First Capital
First Capital Research
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Strategy Report 2020

Jan 2020

SRI LANKA

Fiscal loosening weakens 2H2020 Outlook

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Fiscal loosening weakens 2H2020 Outlook

Executive Summary

Yield Curve to move upwards by 50-100bps

- With the rise in borrowing pressure, we expect a gradual increase in pressure on bond yields throughout 2020 excluding the 4Q where debt maturities are onto the lower side. We have moved up our target bond yield bands and expect the yields to enter the bands by 2Q and afterwards gradually move up further during 2H2020.

Banking Rates (AWPR) to remain low c.9.5% in 1H and range from 9.5%-10.5% over next 12 months

- In line with the 5 Yr bond, we expect the AWPR to have bottomed out around 9.5% and remain around c.9.5% during 1H2020. During 2H2020 we expect a slight increase in AWPR but is likely to remain within the band of 9.5% - 10.5%.

Exchange Rate 2020 target of LKR 188.0-190.0 with stronger depreciation in 2H2020

- With the potentially stable external environment, we expect the USD/LKR rate to stay stable in the 1H2020. As consumer demand accelerates towards 2H, we expect to witness a possible weakness in the currency.

ASPI target maintained at 6,500 by Jun 2020; Dec 2020 ASPI target raised to 7,500 (from 7,000) with the tax cuts; INCREASE EQUITY EXPOSURE to 100% from 90%

- With the recovery in economic activity and company earnings, we expect an upward trend in the market supported by stronger market multiples. The heavy tax cuts and the policy rate cut is likely to be an added boost for company earnings. Considering the mid-term positive impact, we upgrade our equity exposure to 100% while maintaining our ASPI expectations for Jun 2020 at 6,500, assuming Market PER to be in the range of 8.5x – 9.5x. However, We upgrade our ASPI target for Dec 2020 to 7,500 from the previous 7,000 amidst the added boost to the economy.

Track Record [Jan 2019 & Sep 2019]

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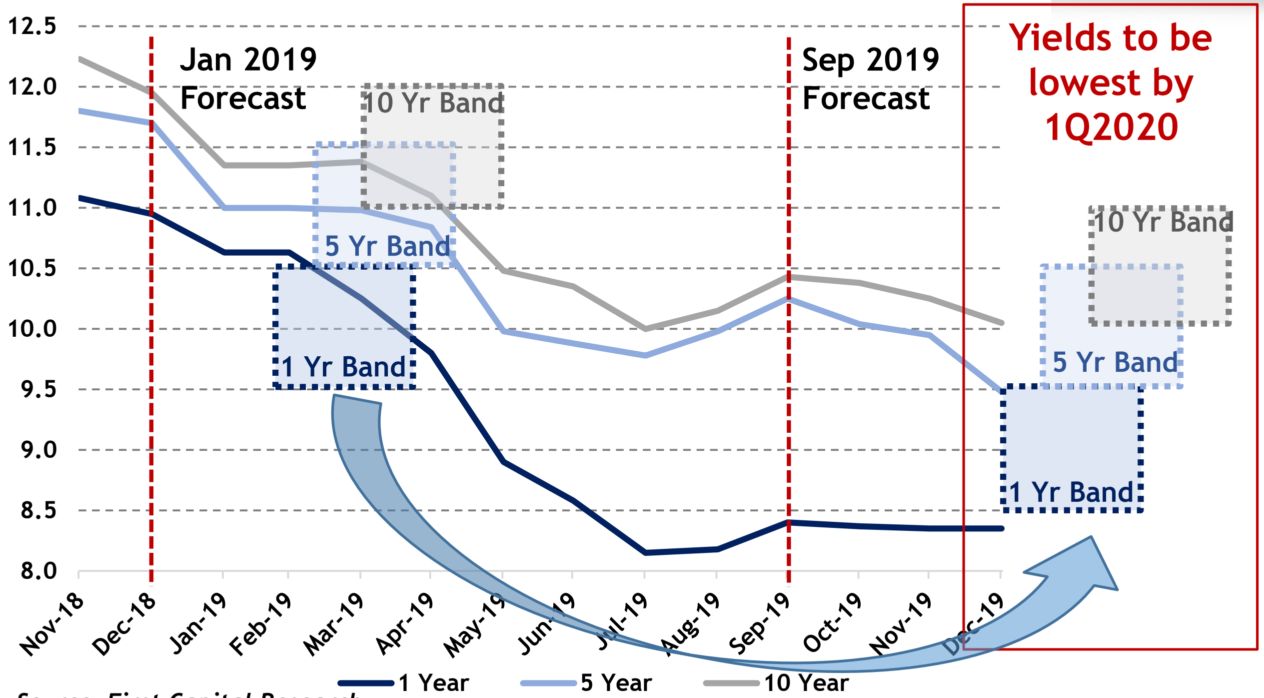
Section 1.0

Jan & Sep 2019 Bonds Re cap: Accuracy Maintained

Bond Yields to touch our lower bands and remain low and gradually trend up from 2Q2020 onwards



Source: First Capital Research

Jul 2019 - Jun 2020	Probability	Impact
Bond Rates are expected to touch our lower bands and remain low upto 1Q2020; Gradually yields are expected to be bearish from 2Q2020 onwards	75%	Bearish
Political Stability may bring in better than expected foreign inflows allowing bond rates to fall below our bands	25%	Stable / Bullish

	3 Months Jul-Sep 2019	3-6 Months Oct-Dec 2019	6-9 Months Jan-Mar 2020	9-12 Months Apr-Jun 2020
Health Score Estimate	50-60	55-60	60-65	55-60
Risk Level - Sep 2019	Medium	Medium	Medium-Low	Medium
Previous Expectations - Jun 2019	Medium-Low	Medium-Low		

Review on Recommendation Jan & Sep 2019

Yields dipped to touch our lower bands and remained low as expected

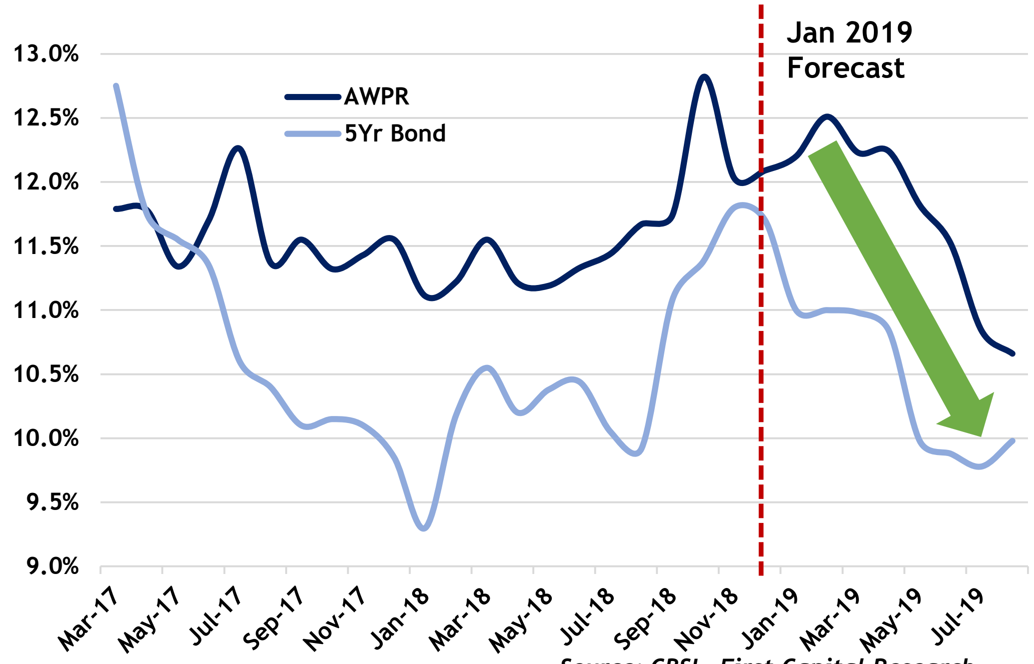
We brought down our yield curve band expectations with the expectation of continuous improvement in our Economic Health Score amidst the strong macro economic fundamentals primarily created by the early raising of foreign debt and strengthening of the foreign reserves. In line with our expectations, yield curve gradually declined and touched our bottom bands and is currently remaining at similar levels. The shorter end of the curve overreacted but has now readjusted upwards.

Jan & Sep 2019 AWPR Re cap: Accuracy Maintained

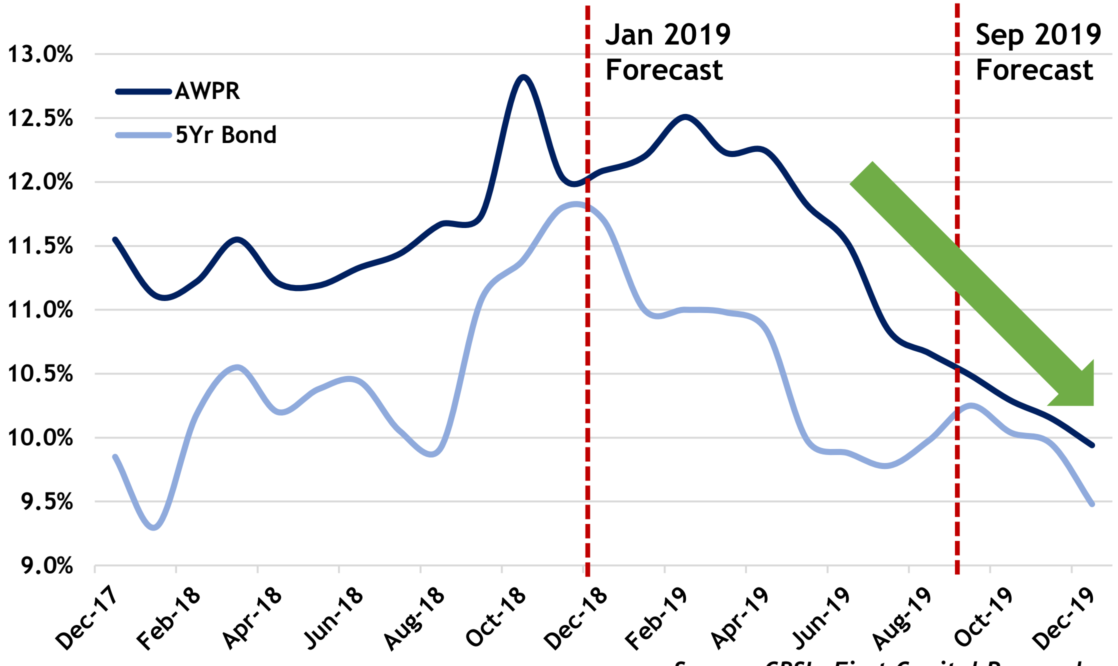
AWPR continuously declines following the 5Yr Bond

