

THE PRINCIPAL BANK FOR
DEVELOPMENT AND AGRICULTURAL CREDIT

SUMMARY REPORT

ON

THE FINDINGS OF THE FINANCIAL
ANALYSIS STUDY

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1. INTRODUCTION

1.1 Based on our contractual commitments with APCP, we have carried-out this study to present a comprehensive financial analysis of the Principal Bank's financial statements which consists of the balance sheet, income statement, profit & loss account and profit distribution account for the financial years from 1985/1986 to 1992/1993. This is in addition to evaluating certain important specialized issues which have impact on the bank's practice and activities, following that we have carried-out a profit projection for the next five financial years.

1.2 The Detailed Report

We have submitted to APCP management our detailed report on the findings of the financial analysis study in compliance with the detailed scope of work as stated in the request for the study which was approved by APCP management.

Our detailed report consists of four main chapters covering the following topics:

Chapter I: General presentation of the findings and trends revealed by the study.

Chapter II: Vertical and horizontal analysis and banking performance ratios.

Chapter III: Important specialized issues.

Chapter IV: Profit projection.

The report consists of 214 pages in addition to appendices which consist of 32 pages gives a total of 246 pages. Considering the above, our detailed report has two main characteristics:

First Character:

The wording of our detailed report is of a technical and professional nature to a great extent. This was mainly because we have explained the alternatives approaches and methods used in the analysis. We have also, presented the scientific and theoretical basis supporting these approaches. Finally we have demonstrated the criteria applied when we chose between these alternatives together with the criteria followed when we evaluated the results of the financial analysis.

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Second Character:

The detailed report is too long. As we have based our analysis on both detailed and consolidated captions of the financial statements in order to extract the results and general trends relevant to the issue under review.

We have also substantiated the reasonableness of the figures and trends extracted by exhibiting a number of tables and appendices to support the detailed steps of our analysis.

As a result of the above, the reader of our detailed report, would have to spent relatively quite a long time in order to adequately grasp and master its findings. This is in addition to the need of a specialized technical knowledge of the approaches employed in this analysis.

However, we trust that our detailed report has answered all the issues and points originally stated in the request for the study, and as such we believe that we have satisfactory fulfilled our contractual responsibilities with APCP management.

1.3 Summary Report

Although our detailed report has presented a comprehensive coverage of the results of the financial analysis study, we very much appreciate the need of the executive management of PBDAC to identify such results and trends in a much more direct way to be used in the decision making process which aim to achieve the bank's strategic objectives.

Consequently, we have prepared this summary report using a simple and direct wording free of complicated technical expressions to demonstrate the results and trends revealed by the study without the need to go through the technical approaches and alternatives used in the analysis.

We believe that our presentation would help the reader to clearly understand the bank's current financial position and identify the financial and funding problems facing the bank.

It would also encourage the management to use the results and the trends revealed by the study as an important input into the bank's strategic planning process.

We have substantiated our summery report with several charts which display the quantifications related to the issues under review, details of which can be obtained form the detailed report.

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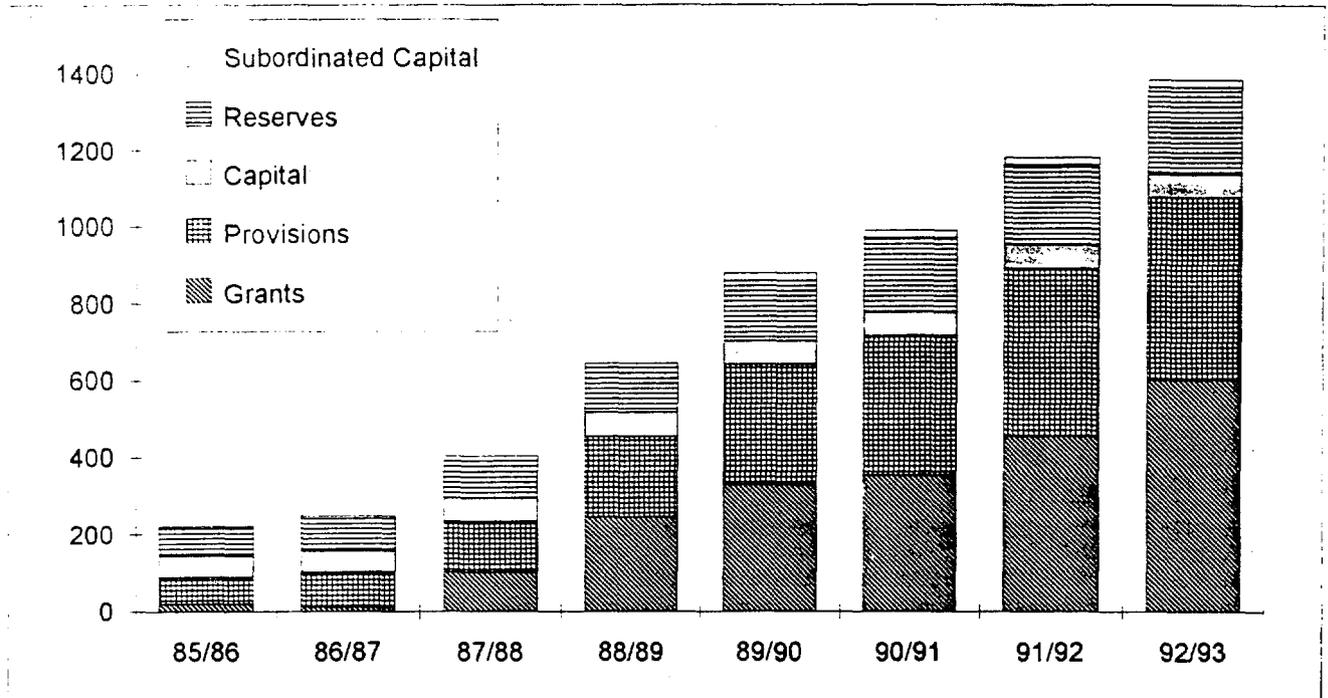
Presentation of Financial Analysis Results

We have presented in our detailed report, the results of the financial analysis using the annual rate of growth approach. This approach concentrates on the yearly rate of variation in each of the financial statements main items and captions. It demonstrates the different trends in the value of these items during the period covered by the study. We have also used the financial ratio approach to present and identify the relative importance of the items under consideration together with the banking performance ratios.

However, in this summary report we have demonstrated the value of the items under review throughout the duration of the study by way of charts with explanatory comments which cover the results and findings derived from the vertical and horizontal analysis and the banking performance ratios as appropriate .

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2.1 Internal Sources of Fund



- The bank has succeeded to increase the value of its internal sources of fund which amounted to L.E 1,385m as of 1992/1993 representing 22% of total sources of funds.
- The relevant importance of the components of the internal sources of fund can be shown as follows :

	92/93 %	85/86 %
Grants	44	9
Provisions	34	31
Reserves	17	35
Capital	4	25
Subordinated capital	1	0
	<u>100</u>	<u>100</u>

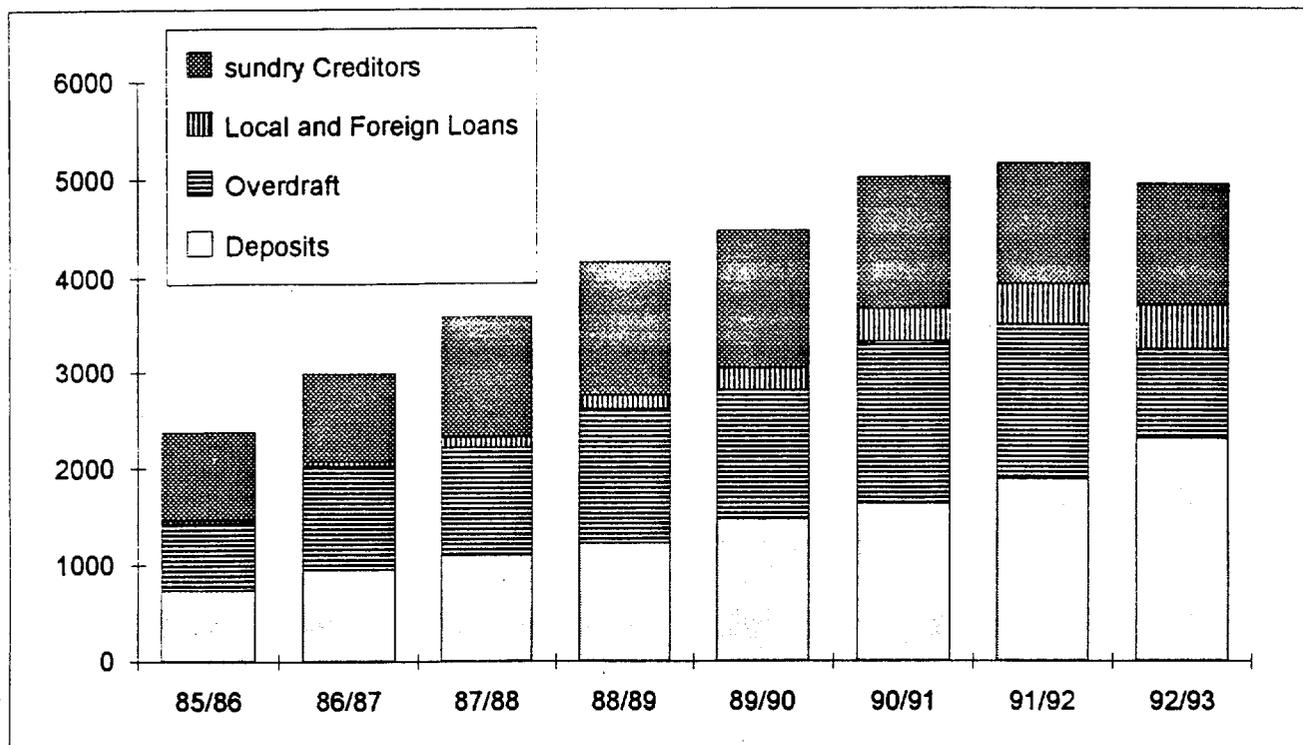
- Although the bank has increased the value of the provisions over the duration of the study, the value of the doubtful and non performing loans has also increased. It would be necessary that the balance of the provisions will be used to cover any future losses in the credit portfolio.

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- Due to decrease of the profits of the bank since 1990, the profits retained as reserves were gradually decreasing. This has sharply affected the relevant importance of the reserves as one of the internal sources of fund.
- Despite the transfer of LE20m made by the Ministry of Finance as a subordinated capital, the total value of the bank's capital is not comparable to the increase in the volume of the bank business. This has drastically reduced the relevant importance of the capital as a source of fund.

