



First Capital  
A Janashakthi Group Company

# *EQUITY STRATEGY*

## *"INTO THE CRISIS"*

FIRST CAPITAL RESEARCH

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Dimantha Mathew

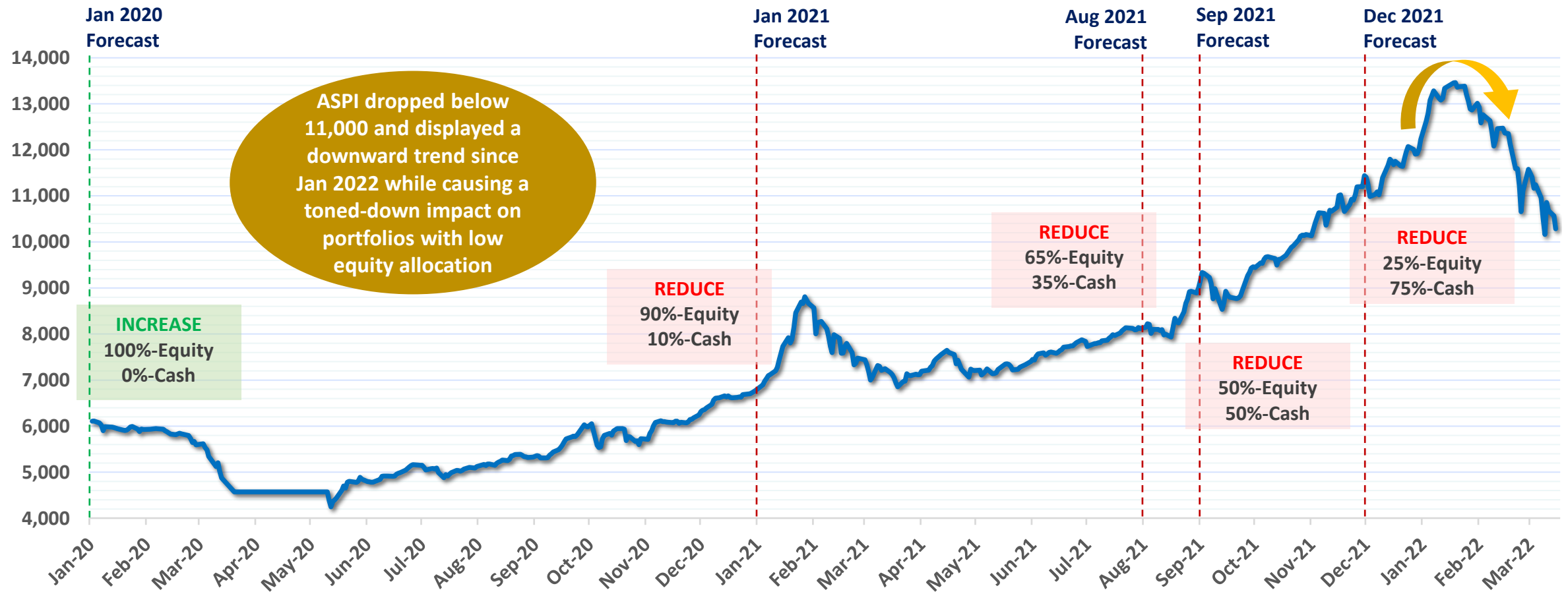
15<sup>th</sup> Mar 2022



# RECAP: DEC 2021

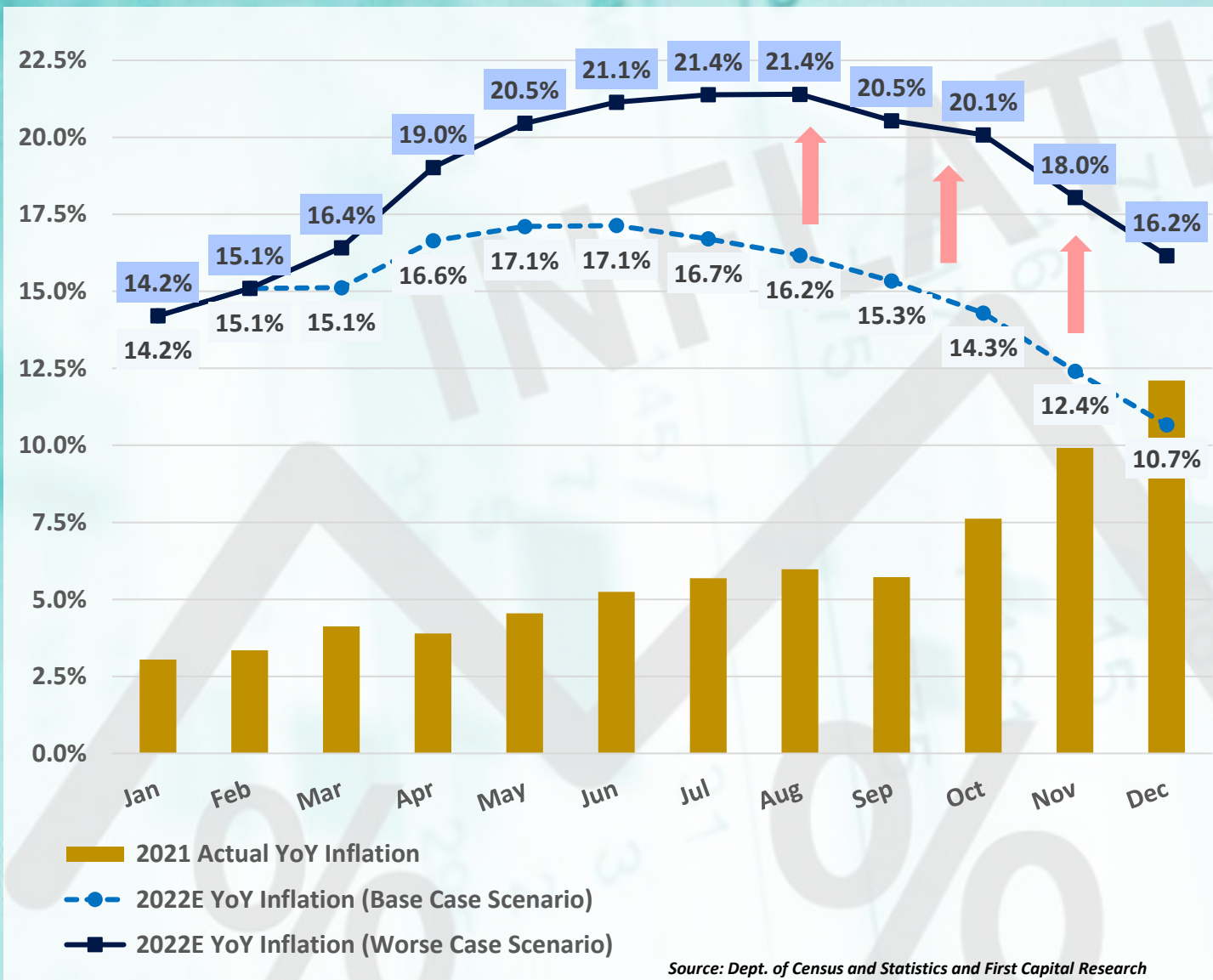
*Accuracy maintained*

Reduce exposure to 25% from 50%; Cash 75%



Source: CSE, First Capital Research



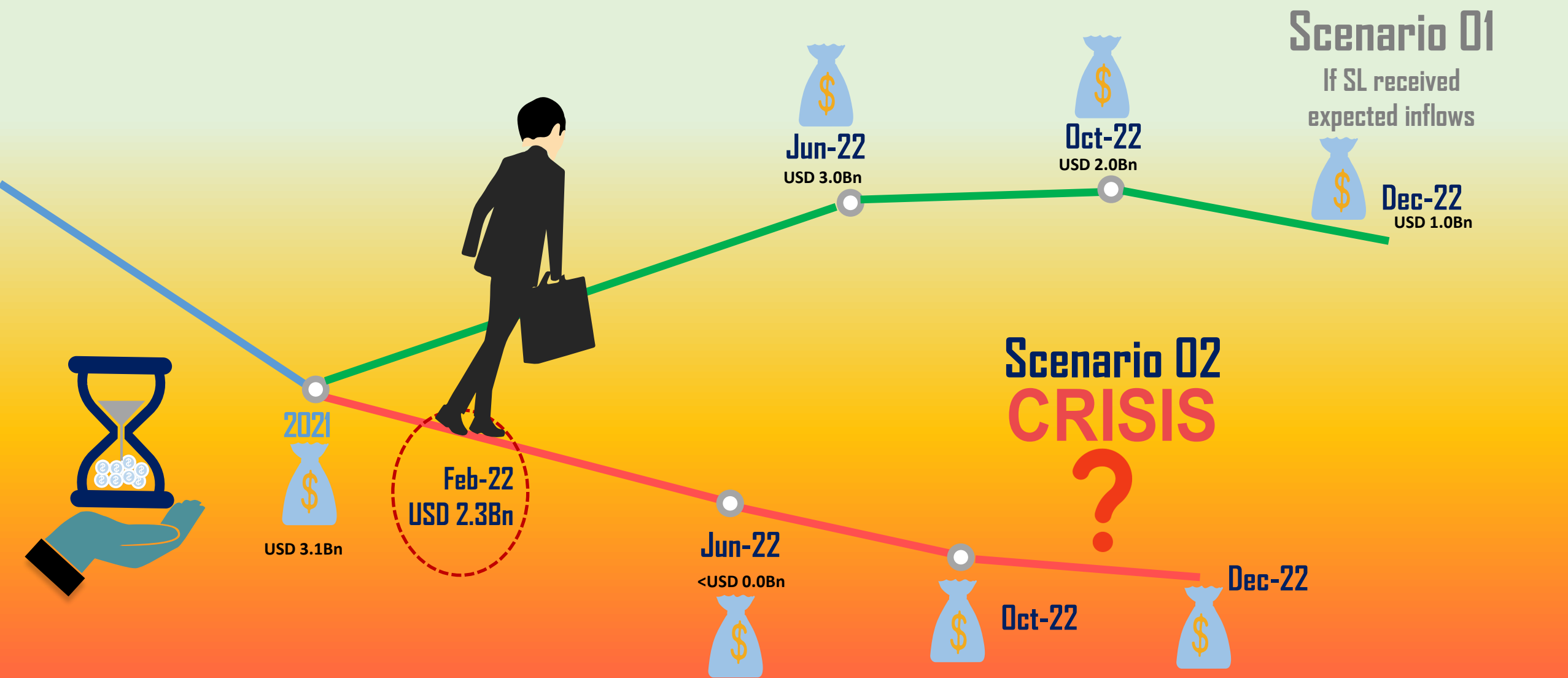


**Inflation**  
accelerated to  
a record high  
of 15.1% in  
Feb 2022...


*while 2022 inflation is  
expected to peak at  
17.1% in a base case  
scenario and may  
increase up to 21.4%  
on worsening  
economic conditions.*



Given the current macroeconomic indications, Sri Lankan economy is heading towards the **'Scenario 2'** and may reach near zero foreign reserve levels prior to the previous forecast of Dec-22