Jan 2019 Expectation:
Banking Rates (AWPR) to be volatile within a 100bps band but dip to c.11% towards 4Q

Sep 2019 Expectation:
Banking Rates (AWPR) to dip below c.10.0% towards 4Q and range from 9.5%-10.5% over next 12 months



Source: CBSL, First Capital Research

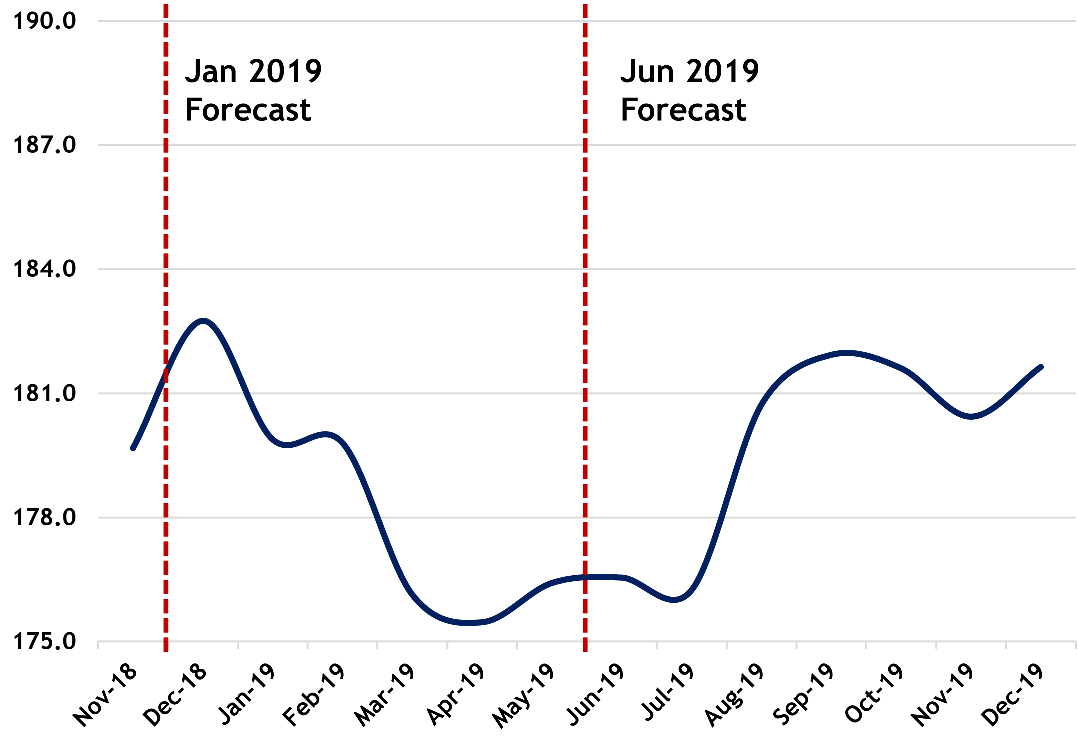


Source: CBSL, First Capital Research

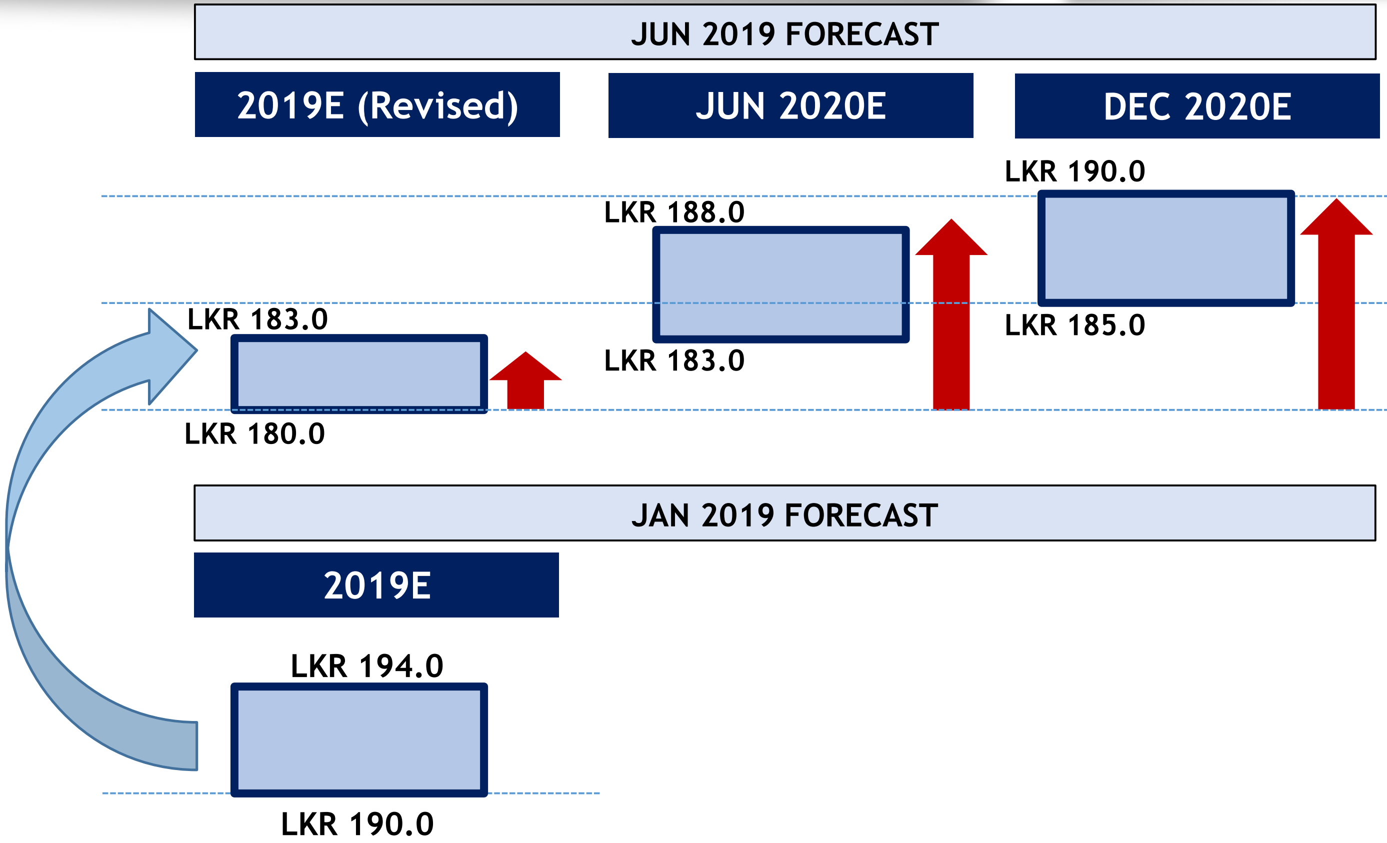
Jan & Jun 2019 Ex-Rate Re cap: Accuracy Maintained

Exchange Rate 2019 target upgraded to a range of LKR 180.0-183.0 [2020E at LKR 185.0-190.0]

In line with our expectations currency depreciated to our target range after our Jun 2019 recommendation



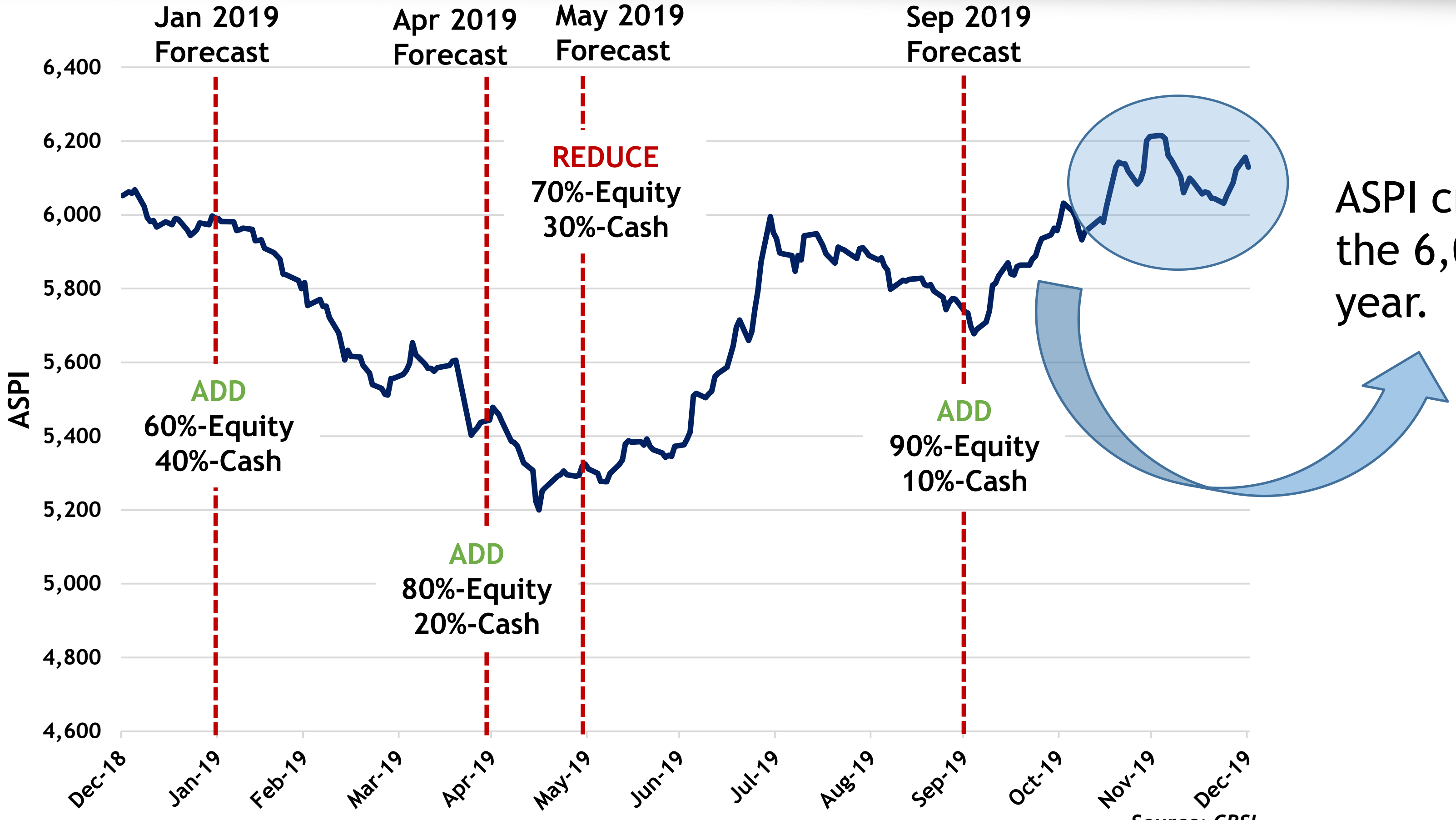
Source: CBSL



Sep 2019 Equity Re cap: Accuracy Maintained

ASPI target of 6500 by Jun 2020; Main target of 6,000 by 2019 Year End

Increase Equity Exposure To 90% From 70%



Source: CBSL

ASPI crosses 6,000 and stays above the 6,000 mark up to the end of the year.