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2.2 External Sources of Fund:



- The components of the external sources of fund are :-

	92/93 %	85/86 %
- Customers' Depoists	47	33
- Bank Overdraft	18	32
- Local and Foreign Loans	10	2
- Other Credit Balances	25	33
	<u>100%</u>	<u>100%</u>

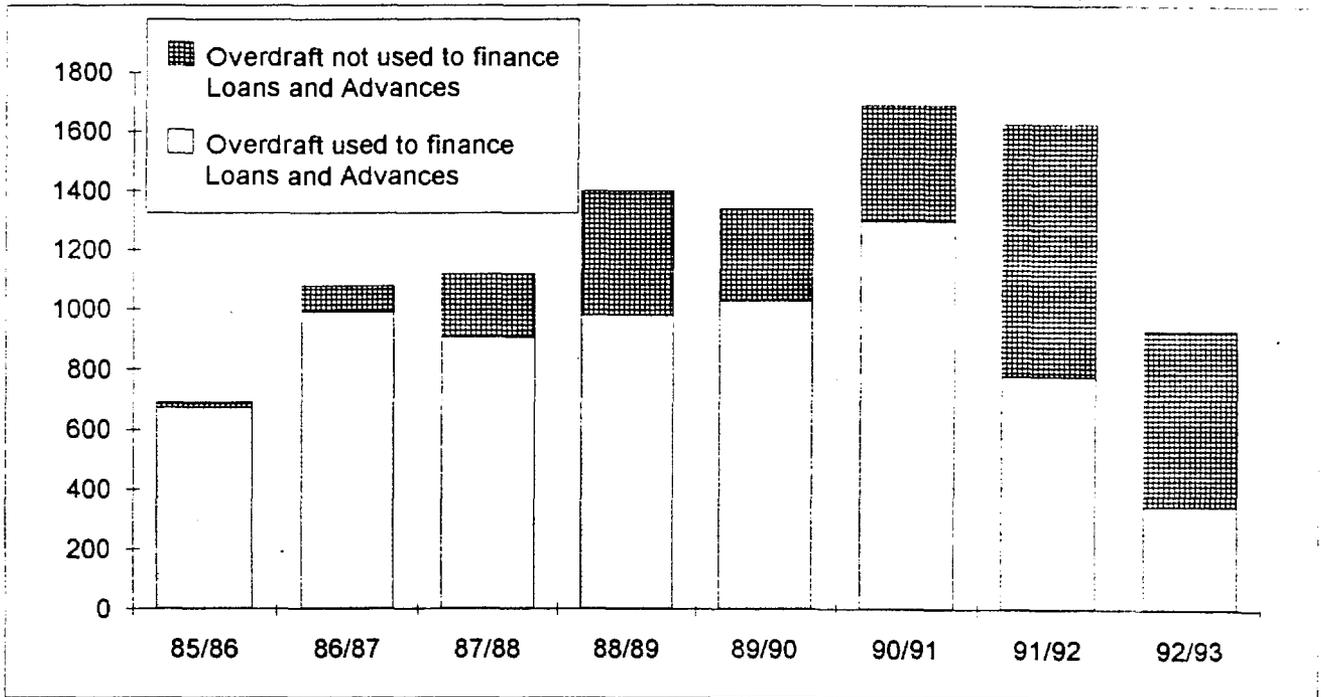
- The rate of increase of the external sources of fund of 125% was less than the rate of increase in the external sources of fund of 524% . As of 92/93 the external sources of fund were representing 78% of the total sources available.
- Customers' deposits represent the most important source of finance. This has been reflected on the enhancement of their relative importance and the decrease of the overdraft relative importance during the duration of the study.

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- As the bank was successful in obtaining new local and foreign long term loans. Their relative importance has been progressively increased. However, PBDAC has obtained foreign loans to finance the expansion of its storage capacity, while it is decided to gradually discontinue the production input activity. These loans amounted to L.E 69 M in 92/93.
- As a result of discontinuing the production inputs activity, the relative importance of other credit balance has been reduced as shown above.

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2.3 Utilization of Overdraft Funds:



- As a result of the shortage of both customers' deposits and internal sources of fund to finance the activities of the bank, it was necessary to depend on the overdraft as an alternative external source of fund to finance such shortage.

Bank overdraft is considered the most expensive source of finance. However, the analysis has indicated that not all of the overdraft funds obtained by PBDAC was utilized in financing an income-generating assets. i.e (credit portfolio).

- On the contrary, the majority of the overdraft funds were utilized to finance non-income generating assets, specially the debits due from Ministries of Agriculture and Finance. That means, PBDAC has suffered a heavy cost, in terms of interest payable on overdraft funds, to finance such debits which generate no income to the bank. The impact of the governmental debits is addressed in point (3-7) below.

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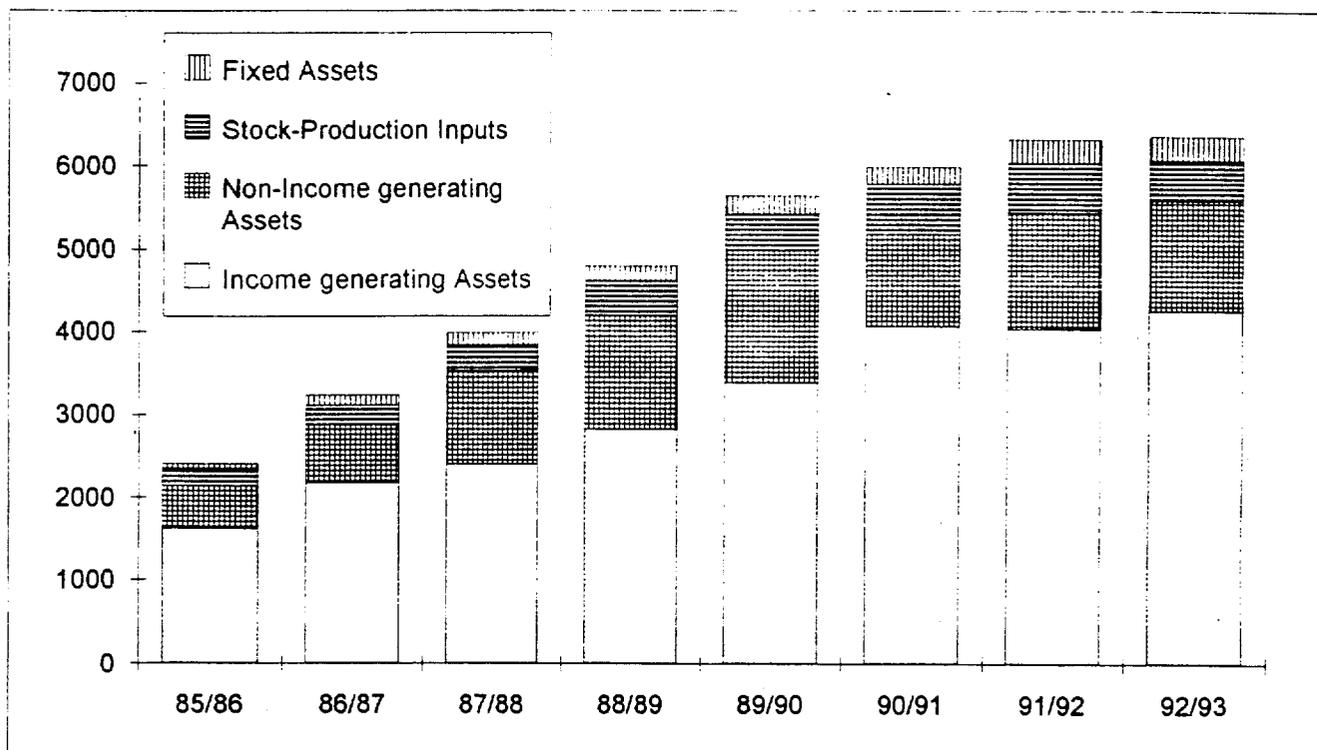
- The above chart has revealed the following utilization ratios of overdraft funds:

	92/93 L.E (m's)	%	85/86 L.E (m's)	%
a- Overdraft used to finance credit portfolio	346	37	674	97
b- Overdraft used to financing non-incomegenerating assets	<u>587</u>	<u>63</u>	<u>19</u>	<u>3</u>
	<u><u>933</u></u>	<u><u>100</u></u>	<u><u>693</u></u>	<u><u>100</u></u>

As indicated above, in the early years of the study there were a better utilization of the overdraft funds. However, due to the accumulation of governmental debits the overdraft funds used to finance non-income generating assets have sharply increased.

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2.4 Income and Non-Income Generating Assets



- The bank's assets are composed of :

	92/93 %	85/86 %
- Income generating assets	67	67
- Non-income generating assets	21	21
- Stock-production inputs	7	9
- Fixed assets	5	3
	<u>100%</u>	<u>100%</u>

- The bank has managed to increase its credit portfolio at a rate of 162% throughout the duration of the study. This is less than the rate of growth achieved for customers' deposits of 314%.

- This is further supported when we compare the percentage of the loans to the assets of 66.6% maintained by PBDAC against 69.5% maintained by the specialized banks.

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- The debit balance due from the Ministry of Finance amounting to LE 406m as at 92/93 representing 30.5% of the total non-income generating assets. This is considered rather significant and would sharply affect the profitability position of the bank.
- The bank is still maintaining a stock of production-inputs amounting to L.E 438m, representing 7% of tot assets, despite the general policy of discontinuing such activities as of July 1992.