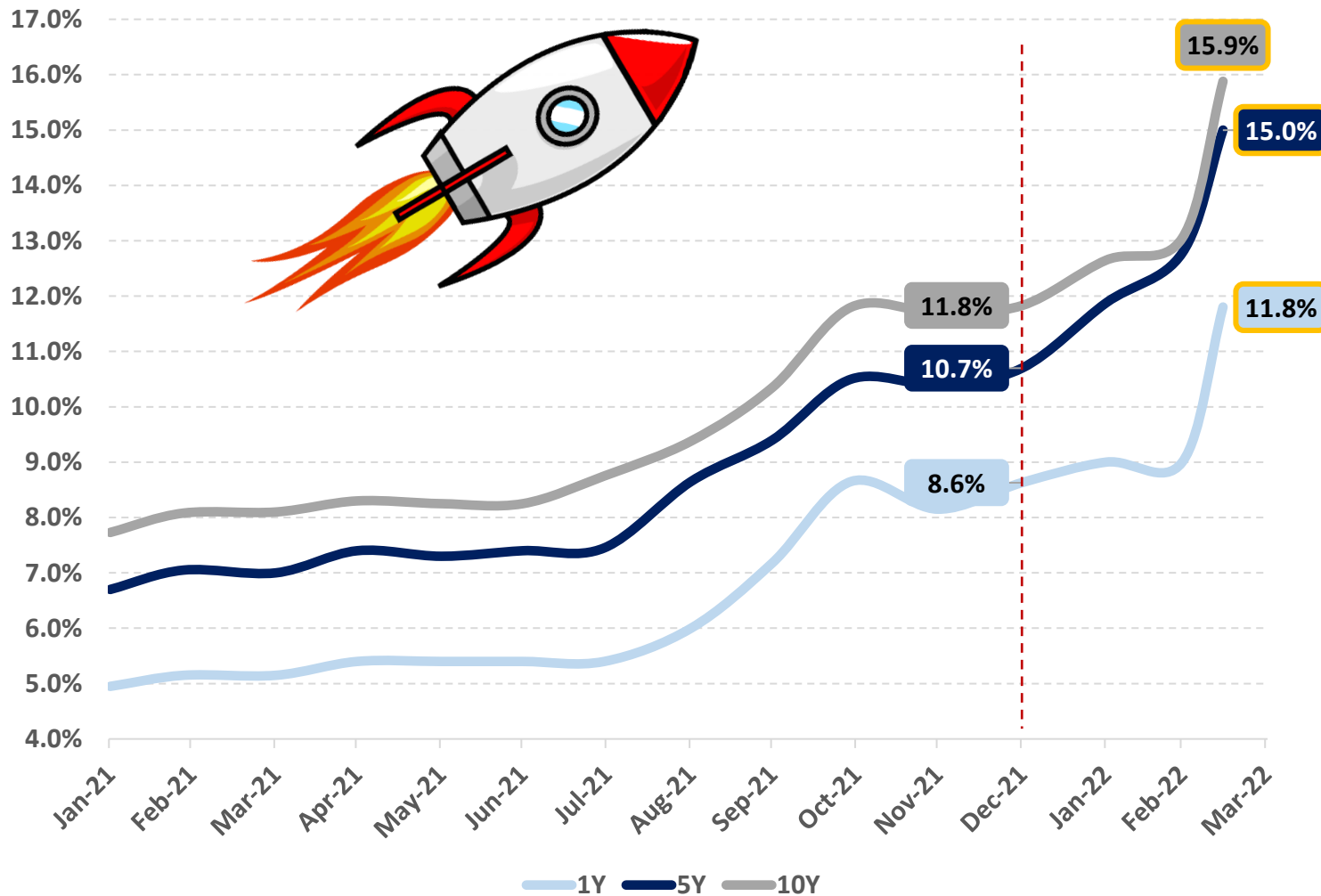


The background of the slide features a collage of financial market data. On the left, there are several candlestick charts in green and red. The right side is filled with various numerical values in different colors (green, red, white) and sizes, some of which are partially obscured by a dark blue rectangular box containing the main text. The overall theme is financial analysis and market trends.