Factors to Consider for 2020 Outlook

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Section 2.0

Factors to make decisions

- Political Factors
  - General Election
  - PC Election

- Economic Factors
  - GDP Growth
  - Foreign Reserves
  - Liquidity Shortage
  - Debt Repayment
  - IMF Agreement

- External Factors
  - South Asia Growth
  - Ratings on Sri Lanka
  - Global fund flow for emerging markets

Political uncertainty to further ease: *Positive*

Section 3.0

Presidential Election results may follow in the parliamentary elections

General Elections possibly in Apr 2020 may enhance political stability

- With the completion of the Presidential Elections a new Cabinet was appointed, but the new Government holds only a minority in Parliament.
- The earliest possible date that President could dissolve Parliament is on the 1st Mar 2020 following the Parliament completing 4.5 Years. The Elections Commissioner has announced that provided Parliament is dissolved on 1st Mar 2020, the earliest possible date to hold elections is 25th Apr 2020.
- Considering the current political environment with a weak opposition, we believe that it is possible for the current Government to obtain a majority in Parliamentary Elections.

PC Elections

- Following General Elections, PC Elections are likely to follow in 2H2020 which again may follow a similar suit to the General Elections.

Economic growth to pick, but 2H Govt. borrowing pressure may increase: Neutral

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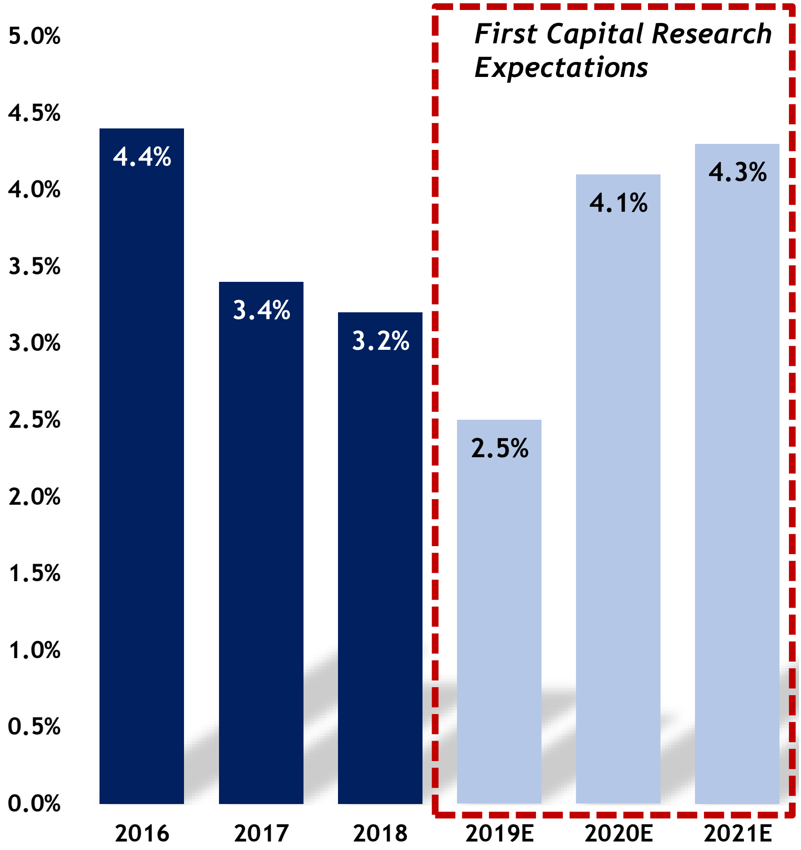
Section 4.0

Economic Forecasts

- GDP to pick amidst eased monetary policy and hefty tax cuts
- Foreign reserves show signs of depletion
- Overall bond repayments dip in 2020, but foreign debt repayments remain high in 2Q & 3Q
- Policy rate cut on top of hefty tax cuts prompts foreign selling
- 2020 private credit growth to rise back to 14%
- Inflation is expected rise, but stay around the range of 5.0%-6.0% for most part of 2020

GDP to pick amidst eased monetary policy and hefty tax cuts

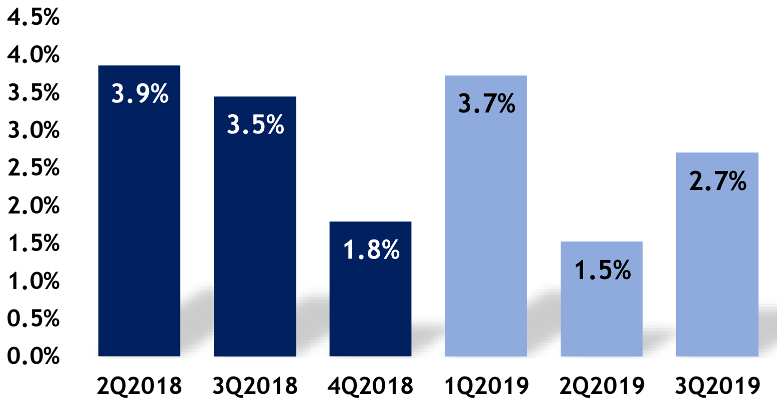
Gradual rise in consumer demand with acceleration towards 2H2020



Source: First Capital Research, Dept. Census and Statistics

SL GDP Growth Forecasts	2018	2019E	2020E
CBSL	3.2%	2.6%	4.0%
World Bank		2.7%	3.3%
IMF		2.6%	3.7%
ADB		2.7%	3.5%
Citi Group		2.7%	3.5%
Standard Chartered		2.7%	4.0%
Average		2.7%	3.6%

Quarterly GDP Growth



Source: Dept. Census and Statistics

- *GDP growth to pick to 4.1% in 2020E:* Following eased monetary policy measures we are already seeing a gradual improvement in consumer demand and credit. The heavy tax cuts and the lower interest rate regime is expected to boost consumption and investments improving GDP growth. However, the acceleration is likely to take place towards the 2H2020.Thereby, we expect growth to reach 4.1% during the year.
- *GDP growth 2021E at 4.3%:* With significant rise in business activity and production during the 2H2020, we expect it to flow towards the 1H2021 while some slowdown may be experienced in 2H2021 amidst a possible monetary tightening measures.

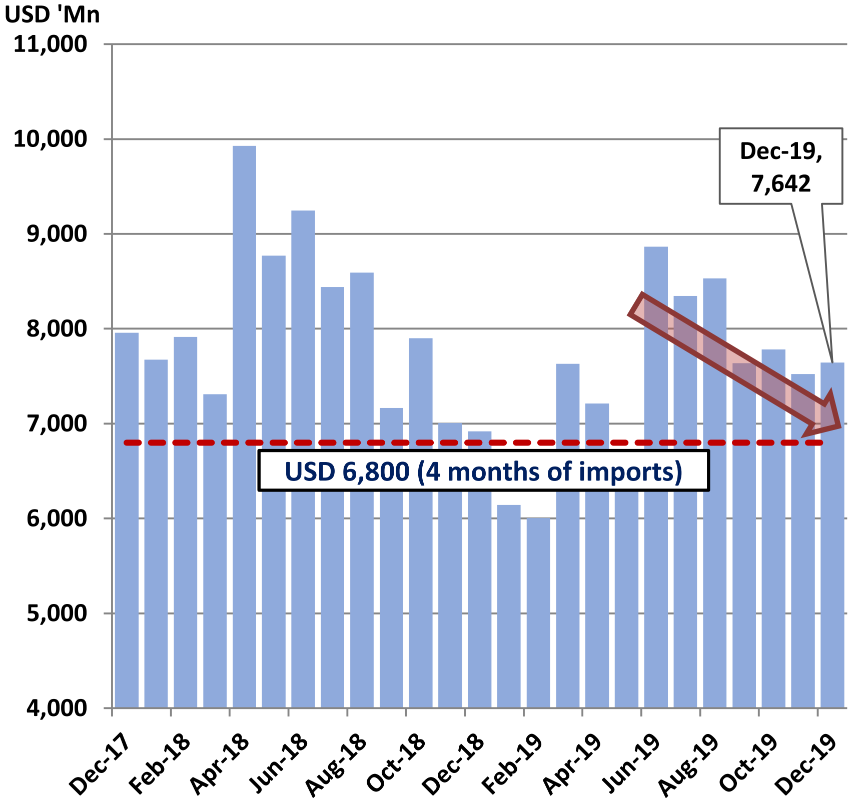
Foreign reserves show signs of depletion

Foreign Repayments cover reverts to 1.3x as Sovereign maturities return

- *Since the successful Sovereign Bond issuance in Jun 2019, SL's foreign reserves have slowly depleted, but over the last 3-4 months CBSL has managed to maintain it around the USD 7.5Bn mark.* ***Govt. has announced plans to raise USD 1.0Bn via a Chinese Loan.***

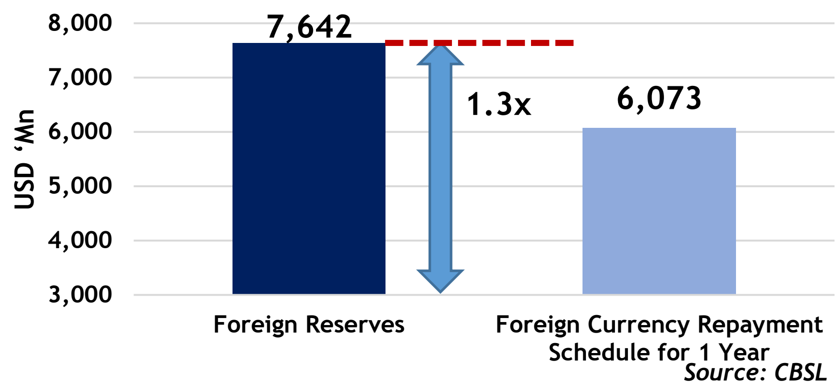
We believe foreign reserves, though currently remains at comfortable levels above the minimum 4 months of imports, foreign repayments start to slowly accelerate especially in the 2H2020. Thereby, it becomes critical for the Govt. to refinance foreign loans of c.USD 6.0Bn, to maintain reserves at the current level. We expect reserves to fall to c.USD 7.0Bn by Jun 2020 due to the debt repayments despite the USD 1.0Bn Chinese Loan. A large Foreign Loan or Sovereign Bond needs to be raised in order to maintain Reserves above the USD 7.0Bn mark.