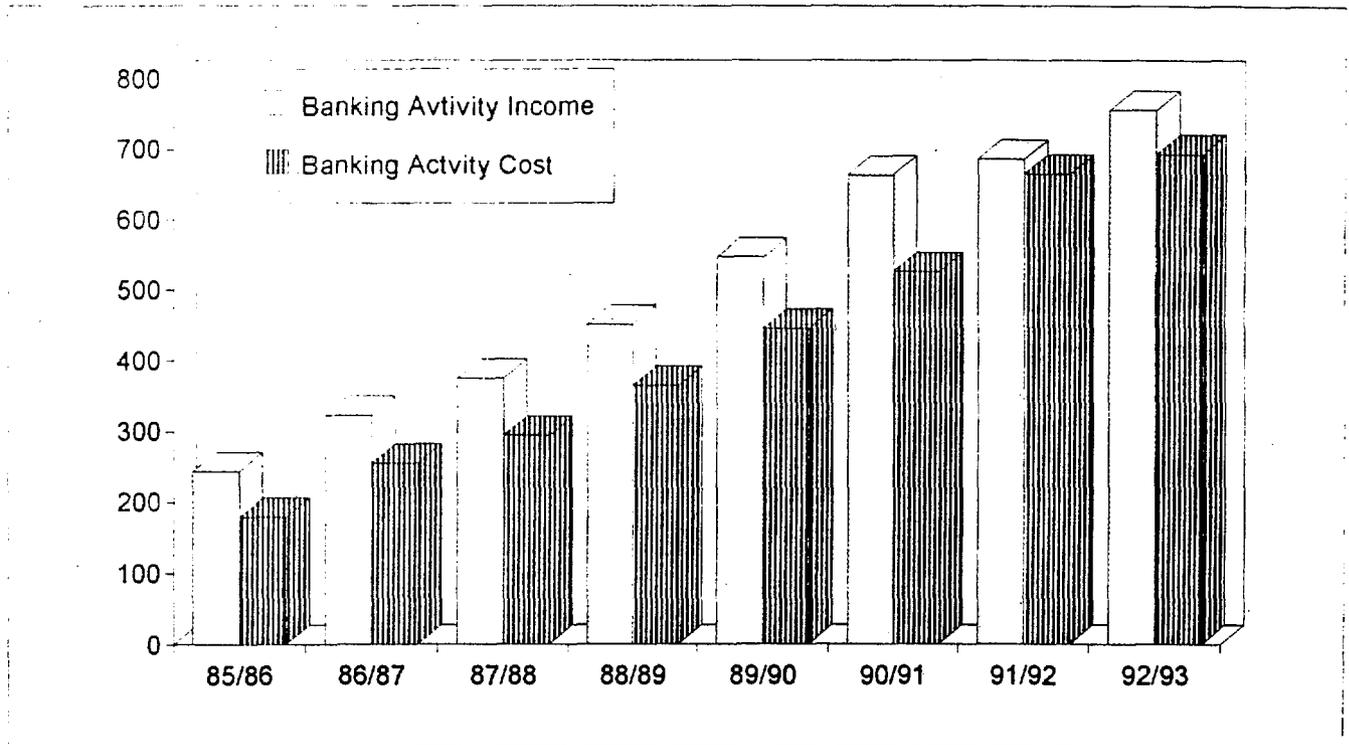
However, the bank is facing a tough competition by the manufacturing companies, co-operative societies and private sector companies in marketing such products.

- The bank has not adequately provided for stock provision necessary to cover the expected reduction in the value of the stock.

However, due to the current economic conditions, PBDAC's management has decided to provide for stock obsolescence provisions to liquidate the obsolete and slow moving stock items as of 1993/1994.

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2.5 Banking Activities Income and Cost



- A comparative of the gross profit of the banking activities would show the following:

	92/93		85/86	
	LE (m's)	%	LE (m's)	%
Income	756	100.0	243	100.0
Cost	693	97.7	179	73.7
Net Income	<u>63</u>	<u>8.3</u>	<u>64</u>	<u>26.3</u>

- The volume of the banking activities has increased. However, the rate of growth of the cost of 287% was higher than the rate of growth of the income of 211%, this was due to :

- a) Cost of funds has increased as a result of the increase in the interest rate applicable to savings and deposit in local currency. Also, the rate of interest payable on bank overdraft has increased and most important the increase of the banking activities share of the admin. expenses.

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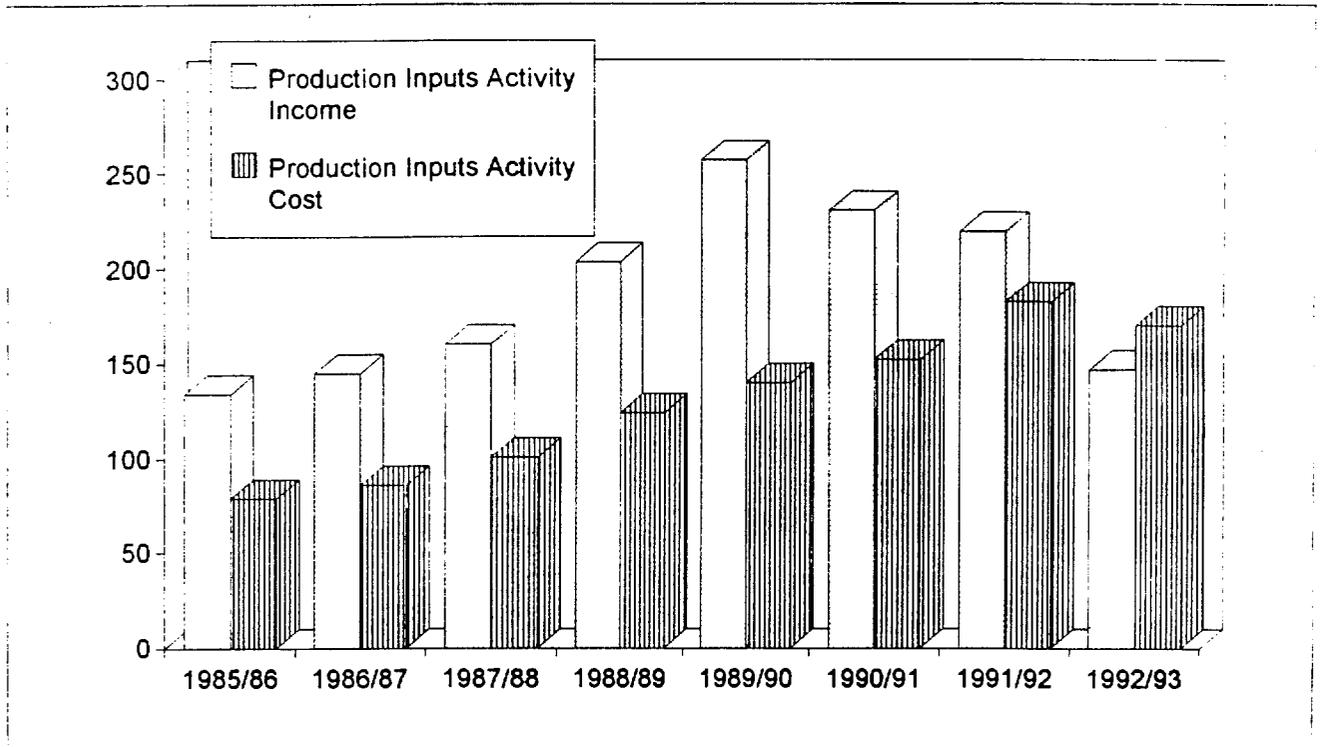
b) Due to the government policy to stop subsidizing the interest rate applicable to agricultural loans as of March 1993. The growth rate of the agricultural loans was relatively reduced during 91/92 and 92/93. For further details, please refer to table (6/2/2/2) of our detailed report.

- The increase in the banking activity income is directly linked to the increase in the volume of the credit portfolio as follows:

	92/93		85/86	
	L.E (m's)	%	L.E (m's)	%
Agricultural Credit	1,738	30	517	32
Investment Credit	3,561	62	1,080	68
Commercial Credit	447	8	0	0
	<u>5,746</u>	<u>100</u>	<u>1,597</u>	<u>100</u>

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2.6 Production Inputs Activities Income and Cost



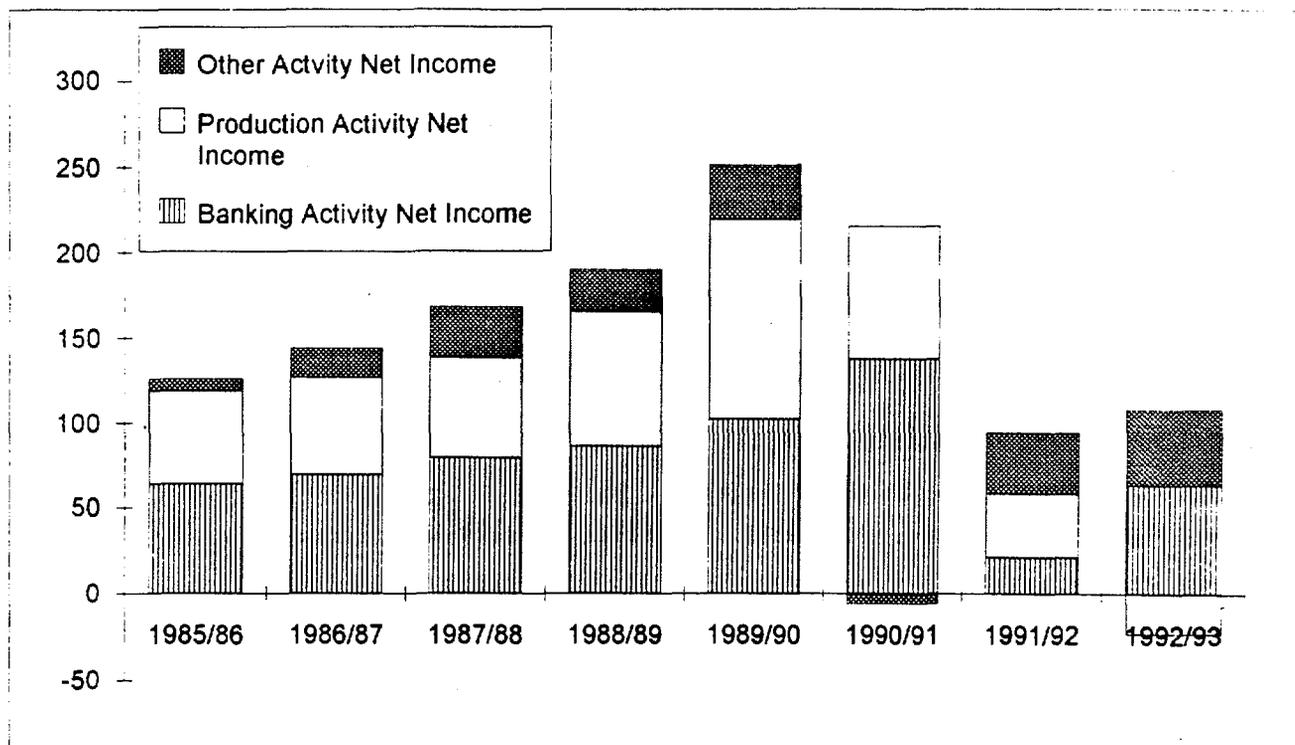
- A comparative of the gross profit of the production inputs activity would show the following:

	92/93		85/86	
	L.E (m's)	%	L.E (m's)	%
Income	147	100	134	100
Cost	170	115	79	59
	<u>-23</u>	<u>-15</u>	<u>55</u>	<u>41</u>

- Total cost of production input activity increased at a rate of 115% which was higher than the rate of the increase of the income of 9.7%. This has resulted in a loss L.E 23m as at 92/93
- This was a direct result of the loss of the bank's monopolistic position in marketing and distribution of the agricultural production inputs since 1990.
- To compensate for the above loss, the bank has started in 1992/93 a new business activity of renting its warehouses to third parties; however, this new activity has realized L.E 4m only.