“Worsening macroeconomic indicators signal that Sri Lanka is moving closer towards an **Economic Crisis** in line with our worse case scenario”



# Bond Yields leaped sharply by 320-430bps during Dec-21 to Mar-22



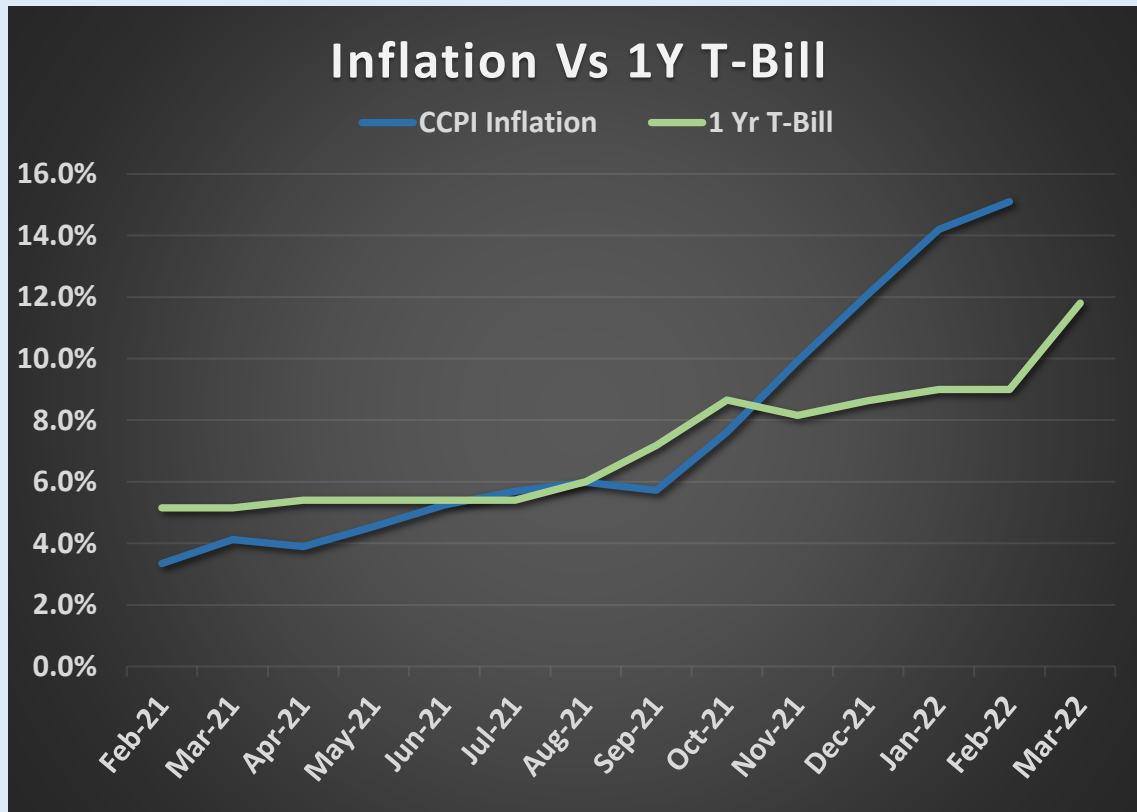
***CBSL's further monetary policy rate hike of 100bps on 04<sup>th</sup> Mar 22 resulted in a spike in treasury yields***