Foreign Reserves



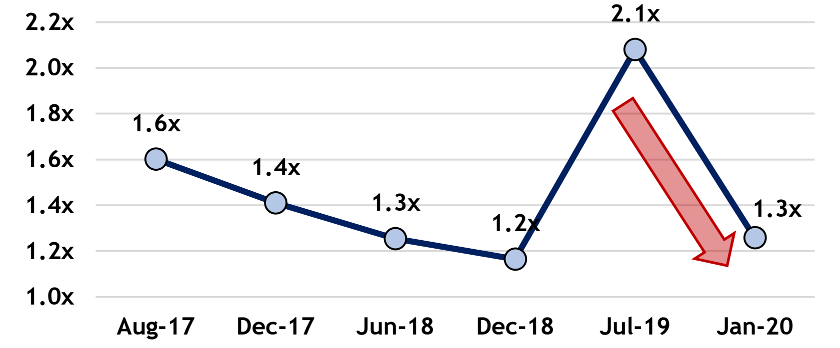
Source: CBSL

Foreign Reserves vs Foreign Repayments



Source: CBSL

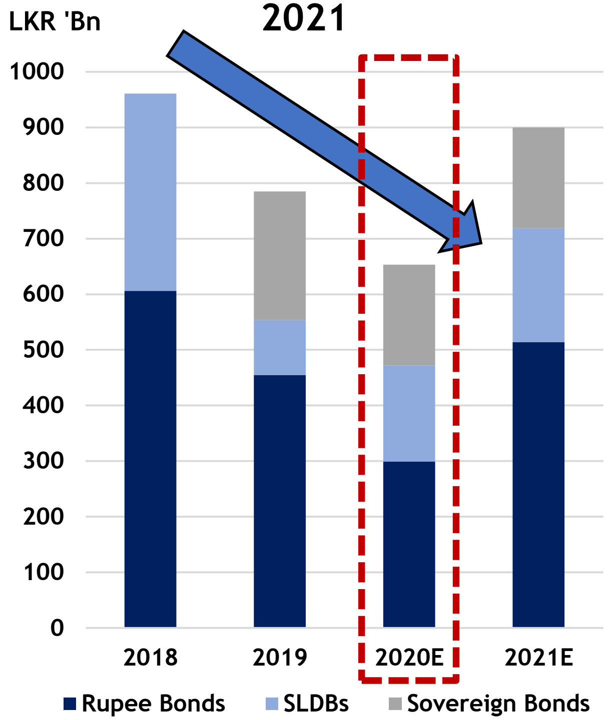
Foreign Repayments Cover



Source: First Capital Research

Overall bond repayments dip in 2020, but foreign debt repayments remain high in 2Q & 3Q

Debt Payments continue to slide in 2020E, but spikes in 2021

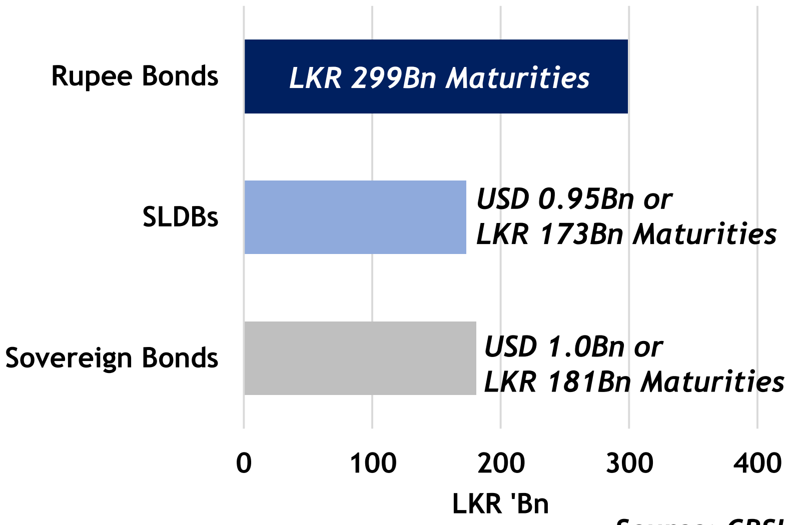


Source: CBSL

2020 Outlook (Next 12 Months)

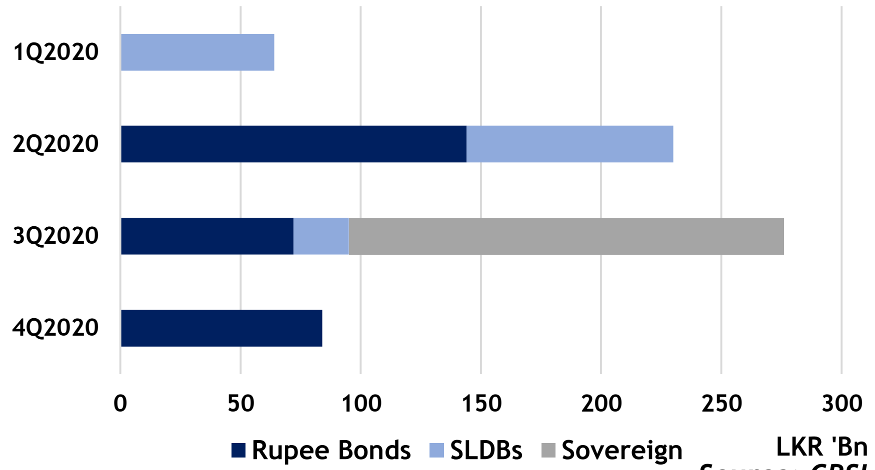
The Year 2020 illustrates a notable reduction in repayments especially in 1Q2020 and 4Q2020. However, we expect foreign payments in the range of USD 300-350Mn to exist on a monthly basis in the form of project loan repayments while 2Q & 3Q illustrates relatively high repayments.

Next 12 Months



Source: CBSL

Repayments high in 2Q2020 & 3Q2020



Source: CBSL

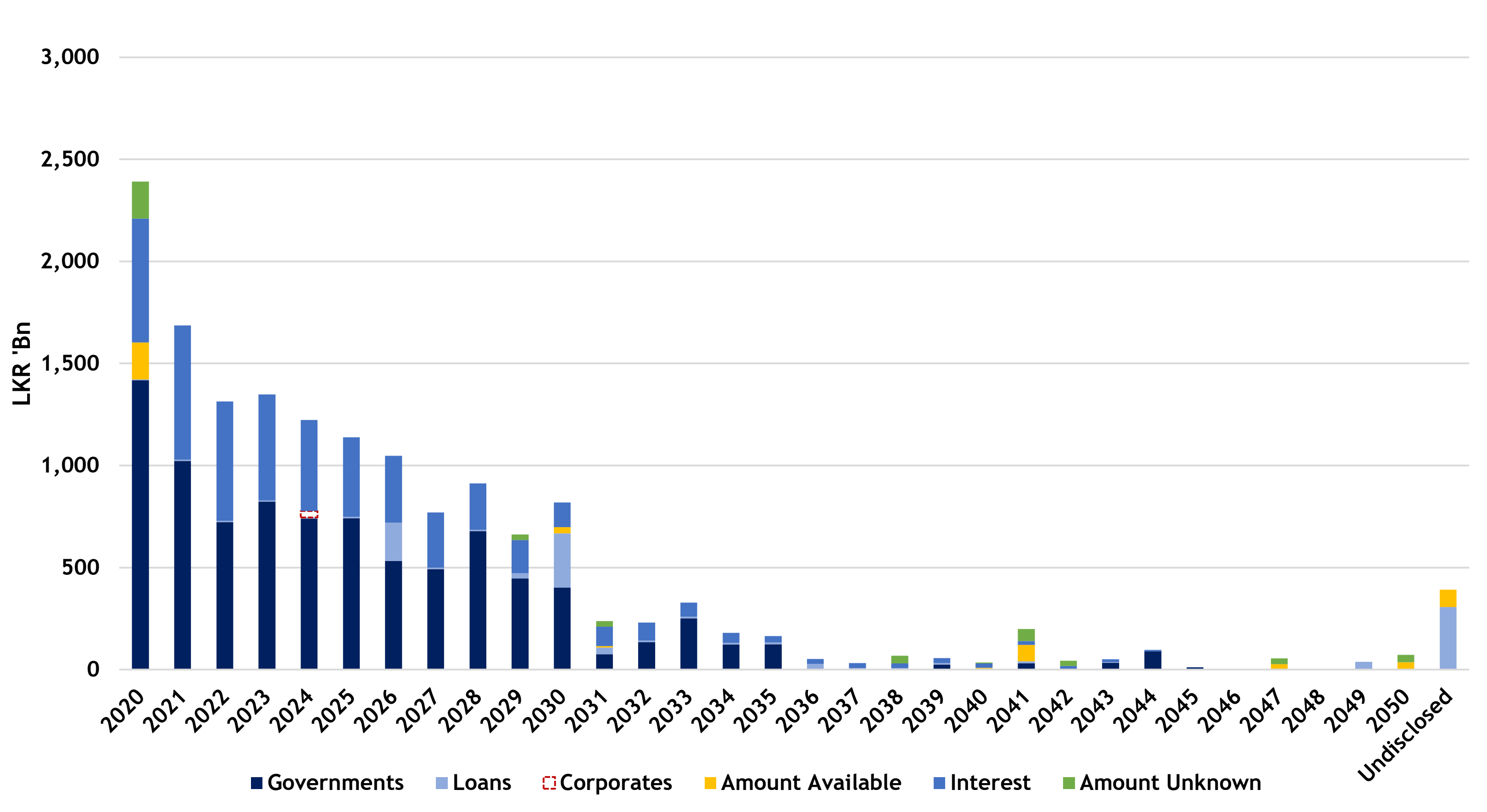
Total Debt payment for 2020 is at LKR 2.4Tn

- Sri Lanka's Current Debt Payments are as follows:

Date	Debt Repayment (LKR 'Bn)	Interest (LKR 'Bn)
2020	1,783.85	606.81
2021	1,028.43	656.93
2022	729.51	583.83
2023	829.29	519.46
2024	777.61	444.68

- We expect Debt to GDP to rise to 85% in 2019 while we expect it to marginally dip to 84% in 2020 partly with the acceleration of GDP growth, comparatively lower debt repayments and possible large FDIs led by the Port City