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2.7 Net Income



- The net income from all the bank's activities is as follows:

	92/93	%	85/86	%
	L.E (m's)		L.E (m's)	
Banking	63	74	64	50.8
Production Inputs	-23	-27	55	43.6
Sub-Total	<u>40</u>	<u>47</u>	<u>119</u>	<u>94.4</u>
Other Reconciliations	45	53	7	5.6
Net Income before Tax	<u>85</u>	<u>100%</u>	<u>126</u>	<u>100%</u>

- The bank has managed to achieve an increasing growth in its net profits before tax up to 89/90, then profitability position has deteriorated from 90/91 up to 92/93.
- The bank has managed to maintain a relatively steady level of profit for the banking activities (LE 62m in 85/86 compared to LE63m in 92/93).

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- However, the production-inputs activities have realized a loss of LE 23m in 92/93 as compared to profits of LE 55m in 85/86 for reasons stated earlier.
- Most important, the bank has used the accounting adjustments of prior years income and expenses as a balancing tool to maintain the level of the reported profits. This is substantiated by the fact that the net income generated by the banking and production inputs for 92/93 was L.E 40m only as compared to LE 45m being net income relating to accounting adjustments in the same year.

This means that :

- a) PBDAC will be taxed on book profits for LE 85 at a rate of 42%.
 - b) The retained income should be transferred to Ministry of Finance.
 - c) The cash required to pay for (a) and (b) above will be funded by the bank overdraft as the reported profits are not generated from the normal activities of the bank.
- When evaluating the bank's performance by comparing the income before tax with the equity and total assets employed the following results are noticed:
 - a) In general, return on equity is considered relatively high, although it has been affected by the level of the profits reported during the years of the study.

However, the reason for high return on equity can be attributed to the low value of the equity as compared to the high volume of activities and the level of funds managed by the bank.

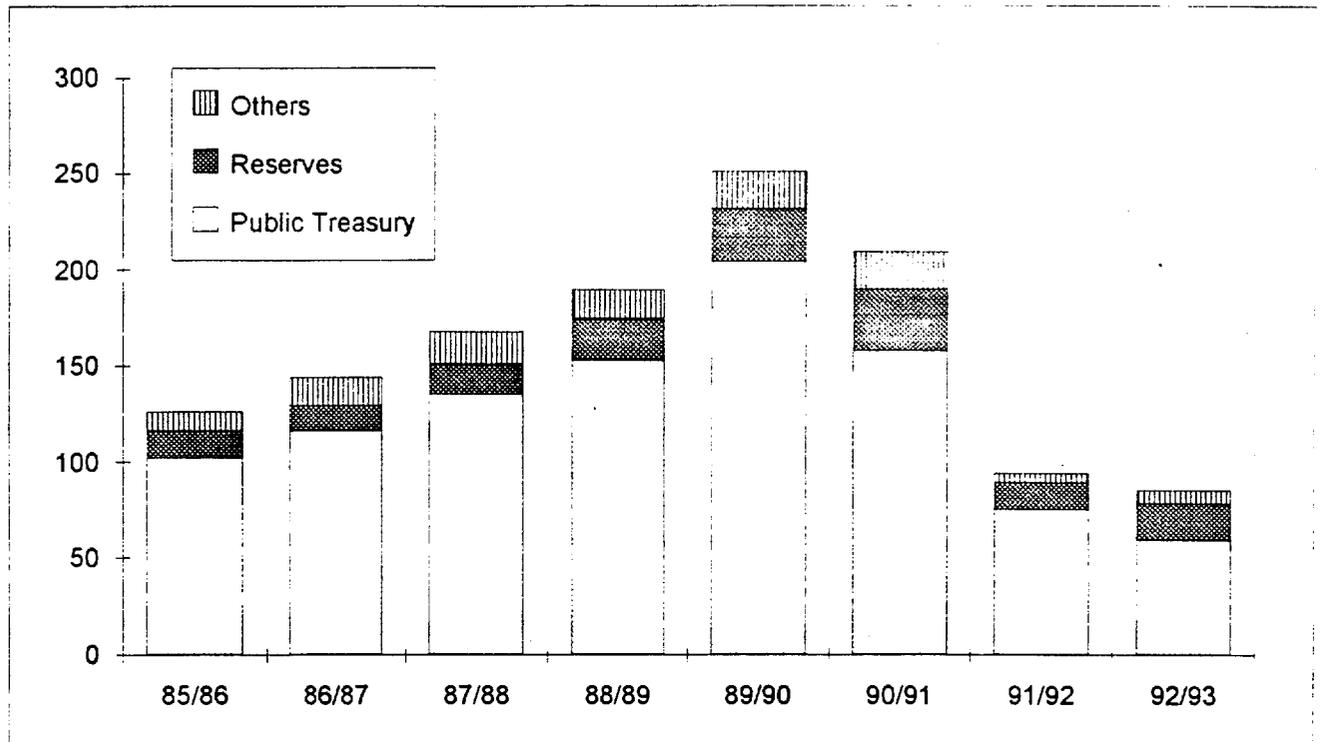
- b) Adversely, the return on assets employed excluding assets relating to the grants, is considered rather low as it average between 1.5% to 5% during the years when the bank has reported high profits.

This is caused by the significant changes made to the agricultural sector and PBDAC decision to discontinue its production inputs activity.

This is in addition to the ever increasing competition in the banking sector by commercial banks which have accumulated liquidity as a result of the financial reform policies applied by the government in recent years.

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2.8 Profit Distribution



- The distribution of the bank's profits revealed the following:

	92/93		85/86	
	L.E (m's)	%	L.E (m's)	%
Corporate Tax	49	58	64	51
Transfer to M. O. F.	10	12	38	30
	<u>59</u>	<u>70</u>	<u>102</u>	<u>81</u>
Reserves	19	22	14	11
Employees' and Naser				
Bank's Shares	7	8	10	8
	<u>85</u>	<u>100%</u>	<u>126</u>	<u>100%</u>

- Ministry of Finance has taken the biggest share of PBDAC profit distribution throughout the duration of the study in the form of corporate tax and profit transfers.

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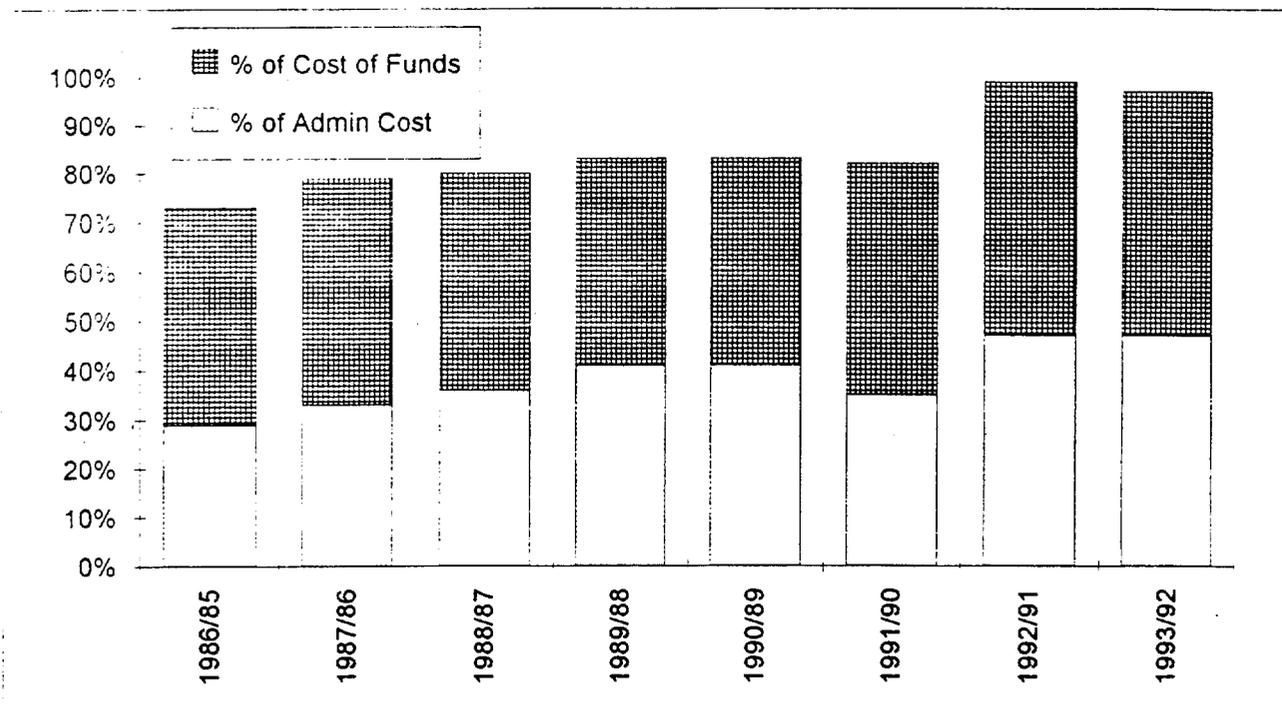
- However, due to the decreasing level of profits in 91/92 and 92/93 this share was considerably reduced.
- It should be noticed that the yearly transfer of the retained income to Ministry of Finance is depriving the bank from one of the most important internal funding source, i.e the retained earnings. No doubt this negatively affecting the performance and profitability of the bank.
- For further details on profits distribution, please refer to table (19/2/3/2) on page 108 of the detailed report.

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3.1 Lending Cost/Benefit Analysis



- Considering PBDAC performance in the lending activities would reveal the following:

	92/93		85/86	
	L.E (m's)	%	L.E (m's)	%
Interest Income	717	100	223	100
Interest Expense	-357	-50	-97	-44
Gross Income	360	50	126	56
Admin. Cost	-336	-47	-65	-29
Net Income	24	3	61	27

- The bank was able to increase the value of interest income, as a result of increasing the volume of the credit portfolio and relevant increase in the interest rates.