***Accordingly, 1Yr T-Bills, 5Y and 10Y T-Bonds surpassed our upper band target for 1H2022 under the base case scenario and may reach yields of worse-case scenario with no IMF or further foreign inflows***

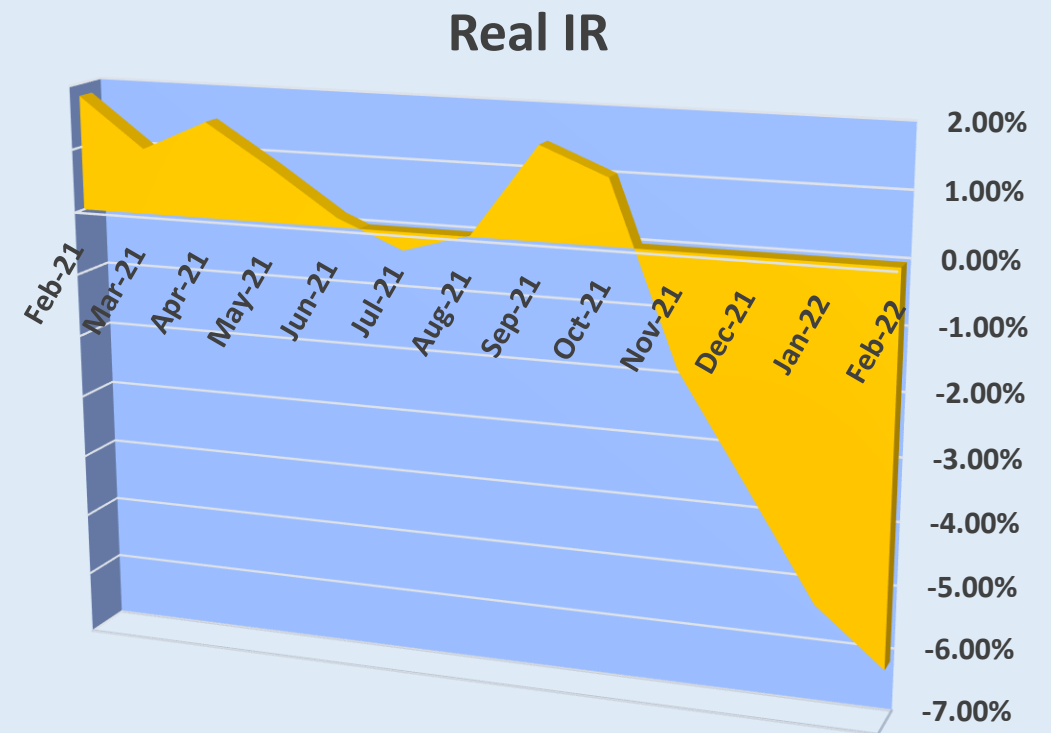


Real interest rates may remain negative, yet funds may shift due to FD rates going beyond physiological 10.0% mark amidst rising T-Bill rates...

