | -49 | 29 | -101 | -59 | -57 |
| (Increase)/decrease in trade and other receivab | -19 | 53 | -66 | -58 | -14 | -85 | -68 |
| Increase/(decrease) in amounts due from relat | -1 | 0 | 2 | -3 | 0 | 0 | 0 |
| Increase/(decrease) in trade and other payable | 18 | 99 | -6 | 16 | 518 | 178 | 171 |
| Increase in amounts due to related companies | 2 | 15 | -4 | -1 | 0 | 0 | 0 |
| Cash Generated from Operating Activities | 623 | 1,425 | 1,174 | 1,175 | 1,441 | 1,179 | 1,195 |
| Retiring gratuity paid | -4 | -13 | -9 | -12 | 0 | 0 | 0 |
| Income tax paid | -15 | -38 | -59 | -86 | -238 | -265 | -263 |
| Net Cash From Operating Activities | 604 | 1,375 | 1,105 | 1,077 | 1,203 | 915 | 932 |
| Cash Flows from Investing Activities | | | | | | | |
| Acquisition of property, plant and equipment | -630 | -278 | -306 | -645 | -200 | -200 | -200 |
| Expenditure incurred on capital work-in-progre | -17 | -12 | -52 | -12 | 0 | 0 | 0 |
| Purchase of intangible assets | -27 | -11 | -9 | -48 | 0 | 0 | 0 |
| Proceeds from disposal of property, plant and c | 4 | 4 | 5 | 4 | 0 | 0 | 0 |
| Advance lease premium paid | -19 | -19 | -19 | -19 | -19 | -19 | -19 |
| Interest income received | 65 | 42 | 117 | 149 | 220 | 222 | 224 |
| (Investment)/withdrawal in other financial ass | 17 | -625 | -498 | -197 | 0 | 0 | 0 |
| Net Cash Flows Used In Investing Activities | -606 | -900 | -762 | -768 | 2 | 4 | 6 |
| Cash Flows from Financing Activities | | | | | | | |
| Dividend paid | -112 | -336 | -447 | -224 | -238 | -265 | -264 |
| Net cash outflow from financing activities | -112 | -336 | -447 | -224 | -238 | -265 | -264 |
| Net Increase in Cash and Cash Equivalents | -114 | 139 | -104 | 85 | 967 | 653 | 674 |
| Cash and Cash Equivalents at the Beginning of tl | 11 | -103 | 36 | -68 | 17 | 983 | 1,636 |
| Cash and Cash Equivalents at end of the Year | -103 | 36 | -68 | 17 | 983 | 1,636 | 2,310 |

Source : Company Annual Reports and First Capital Research Estimates

Appendix IV: Top 20 Shareholders

| Top 20 shareholders - (% held) | 2Q2018 | 1Q2018 | QoQ | 2Q2017 | YoY |
|---|--------|--------|------|--------|------|
| Sri Lanka Insurance Corporation Ltd - Life Fund | 29.5% | 29.5% | - | 29.5% | - |
| Fortis Healthcare International Pte Limited | 28.7% | 28.7% | - | 28.7% | - |
| Sri Lanka Insurance Corporation Ltd - General Fund | 25.1% | 25.1% | - | 25.1% | - |
| Property Development PLC A/C 01 | 9.5% | 9.5% | - | 9.5% | - |
| Bank of Ceylon A/c Ceybank Unit Trust | 1.3% | 1.3% | - | 1.3% | 0.0% |
| Bank of Ceylon A/c Ceybank Century Growth Fund | 0.4% | 0.4% | - | 0.4% | - |
| Deutsche Bank AG as Trustee for Namal Acuity | 0.4% | 0.4% | - | 0.4% | - |
| Deutsche Bank AG as Trustee to Candor Opportunities Fund | 0.2% | 0.1% | 0.1% | 0.0% | 0.2% |
| Ceylon Investment PLC A/c # 01 | 0.2% | 0.2% | - | 0.2% | - |
| Bank of Ceylon No.1 Account | 0.1% | 0.1% | - | 0.1% | - |
| Deutsche Bank AG-National Equity Fund | 0.1% | 0.1% | - | 0.1% | - |
| Ceylon Guardian Investment Trust PLC A/C # 01 | 0.1% | 0.2% | 0.6% | 0.2% | 0.0% |
| Deutsche Bank AG-As Trustee for Guardian Acuity Equity Fund | 0.1% | 0.1% | - | 0.1% | - |
| Sandwave Limited | 0.1% | 0.1% | - | 0.1% | 0.0% |
| Mrs. Conceicao Aparecida Dos Santos Woodward | 0.1% | 0.1% | - | 0.0% | 0.1% |
| Mr.Abeysiri Hemapala Munasinghe | 0.1% | 0.1% | - | 0.1% | - |
| Sezeka Limited | 0.1% | 0.1% | - | 0.1% | - |
| Mr.Surendran Subramaniam | 0.1% | 0.1% | - | 0.1% | - |
| Pinnacle Trust (Pvt) Limited | 0.1% | 0.0% | 0.1% | 0.0% | 0.1% |
| Mr.Mohamed Naizer Cader | 0.1% | 0.0% | 0.1% | 0.0% | 0.1% |