However, the increase in the cost of funds and the admin. cost were higher than the rate of increase in the interest income. This had resulted in the decrease of the net income from the lending operations, which has negatively affected the level of the bank's profits.

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This was due to:

- a- Continue to depend on the external sources of funds with relatively high cost.
- b- Increase the cost of bank overdraft from approximately 8% in 85/1986 to 15% in 92/1993.
- c- The increase of the lending activity share of the administrative cost as a result of the sharp reduction in the volume of the production-inputs activity.

This has resulted in the increase of administrative cost allocated for each L.E 1.00 credit granted from L.E 0.04 to L.E 0.072 with a growth rate of 80%

The above table shows that only 3% has been realized as net profits from the lending activity as compared to 27% in 85/86. The main reason revealed by the study is the increasing share of the administrative costs allocated to the lending activity.

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3.2 Matching between Sources and Applications of Funds

- The study has revealed the following ratios relating to the application of the funds available.

	92/93	%	85/86	%
- Ratio of short term applications/sources	103		65	
- Ratio of medium term applications/sources	185		282	
- Ratio of long term applications/sources	17		134	
- Ratio of other term applications/sources	102		86	

- The financial analysis has indicated that both short and long term sources have realized a surplus after funding the short and long term applications. On the contrary the medium term sources has realized shortage, throughout the duration of the study, in financing the medium term applications. Such shortage was funded by the surplus realized from the short and long term sources.
- However, the use of short sources to finance the medium term applications has resulted in a liquidity problem facing the bank. This reflects a high degree of mismatching between the sources and the applications of funds, thus we recommend that :

First : To enlarge the bank's medium term sources of funds, specially term deposits. This would be achieved through the presentation of a new saving schemes to attract new customers. Considering the existance of competition by the commercial banks.

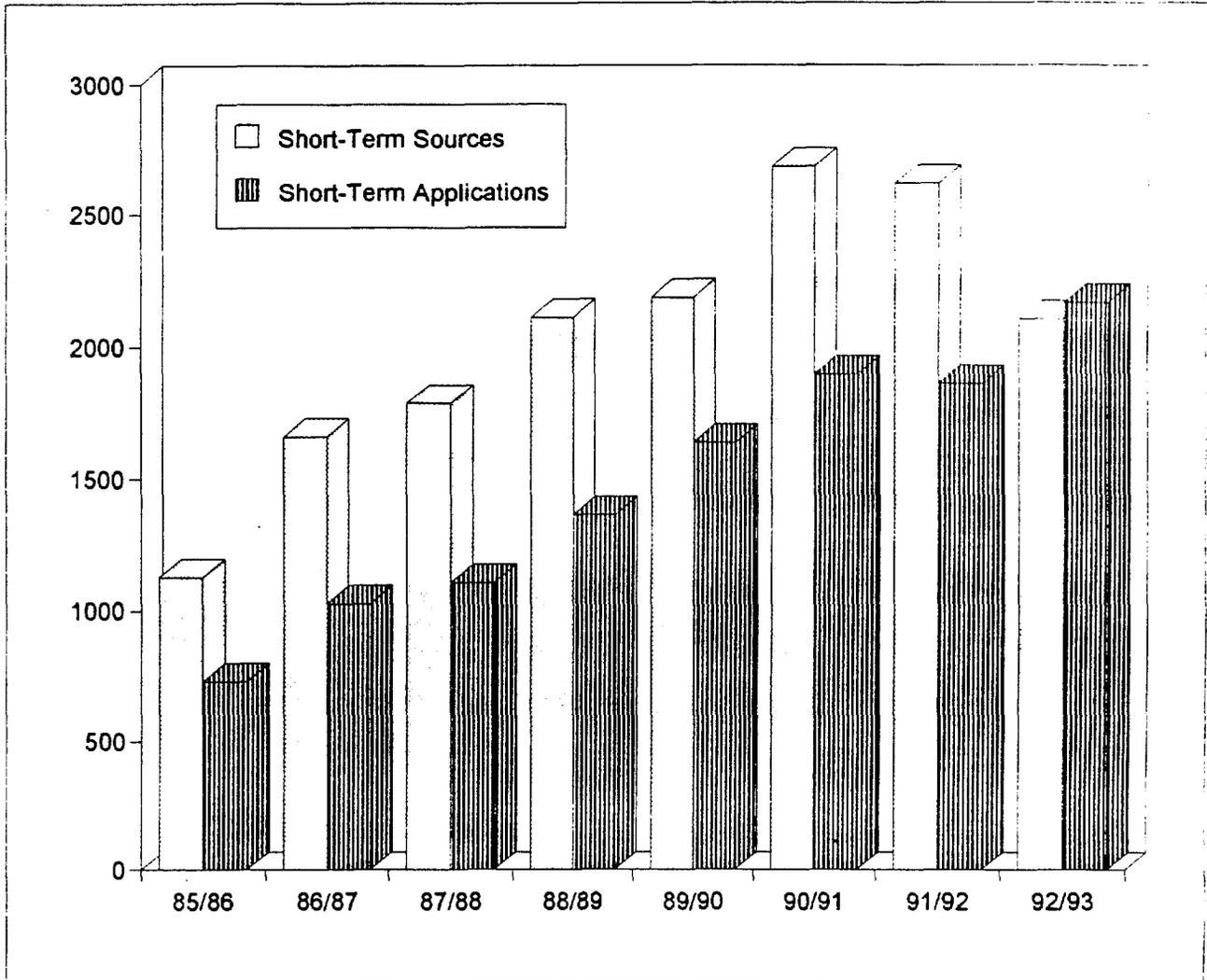
Second : To reduce the bank overdraft to the minimum and compensate such reduction by attracting customers' deposits, possibly in the form of deposits at calls.

Third : To increase the bank's short term lending portfolio, specially the commercial credit which has relatively short business cycle.

- It was noticed that cash and bank balance amounting to L.E 159M in 92/93 was entirely financed by bank overdrafts.
While such balance does not generate any income, PBDAC pays interest expense due on the bank overdraft, thus we recommend that an assessment should be made to identify PBDAC's needs for liquid cash and bank balances in order to reduce them to the lowest possible level and consequently reduce the overdraft and its associated cost of finance.
- It was also noticed that the surplus in long term sources as from 78/1988, was realized as a result of grants obtained by PBDAC which have a positive impact on the sources of funds, in general.

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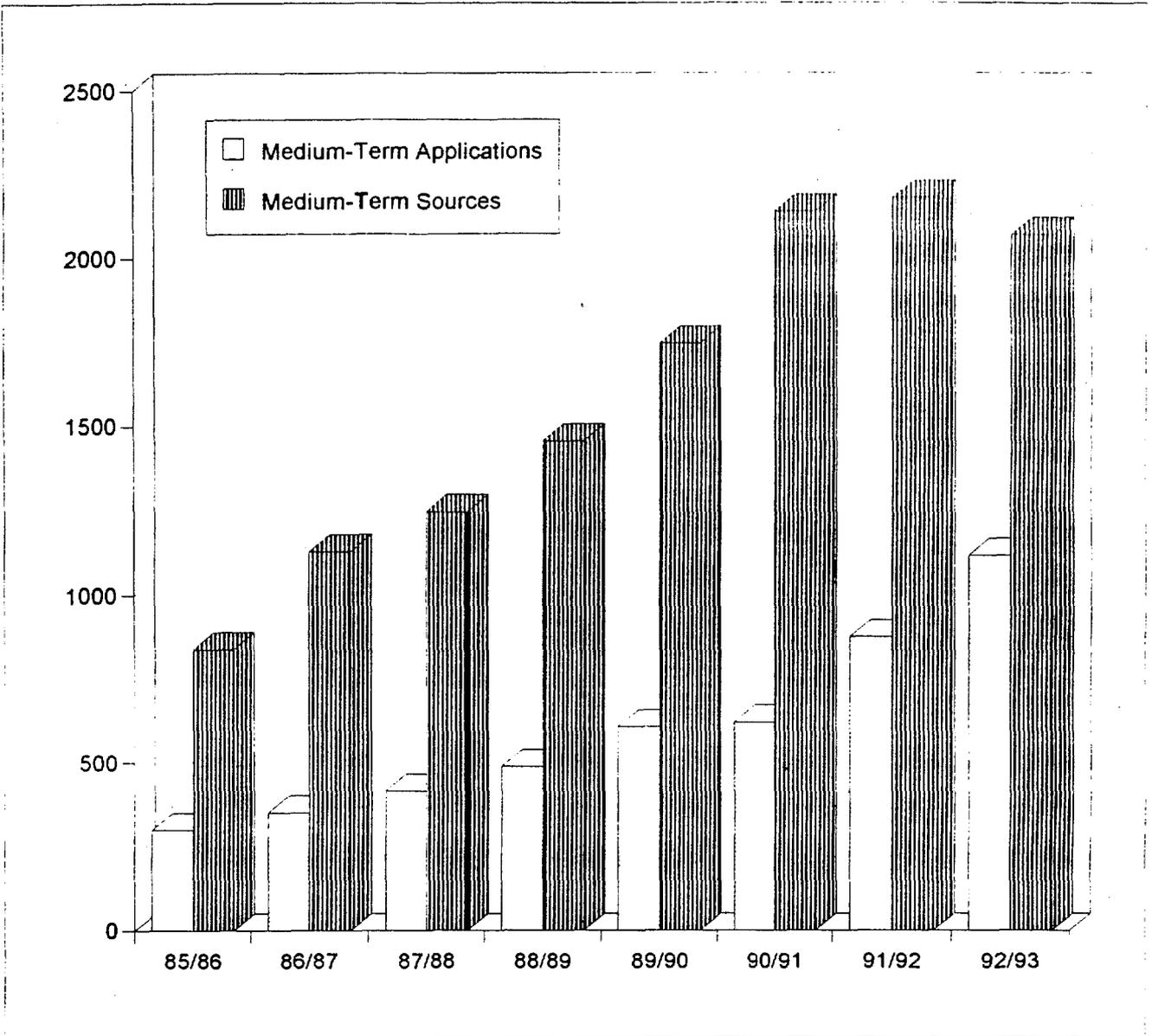
Short Term Sources and Applications



- Short term sources include demand deposits, saving accounts and bank overdraft.
- Short term applications include cash in hand and banks, securities and short term loans.