...raising the bar for maximum FD rates to near 13.0% by 1<sup>st</sup> Apr



Source: Department of Census and Statistics, CBSL, First Capital Research



Source: Department of Census and Statistics, CBSL, First Capital Research



# Why do rising interest rates matter to Stock Market?

## *Shift of funds due to FD rates moving beyond 10.0%*

As a consequence of further monetary tightening by CBSL, the secondary market yield for 1Y T-Bill currently stands at 10.5% and a persistent rise in treasury yields may turnaround the negative real interest rates shifting the investor focus from high-risk equity market towards safer fixed income instruments especially fixed deposits which the cap is directly linked to T-Bill rates, are likely to move beyond 10.0% psychological benchmark in tandem with the policy rates.

## *Rise in risk-free ( $R_f$ ) rate level up the expected Return on Equity*

Furthermore, as a result of the continuous rise in risk-free rate, equity investors may require additional premium to compensate for systematic and unsystematic risks undertaken by them, thus increasing the required rate of Return on Equity.

## *Domestic cost of borrowings become expensive*

Rise in interest rates will make domestic borrowings more expensive thereby significantly increasing the finance cost. This may discourage additional borrowings and hinders future corporate expansion plans. Therefore, these factors may weigh on corporate valuations while lowering the fair value estimations.

## *Rising inflation may dry-up the disposable income*

Although monetary policy tightening is expected to trim down inflation by easing pressure from demand-pull factors, major supply-side issues may remain unattended and thereby push the prices further upward amidst the current macroeconomic and external sector turmoil. This may lead to consumers being left with less disposable income which reduces the discretionary expenses that may in turn impact negatively on business earnings.