Sri Lanka Debt Maturity Profile



Policy rate cut on top of hefty tax cuts prompts foreign selling

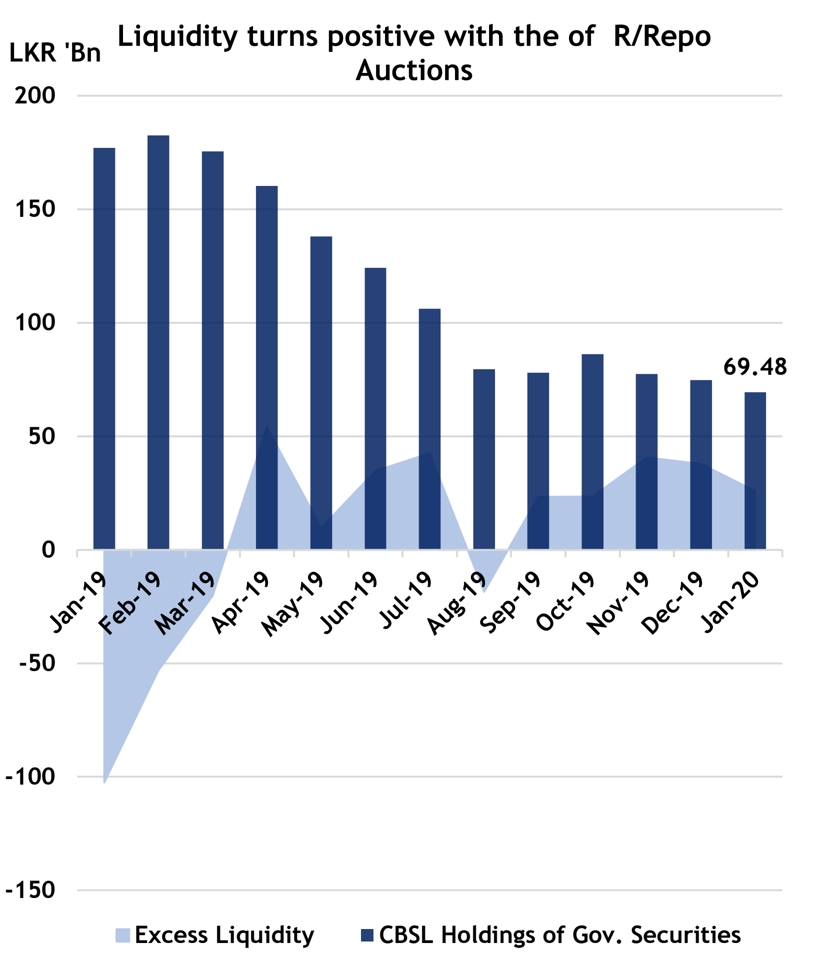
Private Sector Credit may accelerate to 14% in 2020 resulting in continued lower liquidity in the system

Liquidity improvement halts with foreign selling

Improvement in macro conditions and political stability saw foreign inflows into the bond market at a gradual pace which also supported to improve the liquidity position in the system possibly with dollar purchases by the CBSL.

However, following the rate cut provided by the CBSL foreign selling returned to the market. Credit has also picked in the system though still at a gradual pace.

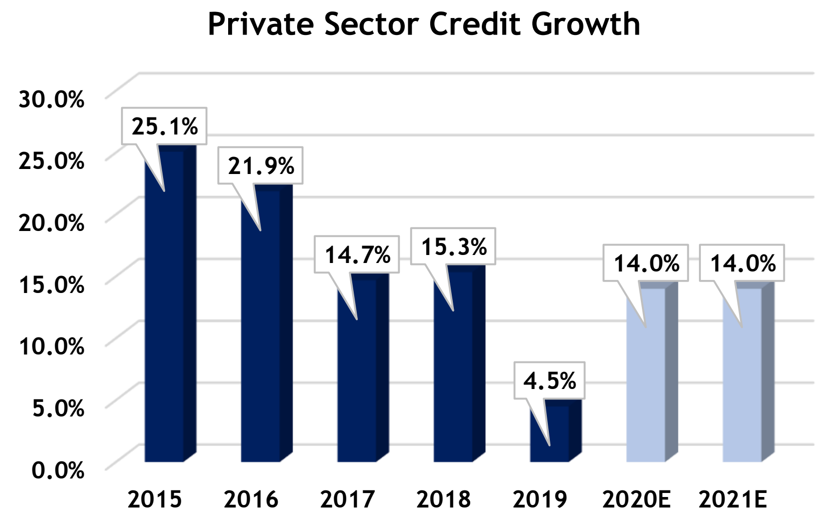
Thereby, liquidity in the system is currently positive only due to the R/Repo auctions being conducted. Excluding the said amount the liquidity remains negative. Considering the developments with the foreign selling in the market and pick in credit growth is likely to result in lower level of liquidity in the system throughout 2020.



Source: CBSL

2020 private credit growth to rise back to 14%

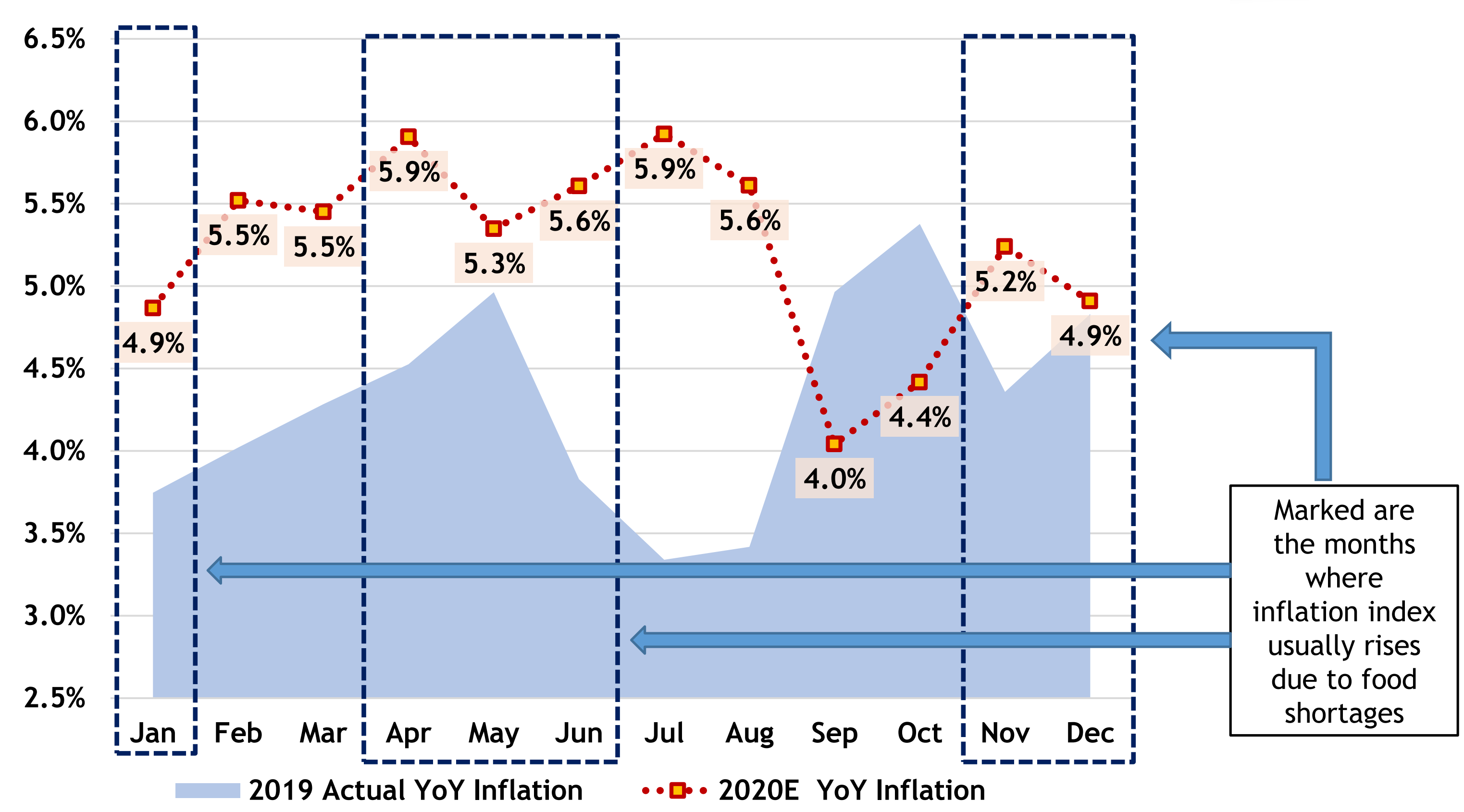
Supported by monetary easing and slashing of tax rates, consumer demand and business activity has already started to improve resulting in improving private sector which may accelerate to 14% supported by stronger growth in 2H2020



Source: CBSL

Inflation is expected rise, but stay around the range of 5.0%-6.0% for most part of 2020

- *The floods in Nov 2019, has resulted in food inflation in the last few months. Despite the adjustment with the supply improving inflation is likely to be around the 6.0% mark during the 1H2019.*
- *Subsequently with the higher base effect in the previous year inflation may slightly ease off. However, the rising consumer demand is likely to keep between the range of 5.0%-6.0% during most part of the year.*



Source: Dept. Census and Statistics

Summary of the Economic Indicators for next 12 months

Positives

- GDP may pick to 4.0%
- Overall bond repayments dip in 2020, though foreign repayments are higher in 2Q & 3Q
- Inflation under control

Negatives

- High budget deficit may increase Govt. borrowing requirement
- Weakening foreign currency reserve position
- Low liquidity amidst rising Credit growth

Economic Outlook: Neutral

Positive External Environment; However affected by rating outlook downgrade: Neutral

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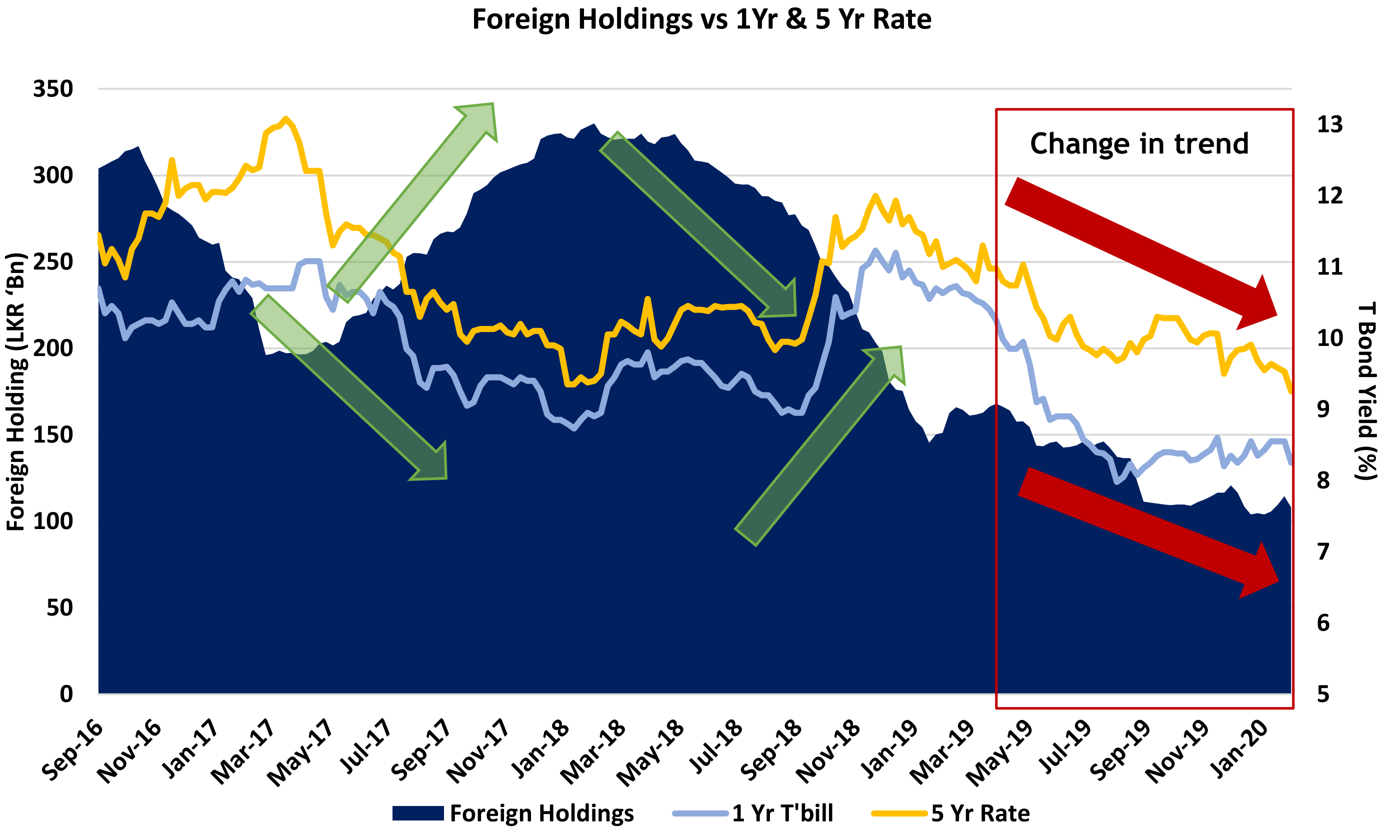
Section 5.0