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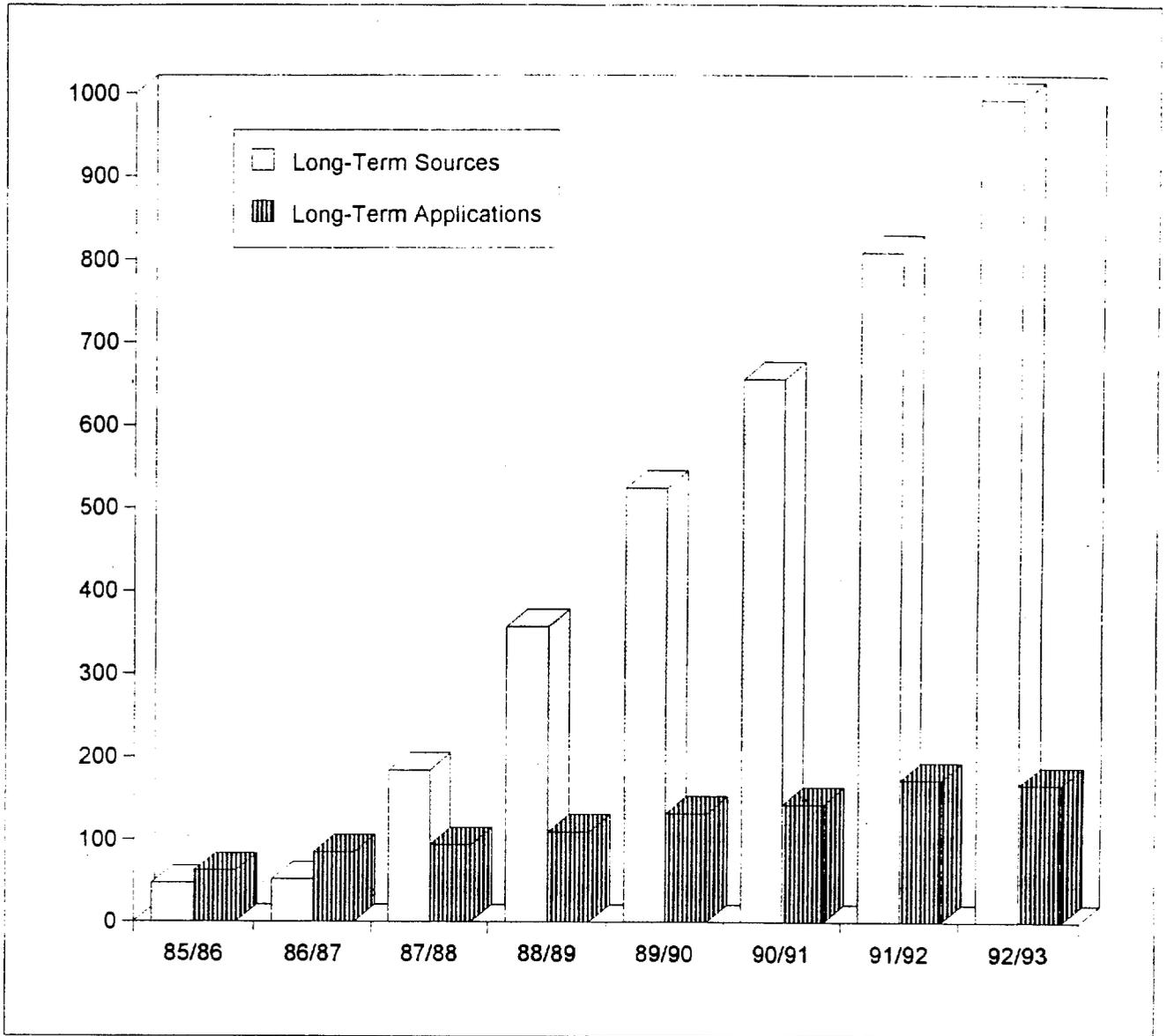
Medium Term Sources and Applications



- Medium term sources include term deposits, saving certificates and other deposits.
- Medium term applications include medium term loans and advances.

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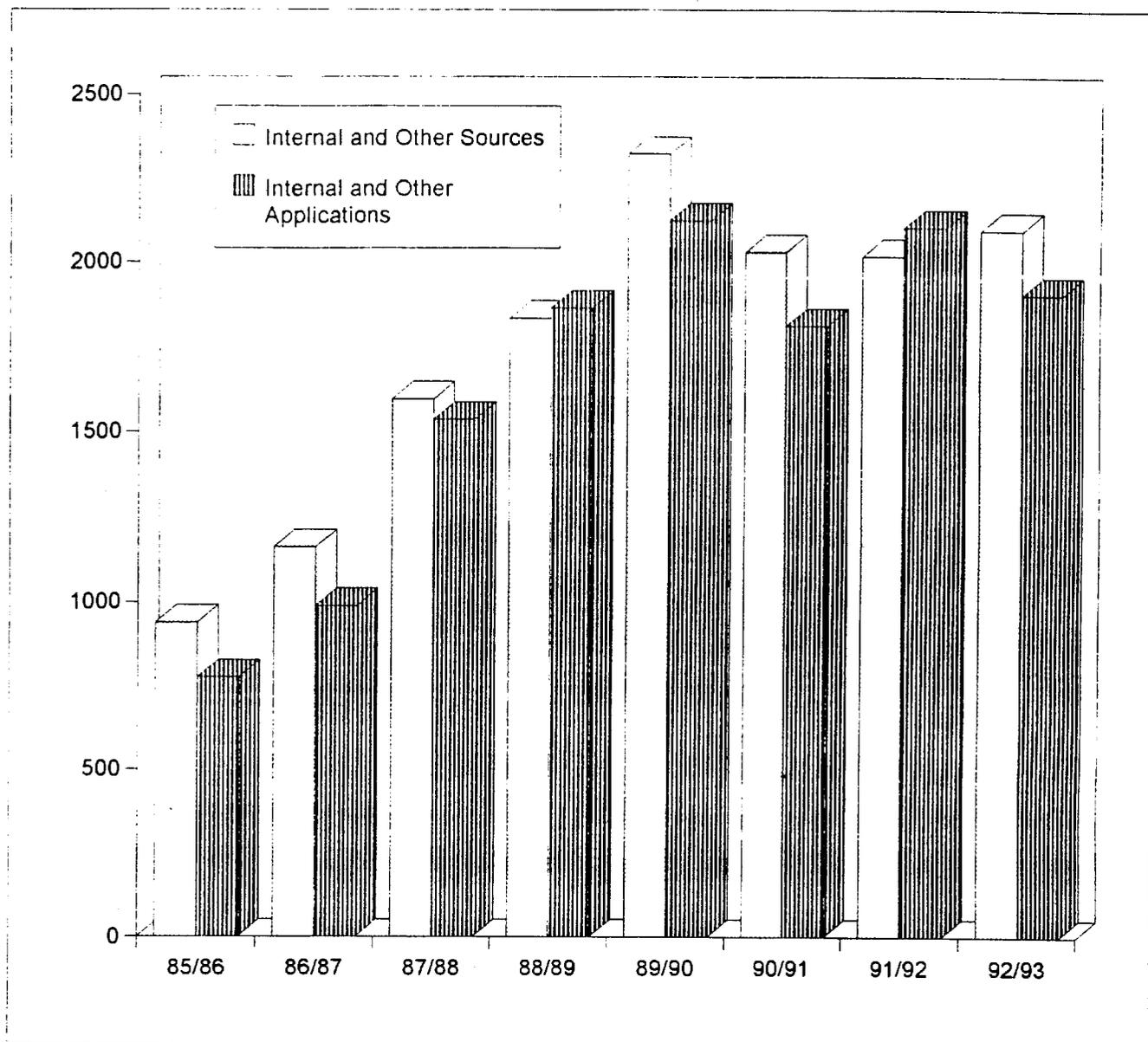
Long Term Sources and Applications



- Long term sources (banking activity) include grants, foreign and local loans allocated to finance loans and advances.
- Long term applications include long term loans and advances.

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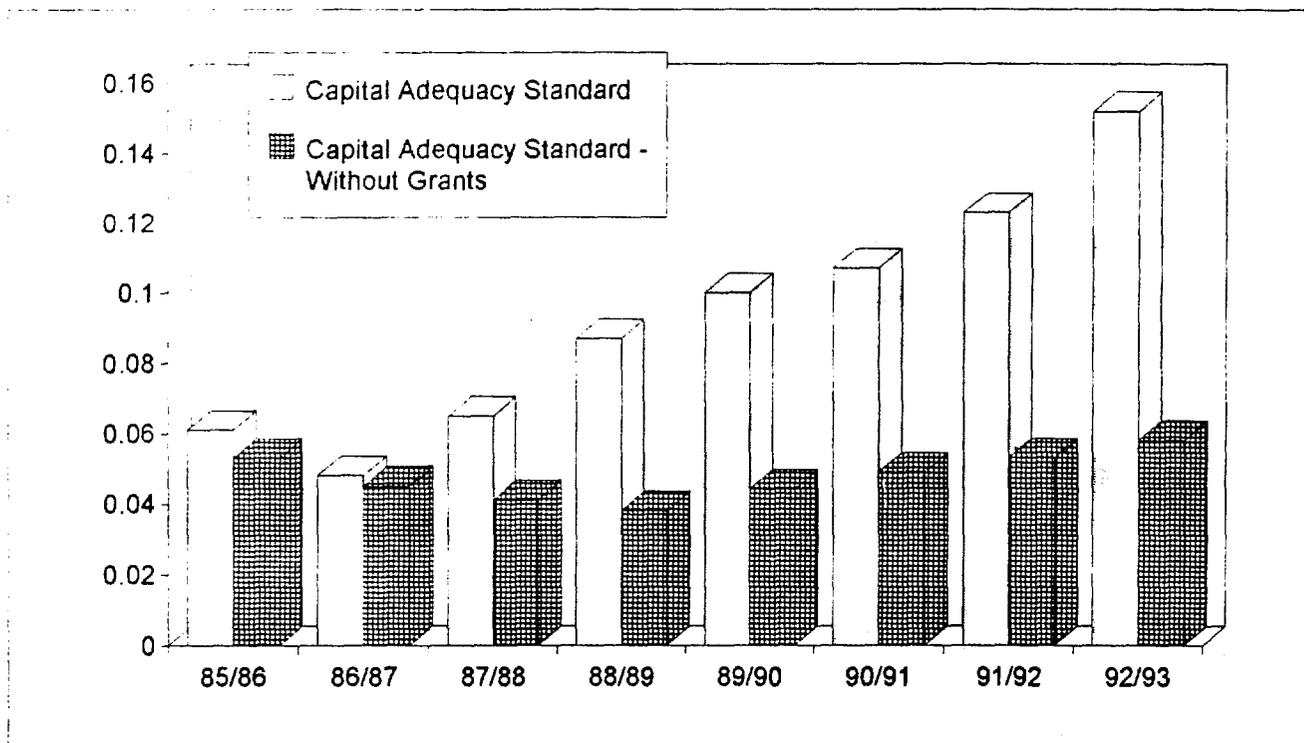
Internal and Other Sources and Applications



- Internal and other sources include capital, reserves, subordinated capital, provisions and local and foreign loans allocated for capital expansion.
- Other applications include fixed assets, work in progress, stock, letter of credit and debit balances.