Appendix V: Recommendation criteria

| Categorization | Company Category | Buy | Hold | Sell |
|----------------|--|----------------------|---------------------|-------------------|
| Grade A | S&P SL20 Companies | T.Bill + 5% & Above | T.Bill + 1% & Above | Below T.Bill + 1% |
| Grade B | Rest of the Companies | T.Bill + 8% & Above | T.Bill + 3% & Above | Below T.Bill + 3% |
| Grade C | Companies less than LKR 1Bn Market Cap | T.Bill + 11% & Above | T.Bill + 6% & Above | Below T.Bill + 6% |

| Categorization | Company Category | Buy | Hold | Sell |
|----------------|--|--------|--------|--------|
| Grade A | S&P SL20 Companies | 14.46% | 10.46% | 10.46% |
| Grade B | Rest of the Companies | 17.46% | 12.46% | 12.46% |
| Grade C | Companies less than LKR 1Bn Market Cap | 20.46% | 15.46% | 15.46% |

Weighted Average 1-year T-bill rate during Jun 2018: 9.46%



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| Amanda Lokugamage | +94 11 2639 868 | | |

GOVERNMENT SECURITIES SALES

| | | | |
|---------------------|-----------------|---------------------|-----------------|
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| Anushka Dissanayake | +94 77 2220 021 | Arun Kandasamy | +94 75 4861 506 |
| Anushi Ranawaka | +94 77 3876 819 | | |

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| | | | |
|-------------------------|-----------------|--------------------------|-----------------|
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| Nethalie De Mel | +94 11 2639 854 | Dharshanie Vasanthajothy | +94 77 9159 878 |

EQUITY SALES

| | | | | |
|----------------------|------------------|-----------------|--------------------|-----------------|
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| | | | Priyanka Anuruddha | +94 70 2910 035 |
| Colombo | | | Priyantha Wijesiri | +94 70 2910 036 |
| Damian Le Grand | | +94 70 2910 032 | | |
| Nishantha Mudalige | | +94 70 2910 041 | | |
| Isuru Jayawardana | | +94 70 2910 034 | | |
| Ifadh Marikar | | +94 77 9625 679 | | |
| Thushara Pathiraja | | +94 70 2910 037 | | |
| Anushka Buddhika | | +94 70 2910 030 | | |
| Gamini Hettiarachchi | | +94 70 2910 039 | | |

UNIT TRUST SALES

| | | | |
|-----------------------|-----------------|---------------------|-----------------|
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| Imali Abeygunawardena | +94 77 1764 799 | Deepal Pathmaperuma | +94 77 9159 878 |

BRANCHES

| | | | |
|--|--|---|---|
| Kandy | Kurunegala | Matara | Negombo |
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| Manager: Salinda Samarakoon | Manager: Menaka Wavegedara | Manager: Rohana Jayakody | Manager: Buddhika Edirisinghe |
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