Foreign inflows reverse back to outflows with further monetary easing; But lower holding reduces risk

- Supported by rise in investment and private consumption, World Bank Group expects South Asia's growth to jump to 6.3% in 2020 and 6.7% in 2021 compared to 5.9% in 2019 - Positive
- Significantly low level of foreign holdings reduces risk of outflows - Positive
- Hefty tax cuts have prompted rating agencies to downgrade outlook of Sri Lanka to "Negative" indicating a possible rating downgrade in the future. It is likely to negatively impact when raising funds in the international market - Negative
- Fed indicated an end to its latest monetary easing cycle suggesting that they would stay on hold with policy rates through 2020 – Neutral

External Outlook: Neutral



Source: CBSL & First Capital Research

What does the indicators say for investments?

- Political Outlook : Positive
  - ❑ Political Uncertainty settles post election
- Economic Outlook : Neutral
  - ❑ Economic growth to pick, but 2H Govt. borrowing pressure may increase
- External Outlook: Neutral
  - ❑ Positive External Environment affected rating downgrade

Overall Outlook : Neutral

Time Period	Political	Economical	External
Jan 2018	Negative	Neutral	Neutral
Jun 2018	Negative	Neutral	Negative
Jan 2019	Negative	Neutral	Positive
Sep 2019	Positive	Neutral	Neutral
Jan 2020	Positive	Neutral	Neutral

Recommendations

Section 6.0

First Capital Research View on Bond Market 2020

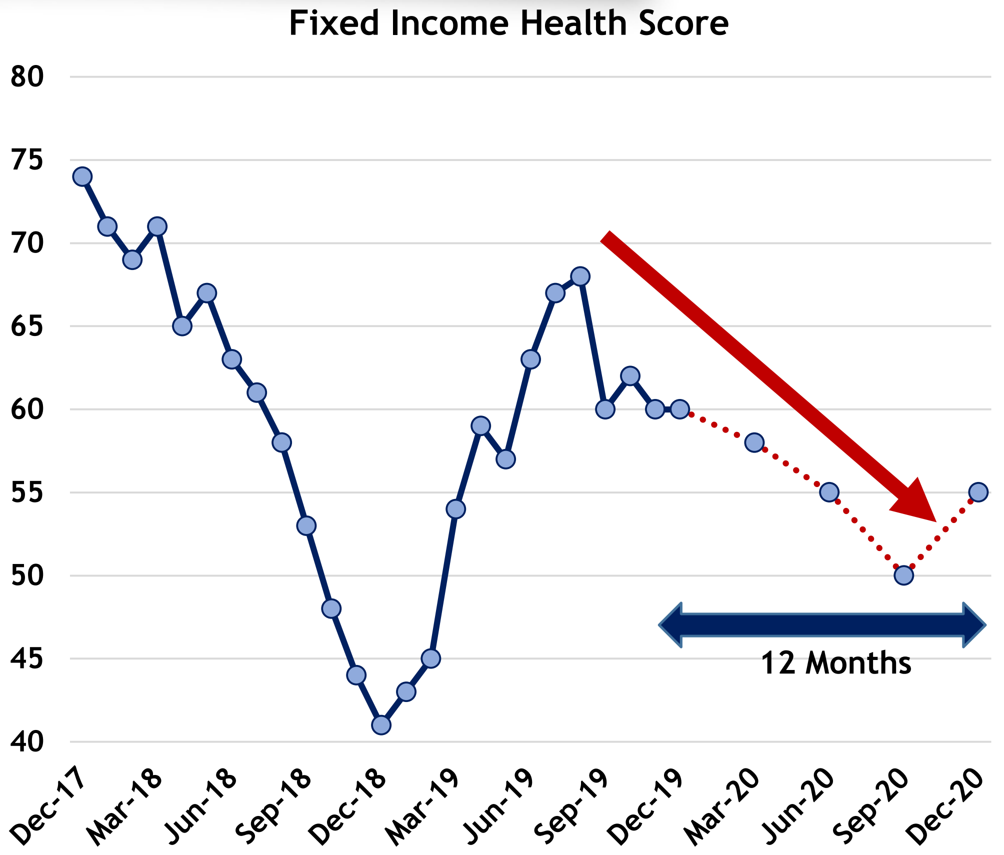
Section 6.1

Pressure on Bonds yields to rise from 2Q2020 onwards

- Foreign debt repayments are high during 2020, with a USD 1.0Bn Sovereign Bond maturing in Sep 2020.
- Though rupee debt repayments remain low in 2020, potentially high budget deficit is likely to be created with the hefty tax cuts. The high budget deficit is likely to push the rupee debt borrowing requirement also higher.
- Trade deficit may also grow wider towards 2H2020 amidst the possible rise in consumer demand possibly leading to a high level of consumer imports pressuring the foreign reserves and the rupee.

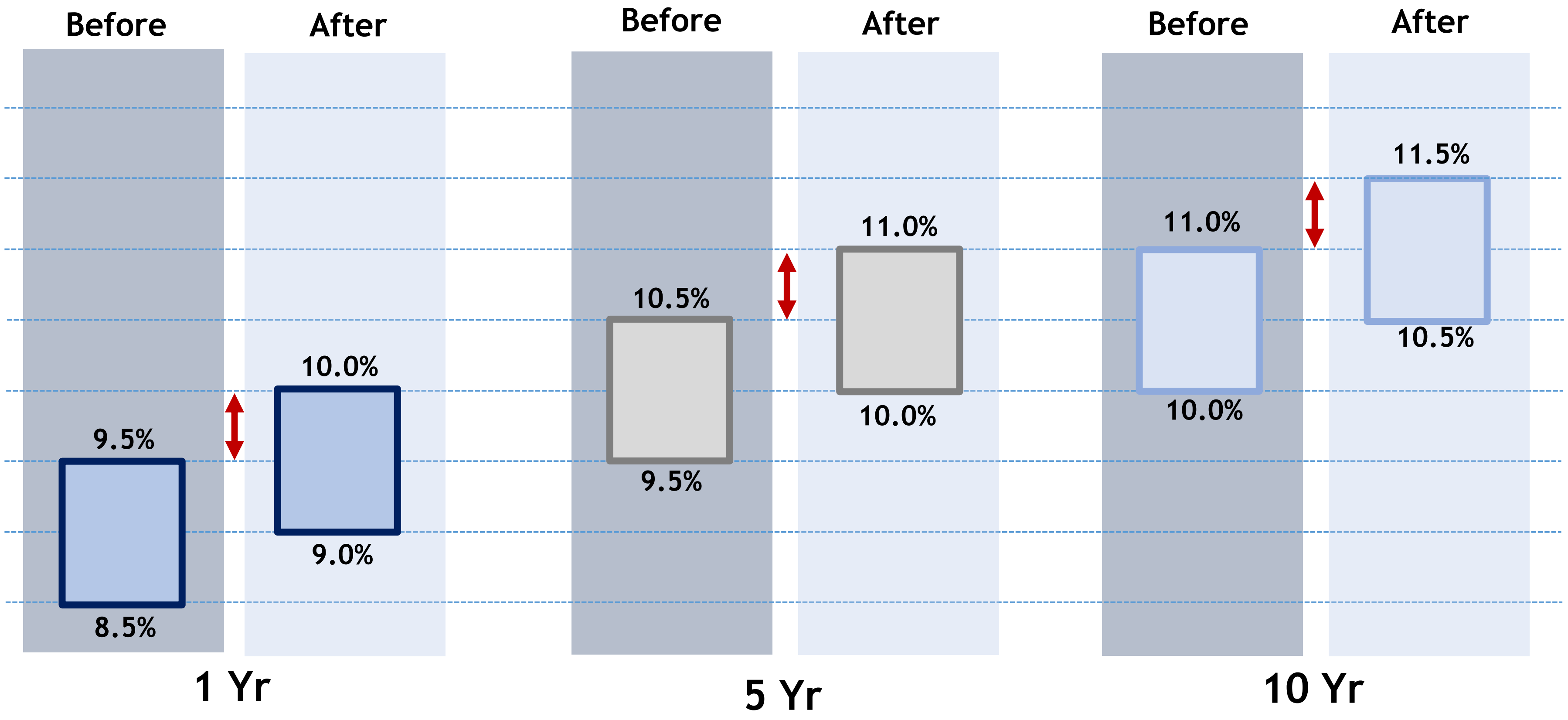
Economic Health Expectations

	3 Months Outlook Jan-Mar 2020	3-6 Months Outlook Apr-Jun 2020	6-9 Months Outlook Jul-Sep 2020	9-12 Months Outlook Oct-Dec 2020
Health Score Estimate	60-65	55-60	50-55	55-60
Risk Level - Jan 2020	Medium-Low	Medium	Medium-High	Medium
Previous Expectations - Sep 2019	Medium-Low	Medium		