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3.3 The Impact of Grants on the Bank's Capital Adequacy and Cost of Funds:



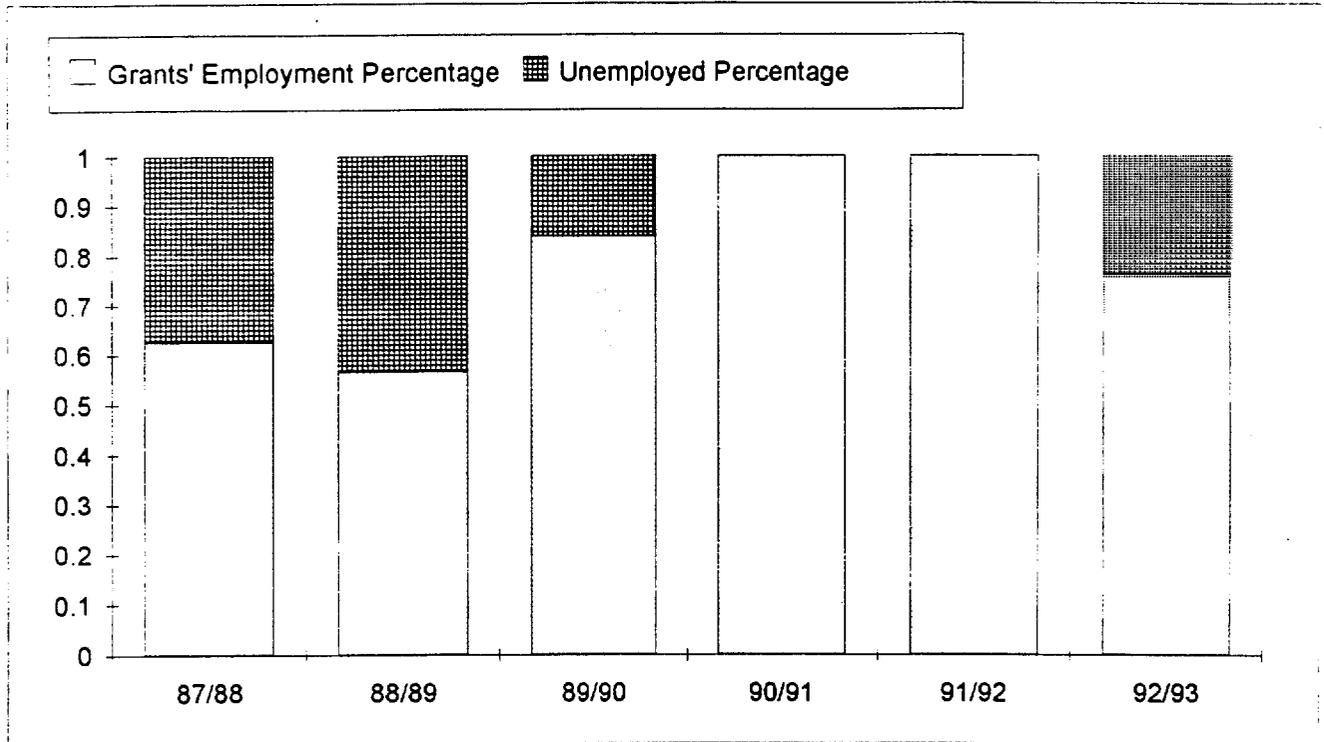
- In accordance with the capital adequacy measurements issued by the Central Bank of Egypt, the value of PBDAC's capital for the purpose of computing the adequacy ratio is as follows:

	92/93 L.E (m's)	85/86 L.E (m's)
- Capital Including Grants	971	154
- Capital Excluding Grants	370	134

- PBDAC was not able in 85/86 and 86/87 to meet, the capital adequacy ratio of 8% of the total risky assets and contingent liabilities, as defined by the Central Bank of Egypt.
- However, as the bank has obtained the capital grants as of 87/88 (small farmer and APCP) it was able to achieve the capital adequacy over and above the ratio fixed by the Central Bank of Egypt. It should be noticed that PBDAC would have not been able to achieve such high ratios through-out the duration of the study, had it not obtained the grants.
This would reflect a very positive impact of the foreign grants on PBDAC's ability to maintain a high ratio of capital adequacy.

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3.4 The impact of the grant on the applications of funds



- The financial analysis has revealed the following ratios:

	92/93	85/86
Ratio of grants to total portfolio	11.50%	1.20%

- The grants have possibly contributed into the increase of the volume of the credit portfolio and the PBDAC business in general. However, it would have been even more effective had the total value of the grants was fully utilized in financing the credit portfolio. As indicated by PBDAC own financial reports there were certain parts of the grants not utilized as displayed in the above chart.
- It is our understanding that the grants money were fully utilized in financing the credit portfolio, but the accounting allocations and practices followed in certain village banks were not correct, which had resulted in reporting under utilization of the grants. Our understanding is further supported by the fact that the financial reports have shown that, APCP grant was utilized in 90/91 at a rate of 139% which is not obviously correct.

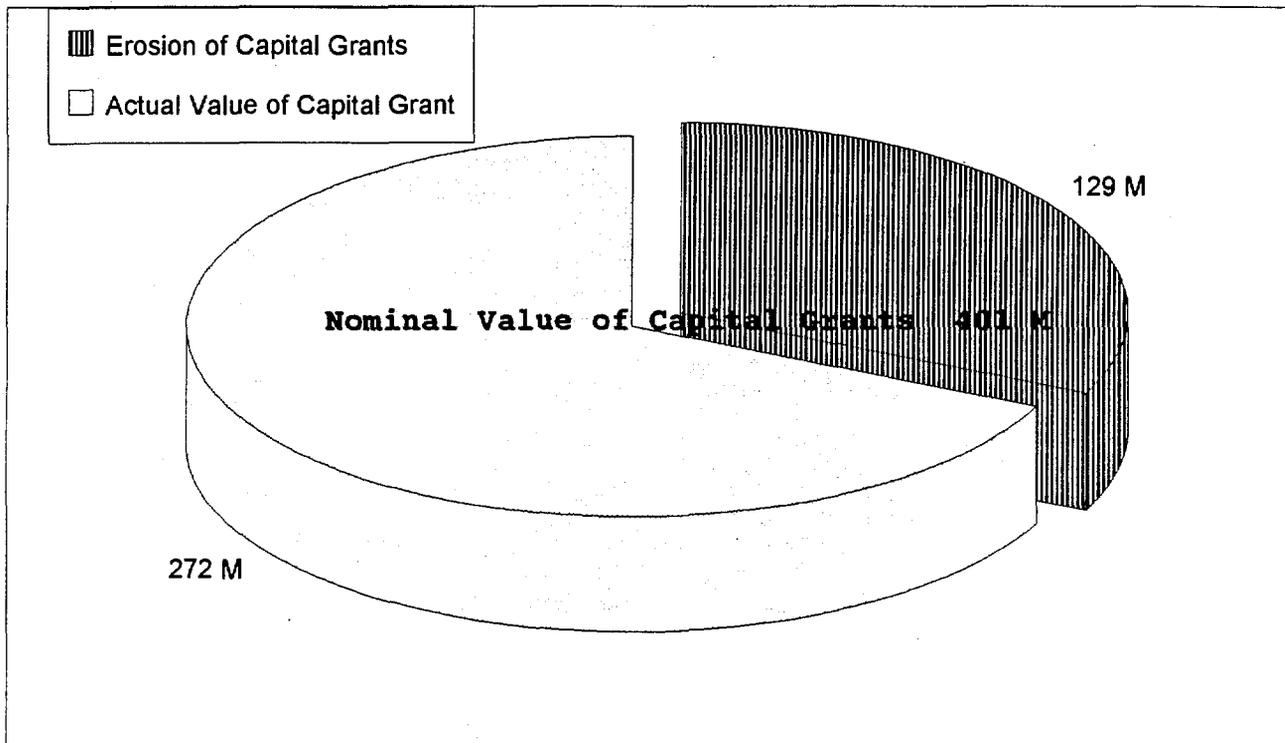
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- Consequently, as a result of the incorrect accounting treatments, there was certain operating income from the grants wrongly reported as part of the PBDAC income in the profit and loss account, at the time where they should have been capitalized in accordance with the terms of the agreement.

This has resulted in PBDAC paying-out corporate income tax and profit distributions out of the capital of the grants.