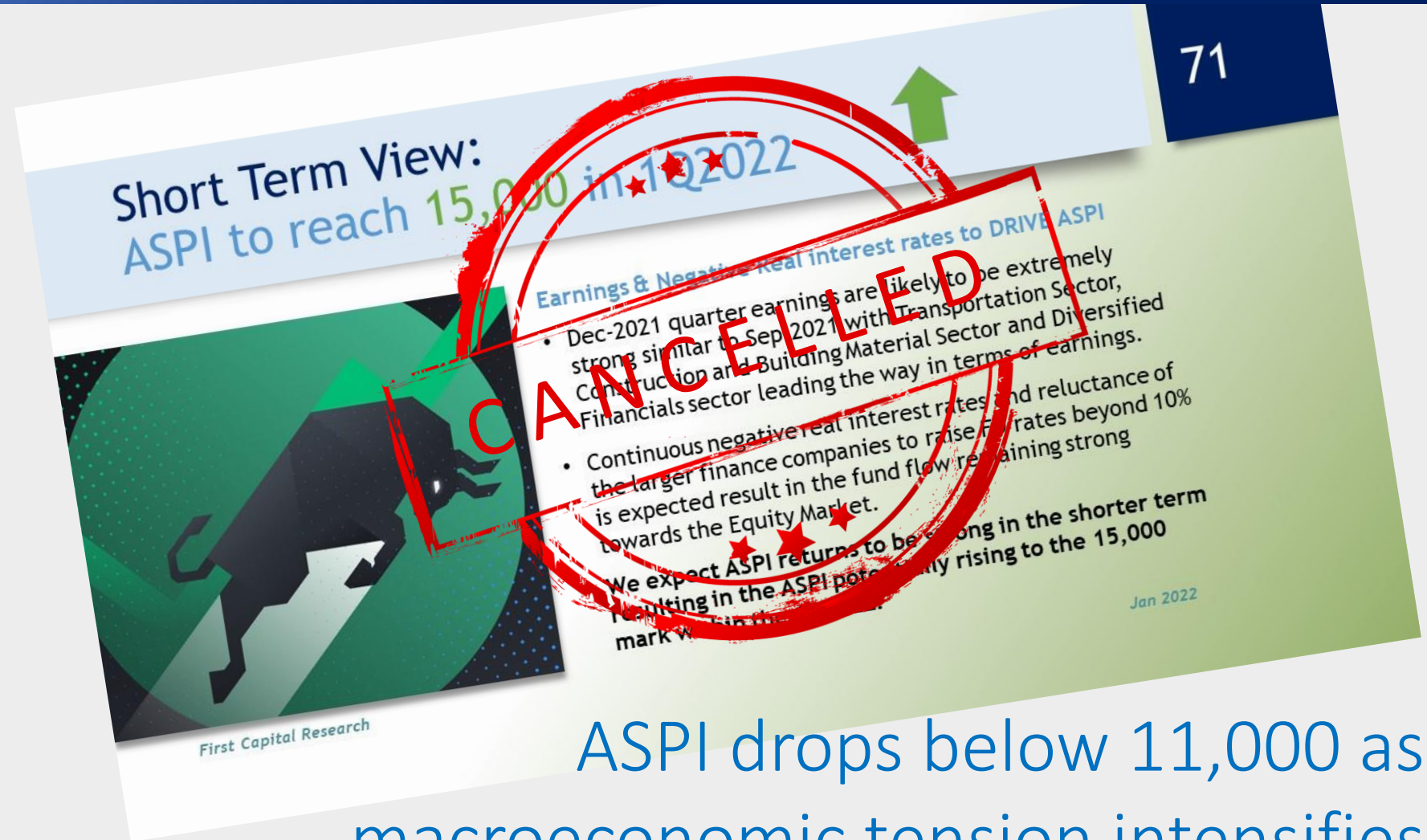




# FCR Short-Term Bullish View Withdrawn!!!



We hereby withdraw our view of short-term bullishness in the market which expected a potential rise in ASPI to the 15,000 mark during 1Q2022 supported by the strong earnings and negative real interest rates as per our Investment Strategy Jan 2022, due to Sri Lanka now heading towards an economic crisis in line with our "Scenario 2"



71

ASPI drops below 11,000 as macroeconomic tension intensifies



## Sri Lanka's CEB maintains 7.5-hour power cut on Tuesday; Fuel deficit, drought weigh

BY CHANKA JAYASINGHE  
Monday March 7, 2022 7:59 pm

Manufacturing industries disappointed over measures taken thus far to avoid power cuts

Facebook Twitter + More 6

8 March 2022 05:09 am 0 -951

- Say businesses losing confidence in policy making bodies finding sustainable solutions for power cuts
- Point out businesses dealing with a toxic combination of fuel shortages and power cuts
- Exporters say struggling to maintain "all ok" narrative to customers

High energy-consuming industries yesterday called on the government to get its act together and give some lev of confidence with regard to its ability to come up with sustainable solutions to resolve the ongoing hours-long power cuts, a result of the prevailing foreign exchange crisis.

**MUST READ** Last flight from Poland in: Stopped even for stragglers, says minister

## Explained: Why has Sri Lanka imposed its longest power cuts in 26 years?

Sri Lanka has announced nationwide daily power cuts, lasting up to seven-and-a-half hours. What is the reason for this? What impact does it have?



March 7, 2022  
6:48 PM GMT+5:30  
Last Updated 21 hours ago

Asia Pacific

**REUTERS**

## Hundreds of bakeries shut in Sri Lanka after cooking gas runs out

By Udit...

MARKETS

## Sri Lanka bourse down on concerns over extended power cuts, economic concerns

Monday March 7, 2022 7:35 pm

97.94	0.14	SPH	3,296.00	50.40	XES	2,261.94
16.03	0.83	WTI	49.55	-0.56	REIT	105.6
130.95	-0.62	BNPT	53.95	-0.50	XSD	45.3
2,564.35	47.27	GOLD	1,558.30	-24.10	KBE	28.6
658.58	7.40	FANG	3,667.14	144.94	GOX	
FTSE	7,439.82	113.51				

THAILAND BUSINESS OPINION AUTO LIFE LEARN

## Sri Lankan energy crisis worsens

Foreign-exchange shortage leaves state petroleum company without dollars to buy oil

PUBLISHED : 18 FEB 2022 AT 20:01

WRITER: AFP



**ALJAZEERA** News Ukraine war Features Economy Opinion

## Sri Lanka imposes rolling power cuts as economic crisis worsens

Deepening financial crisis leads to shortages of fuel and handicaps the island nation's electricity grid.

**CNBC** MARKETS BUSINESS INVESTING TECH POLITICS CNBC TV INVESTING CLUB PRO

## Sri Lanka's central bank chief says measures to deal with economic crisis may not be 'palatable'

PUBLISHED MON, MAR 7 2022-8:44 PM EST

Ee Ming Toh

KEY POINTS

- As Sri Lanka battles one of its worst economic crises in over 70 years, bank governor expressed optimism the country would...