Source: First Capital Research

Yield Curve to move upwards by 50-100bps

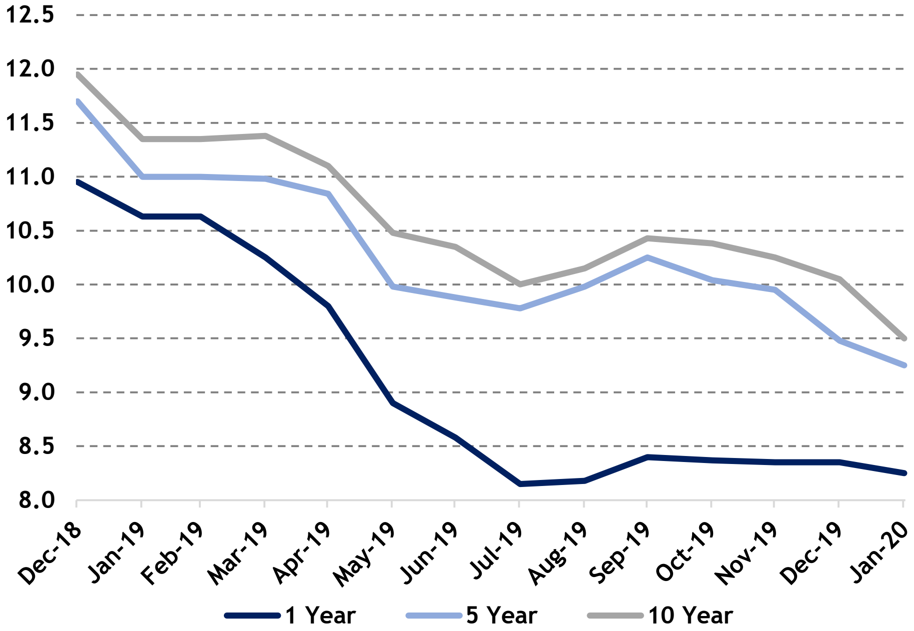


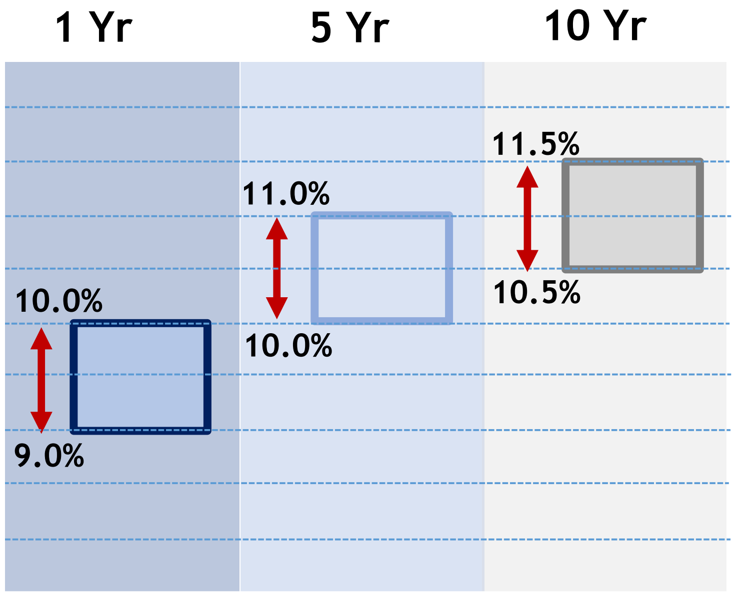
Bond Yields to gradually trend up from 2Q2020 onwards (12 months)

Jan 2020 - Dec 2020	Probability	Impact
Bond yields are expected to be bearish from 2Q2020 onwards	85%	Bearish
Better than expected foreign inflows may allow bond rates to fall below our bands	15%	Stable / Bullish

Expectations: Bearish 2Q2020 onwards

Policy Rate Expectations
On a base case First Capital Research expects a single policy rate hike / SRR hike over the next 12 months.





Source: CBSL, First Capital Research

2020 Outlook - Base Case (85% Probability)

With the rise in borrowing pressure we expect a gradual increase in pressure on bond yields throughout 2020 excluding the 4Q where debt maturities are onto the lower side.

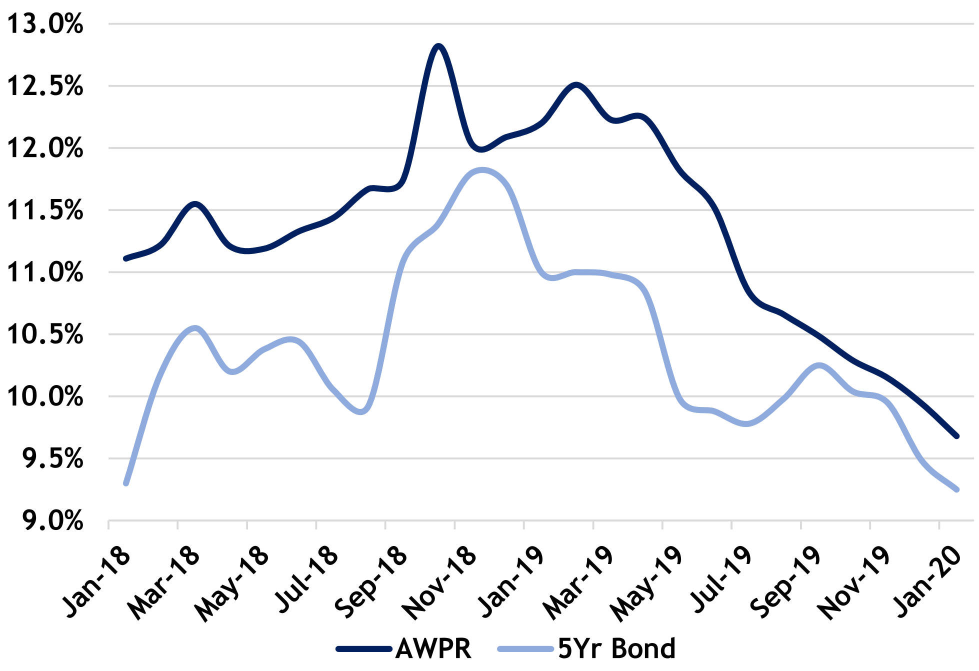
We have moved up our target bond yield bands and expect the yields to enter the bands by 2Q and afterwards gradually move up further during 2H2020.

First Capital Research View on Banking Rates 2020

Section 6.2

Banking Rates (AWPR) to remain low c.9.5% in 1H and range from 9.5%-10.5% over next 12 months

AWPR vs 5 year Bond



Lag effect reduces

- Banking Rates are usually reflective of the bond rates with a 6-month lag. AWPLR usually had a 6-month lag effect for the 5-year bond. However, more recently, CBSL has initiated lending rate caps with the intention of forcefully pushing interest rates down.

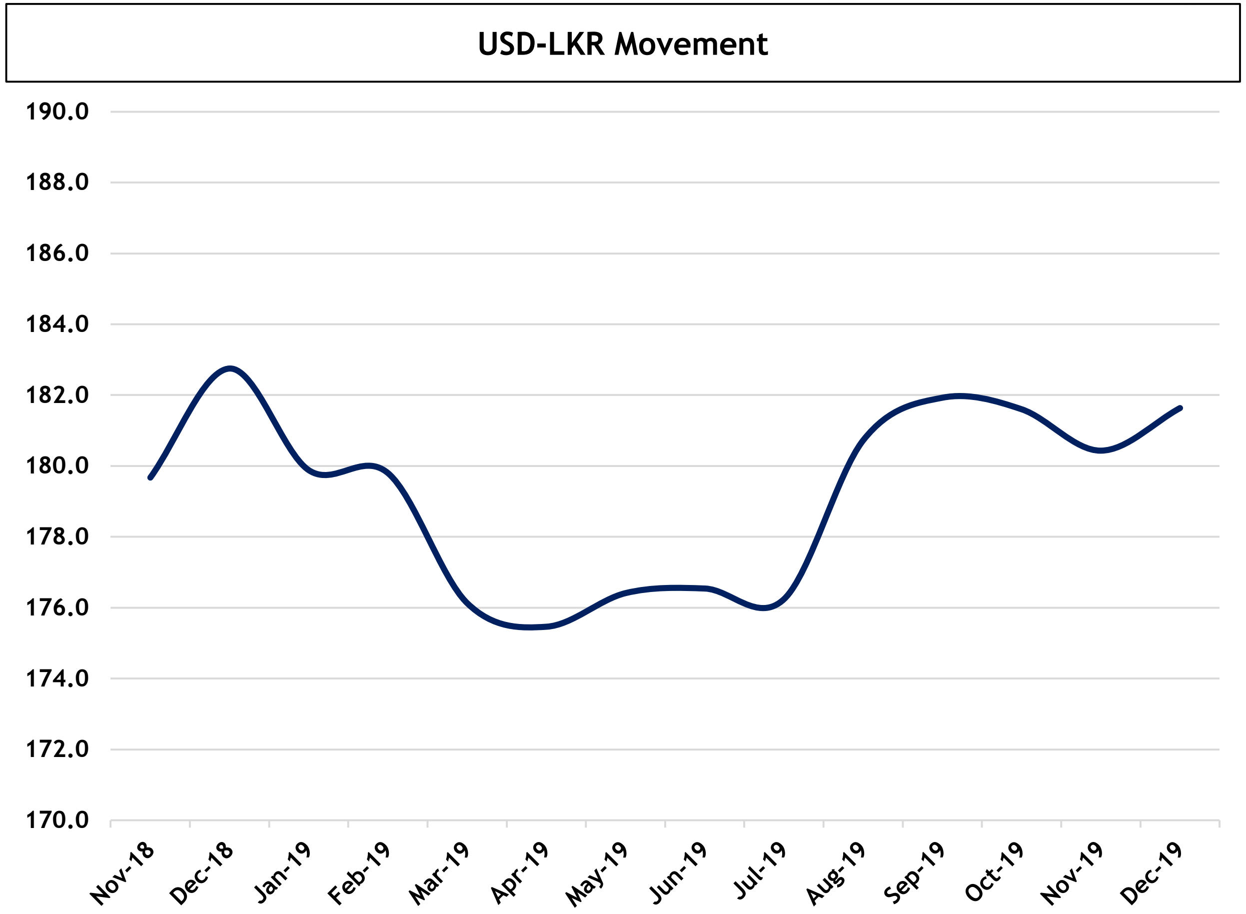
2020 Outlook

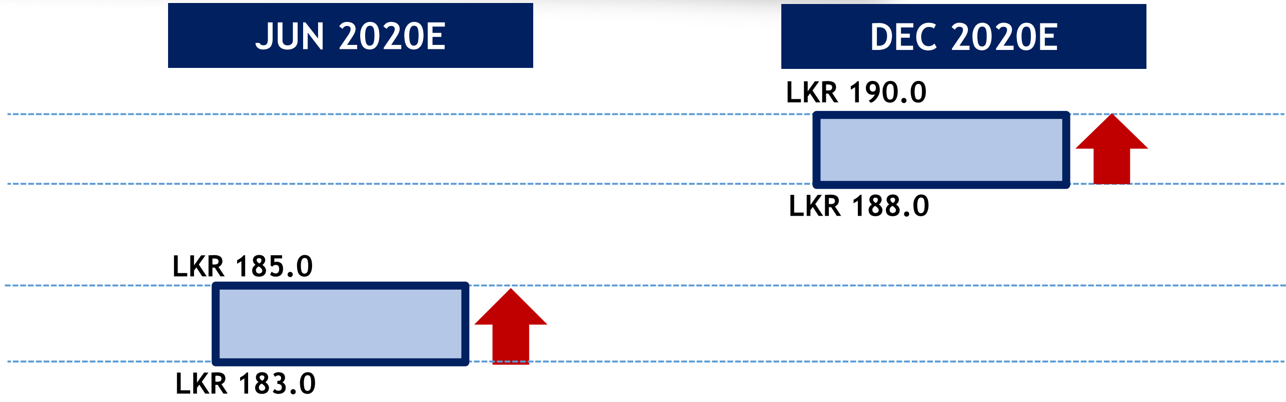
In line with the 5 Yr bond, we expect the AWPR to have bottomed out around 9.5% and remain around c.9.5% during 1H2020. During 2H2020 we expect a slight increase in AWPR but is likely to remain within the band of 9.5% - 10.5%.