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3.5 The Impact of Inflation on the Preservation of Capital Grant of APCP



- The financial analysis has shown that the capital grants were eroded through-out the duration of the study, at the following amount: LEm's

	L.E (m's)
- Reduction in the purchasing power of the capital grant as a result of inflation	222.5
- Less: interest income capitalized	<u>-93.5</u>
- Eresion of capital grant	<u>129.0</u>

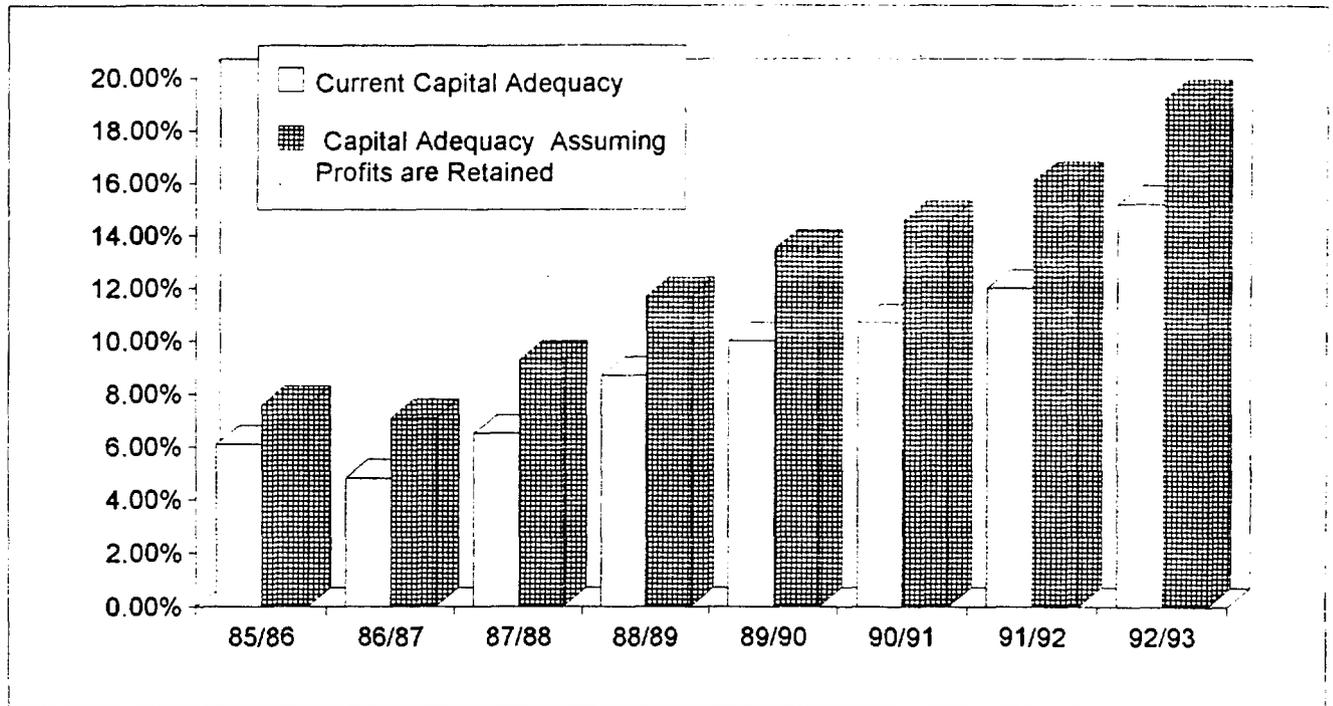
- The increase of the inflation rates in Egypt during 1980's has resulted in the reduction of the purchasing power of the capital grants.

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- It was not possible for PBDAC to fully compensate against such reduction by capitalizing two third of the interest income generated out of the utilization of the grants. This has resulted in an erosion in the value of the grants at a rate of 32% of its total capital value. The erosion was due to the following reasons:
 - a) The rates of inflation were higher than the rates of the interest income due on the loans financed by the grants.
 - b) Interest income was not fully capitalized, due to :
 - Wrong accounting allocations; referred to previously, which had resulted in reporting part of the grants' income as PBDAC's own profits with its negative effect of paying out more corporate tax and distributing profits not earned by PBDAC.
 - Allocation of one third of the income generate to finance the operations of the grant. This allocations amounted to LE 40m out of which only LE 11m were paid out and L.E 29m are still outstanding not capitalized yet.

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3.6 The impact of the profit distribution policy on the capital adequacy and rate of growth.



- The study has revealed the following analysis:

	Current Status	Assuming Profits are retained
- Equity average growth rate	11.30%	21.30%
- Equity value at 92/93 (capital + reserves)	LE 299m	LE 514m

- The compulsory profit distribution policy has negatively affected the rate of growth of the bank's equity through-out the duration of the study.

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It has also affected the value of the equity as the total profits transferred to the Ministry of Finance from 85/86 to 92/93 amounted to LE 222 m.

This has a negative effect on the adequacy of PBDAC's capital, as it was possible for PBDAC to achieve high rates of capital adequacy had it been able to retain all the profits transferred to the Ministry of Finance, as shown in the above chart.

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3.7 The impact of governmental debts on the bank's financial position.

- First: The impact of the debts on the sources of finance and their associated cost:**
PBDAC has borrowed more overdraft to finance the governmental debts due to it. This has cost PBDAC, interest payable amounting to LE 203m on the assumption that the volume of the credit portfolio remains constant. (this was fully explained in appendix 3/3).
- Second: The impact of the debts on the applications of fund and their associated income:**
The governmental debts have resulted in frozen part of the funds available for investment in the credit portfolio. Had these funds were invested, it would have realized income amounting to LE 339m during the duration of the study, on the assumption that the source of funds remain constant. (this was fully explained in table (50/4/2/3) in the detailed report)

Conclusion

To conclude, the existence of the governmental debts represent a non-income generating assets and would have a negative effect on both sources and applications of fund.

It is recommended that further efforts should be made to reduce and liquidate such balances to the lowest possible level.

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4.1 Our approach

Our approach in preparing the profit projection for the next five fiscal years, was based on a mix of:

- a) Assessing the behaviour of a particular item in the past, with a view of identifying its trends.
- b) Evaluating the possibilities, that such trends will continue in the future.
- c) Adjusting unfavourable trends associated with substandard performing ratios through the use of the cause/effect approaches.

4.2 Hypothesis of the profit projections

The strategic objective of PBDAC in the future, is to work as a specialized bank within the agricultural sector having discontinued the production inputs activity completely. Also, to improve the banking performance ratios to be comparable to the ratios prevailing in the banking sector.

The basic operating hypothesis followed in the preparation of the profit projection can be summarized as follows:

- The volume of the credit portfolio will be increased at an annual growth rate of 7%.
- To liquidate the production inputs stock over the next five years at rate of LE 88m yearly- discontinue the production inputs activity at an annual rate of 20% i.e LE 15m.

To retain five groups of production inputs only (insecticides, spare parts, maintenance of crops and seeds storage services) at an annual rate of growth of 15%.
- Increase the volume of customer deposits to finance the future growth and expansion in the banking activity at an annual rate of 13%.
- Reduce the degree of dependence on the overdraft as one of the sources of funds, and its associated cost of finance. The objective is to liquidate the remaining balance by the end of the next five years at LE 186m annually.
- Collection of debts due from both Ministry of Agricultural and Ministry of Finance and use them in financing the settlement of the bank overdraft.

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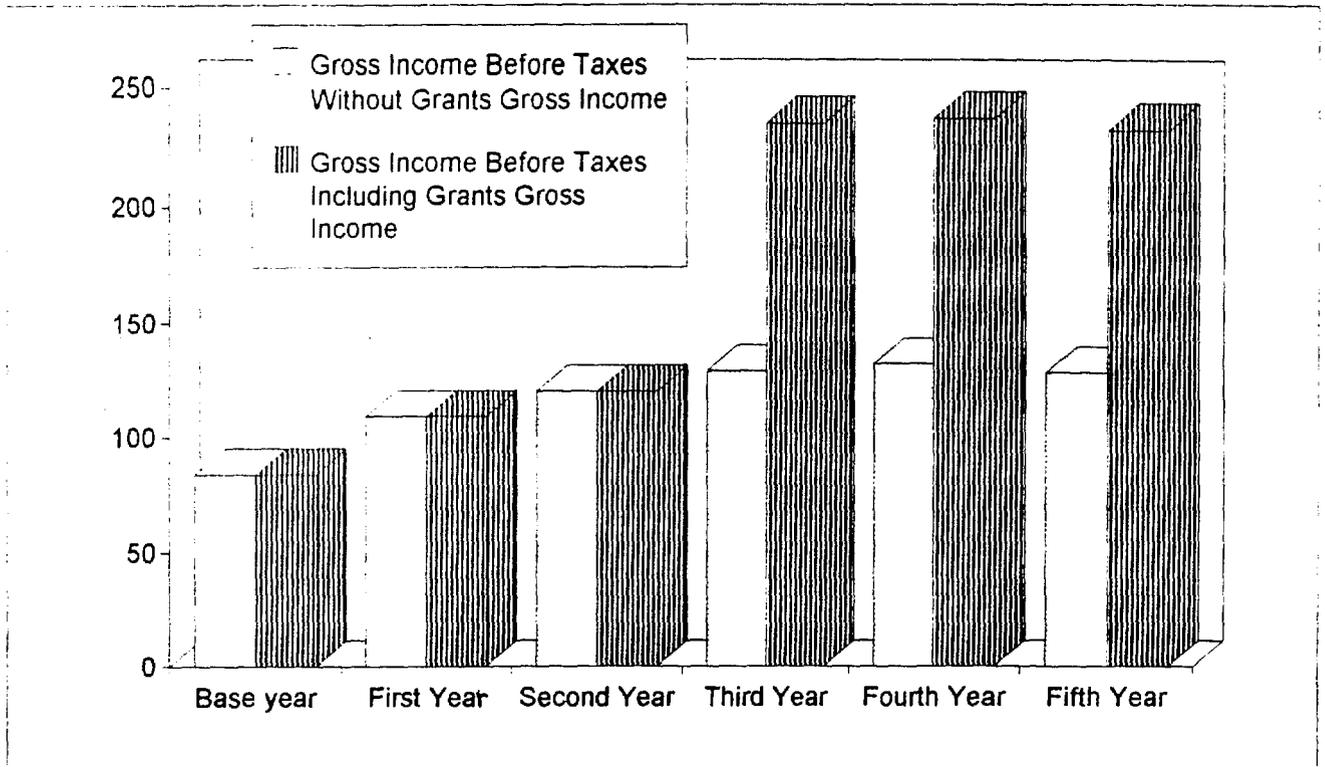
4.3 Assumptions and Limitations

These represent certain limitations imposed on the profit projections process, as a result of non-availability of relevant and sufficient information relating to certain variables or important issues. Other limitations are associated with variables relating to the performance of the national economy and the general banking policies enforced by the Central Bank of Egypt. Such limitations can be summarized as follows:

- Stabilization of interest rates at its current levels during the years covered by the projection.
- No further external sources of funds in the form of grants and foreign loans, will be obtained by PBDAC and no capital increase during the period covered by the projection.
- No capital gains will be realized out of the sale of fixed assets.
- It was assumed that the value of the local and foreign loans and their associated cost of finance will remain constant.
- Investments income will remain at its current level.
- No redundancy will be made to the surplus workforce resulted from the discontinuation of the production inputs activity.

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4.4 Projected Profits



The profit projection process has revealed the possibility of achieving a progressive rates of growth in the value of the profits in most of the next five years covered, whether before or after incorporating the income generated from the foreign grants.

Assuming that the strategy followed in preparing the the profit projection will be approved and applied by the management.