First Capital Research View on Exchange Rate 2020

Section 6.3

Exchange Rate 2020 target of LKR 188.0-190.0 with stronger depreciation in 2H2020





2020 Outlook

With the potentially stable external environment, we expect the USD/LKR rate to stay stable in the 1H2020. As consumer demand accelerates towards 2H, we expect to witness a possible weakness in the currency.

Jan 2020 - Dec 2020	Probability	Impact
Currency expected to depreciate to the band	75%	Stable / Bearish
Inflows well above our expectation is likely to hold the currency with lower depreciation	25%	Bullish

First Capital Research View on Equity Market 2020

Section 6.4

ASPI target maintained at 6,500 by Jun 2020

Dec 2020 ASPI target raised to 7,500 (from 7,000) with the tax cuts

INCREASE EQUITY EXPOSURE to 100% from 90%

- ***Political Outlook stabilizes***

Following the Presidential elections and appointment of the new Cabinet the Political uncertain which prevailed for an extended duration has eased providing stability and policy certainty for investors. It has also given a major boost to business confidence as the LMD-Nielsen business confidence index jumps to a 51-month high of 186 for Dec 2019.

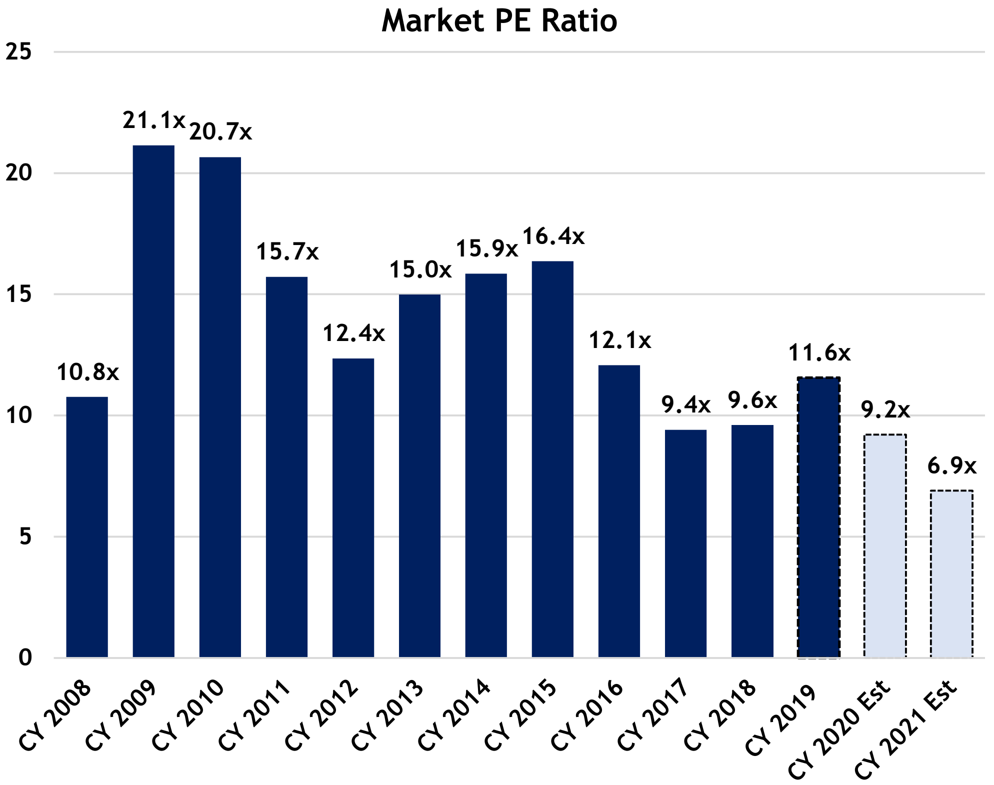
- ***Hefty tax cuts followed by policy rate cut***

On 27th Nov 2019, Government announced hefty tax reliefs including reducing VAT to 8% (from 15%), abolishing NBT and revising PAYE tax with the expectation of increasing the consumer spending while boosting the economic growth of the country. As an extension to the stimulus package, Govt. took measures to remove DRL on banks and NBFIs and revise downwards the corporate tax rates across all sectors. Further, supporting Govt.'s efforts to revive growth CBSL on 30th Jan took to cut policy rates by 50bps despite credit growth accelerating in Nov and Dec 2019.

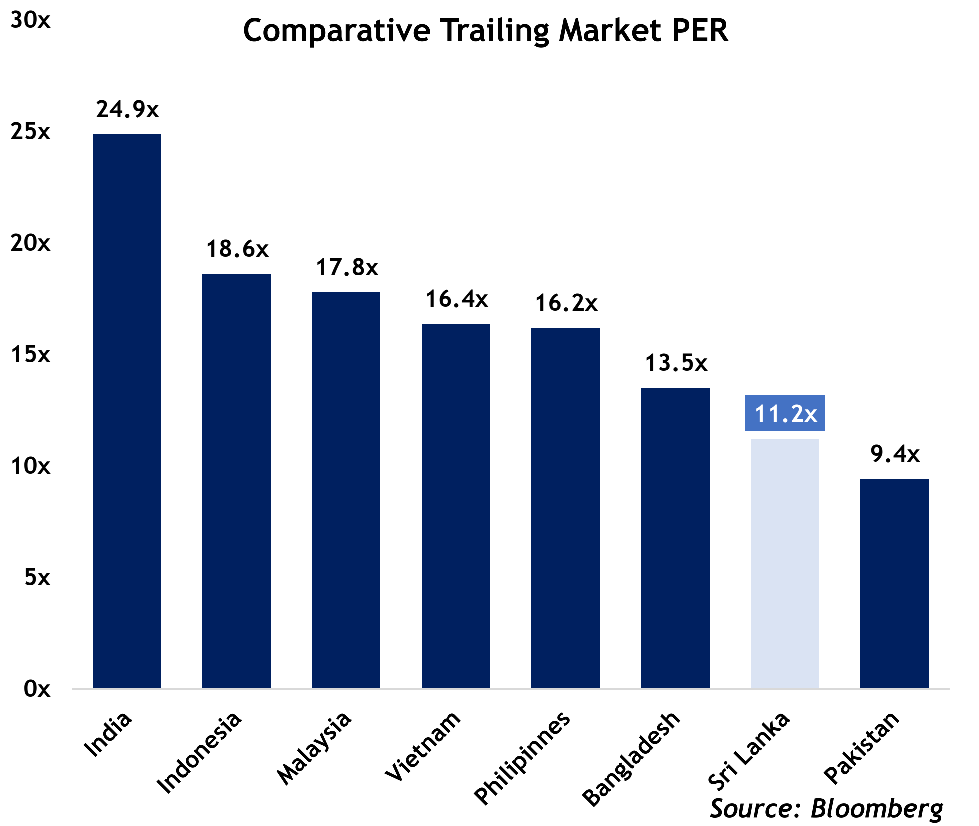
- ***Equity Exposure increased to 100%; ASPI target for Dec 2020 raised to 7,500 from 7,000***

With the recovery in economic activity and company earnings, we expect an upward trend in the market supported by stronger market multiples. The heavy tax cuts and the policy rate cut is likely to be an added boost for company earnings. Considering the mid-term positive impact, we upgrade our equity exposure to 100% while maintaining our ASPI expectations for Jun 2020 at 6,500, assuming Market PER to be in the range of 8.5x – 9.5x. However, We upgrade our ASPI target for Dec 2020 to 7,500 from the previous 7,000 amidst the added boost to the economy.

Stock Market Valuations



Source: Bloomberg



Source: Bloomberg

TOP RECOMMENDATIONS for 2020

In previous years, we recommended investors only to invest a portion of the funds targeted towards equity investments while maintaining a cash allocation.

However, considering the attractiveness of the market we recommend investors to **invest 100% or fully invest the equity allocated funds** into the portfolio.

Stock	Stock Code	Price as at 31.12.2019	Fair Value CY20E/FY21	Fair Value pro-rated to 31 Dec 2020	Upside for 2020
John Keells Holdings	JKH.N0000	167.60	240.00	227.50	*36%*
Commercial Bank of Ceylon	COMB.N0000	95.00	150.00	150.00	*58%*
Hatton National Bank	HNB.N0000	172.20	210.00	210.00	*22%*
Sampath Bank	SAMP.N0000	162.40	225.00	225.00	*39%*
Dialog	DIAL.N0000	12.30	15.40	15.40	*25%*
Hayley's Fabric	MGT.N0000	17.90	25.00	23.75	*33%*
Teejay Lanka	TJL.N0000	40.80	53.00	51.00	*25%*
Lion Brewery	LION.N0000	602.00	800.00	777.50	*29%*
Ceylon Tobacco Company	CTC.N0000	1100.30	1600.00	1600.00	*45%*
Nestle Lanka	NEST.N0000	1299.80	1505.00	1505.00	*16%*
Ceylon Cold Stores	CCS.N0000	795.00	1100.00	1037.50	*31%*
	Average Return				*33%*
	ASI	6,129.20		7,500.00	*22%*

Possible positives preventing our 85% probability

Section 7.0

Possible extraordinary positives that could amend weakness in 2020

If the below mentioned positives materialise, it will prevent our majority probability from being achieved, while giving priority to the minority probability

- Exceptionally Strong Government with close to 2/3 majority
- Significant foreign inflows of USD 2-3Bn is achieved during 1H2020
- External sector significantly improves with rating outlook upgrade and Global fund flows trend towards South Asia

Fiscal loosening weakens 2H2020 Outlook

THANK YOU

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