**THE NEW INDIAN EXPRESS**

NATION WORLD STATES CITIES BUSINESS SPORT GOOD NEWS MOVIES PHOTOS VIDEO

STOCK MARKET BSE 53468.80 626.05(1.18%) NSE 16026.10

## Sri Lanka out of cash to buy oil, fuel shortages could get worse: Minister

The shortage of furnace oil has already led to the shutting down of the electricity generators, resulting in unannounced power cuts across the island.

Published: 18th February 2022 05:36 PM | Last Updated: 18th February 2022 05:36 PM

Latest Maharashtra



# Potential Earnings Impact on Energy Crisis

***Rising prices with lack of foreign reserves may further aggravate the supply shortages***



Dwindling foreign reserves coupled with geopolitical unrest and the supply shortages fuelling up the global commodity prices worsening the country's ability to fulfil the energy requirement to run the business and household activities smoothly.

***Manufacturers may get hammered due to operational disruptions***



Persistent power cuts, disrupted daily operations especially in the high-energy consuming sectors such as manufacturing may experience delayed orders and messes in the distribution channels while losing the credibility towards existing and potential buyers.

***Devaluation of currency may hit negatively on operational costs***



With the CBSL's move towards a free-float of the currency which is currently quoted at LKR 260.0/270.0 per USD (source: CBSL), the energy cost may further higher up puffing out the cost of sales as well as distribution costs in companies.



***Reduced export earnings due to loss of potential orders***

Apparel sector which yields a significant amount of export earnings into the country may see a reduction in their revenues due to loss of orders.





# Equity New Recommendation



# In the Crisis; FCR Mid-Long term view remains intact

**RECAP: DEC 2021** | Possible Economic Shock; Aggressively shift to Defensive counters - *Maintained*

## Sri Lanka currently undergoing a major Economic Shock



Sri Lanka's foreign reserves has fallen to USD 1.6Bn in Nov 2021, the lowest level since 2009 and improved in Dec 2021 to USD 3.1Bn and currently hovering around USD 2.4Bn by Feb 2022. With USD 7.0Bn foreign currency debt to be repaid over the next 12 months, Sri Lanka seems to be at a very critical juncture. Despite the possible foreign inflows as a result of the devaluation of the LKR, unceasing pressure from global commodity prices coupled with geopolitical tensions, the local energy shortages and resultant power cuts may intensify the current economic unrest. With the Governor continuously reiterating that they are NOT willing to obtain IMF support, it is unclear as to the debt repayment plan of the Government. Therefore, we believe that Sri Lanka could be further dive into the core of the economic crisis creating an unbearably high-risk environment.

## Reduce Risk by aggressively shifting to Defensive Counters; Possible Negative Return in the broader market in 2H2022

The weak environment could lead to a further depreciation in the currency, if floated and as well as further hike in interest rates. Though the import restrictions and rise in inflation are supporting the growth in earnings, it is likely to be temporary in the face of the crisis. It will be prudent for investors to move towards defensive counters out of which **Dollar income companies** are on the priority list, though it's best to move into companies that have NOT surged in price. **Life Insurance Companies** and **Banks** are expected to benefit from the rise in interest rates. We would also recommend **high dividend yielding counters** (Refer First Capital's Dividend Tracker Report).

For risk-averse conservative investors who are unwilling to take an economic shock, we would recommend to further reduce equity exposure. From our previous cash allocation of 75%, it would be wise to increase to 90%.






# We **maintain** our ASPI expectations for 2022E at 9,000-10,000 as stated in our Equity Strategy (Dec 2021)



Source: CSE, First Capital Research



Stock	Stock Code	Price as at 15.03.2022	Fair Value CY22E/FY22E
		LKR	LKR
 Teejay Lanka	TJL.N0000	40.90	75.00
 Hayleys Fabric	MGT.N0000	33.00	60.00
 Hayleys	HAYL.N0000	97.00	125.00
 Commercial Bank of Ceylon	COMB.N0000	77.80	115.00
 Hatton National Bank	HNB.N0000	129.50	160.00
 Sampath Bank	SAMP.N0000	52.30	65.00
 National Development Bank	NDB.N0000	60.30	85.00
 HNB Assurance	HASU.N0000	48.10	66.00
 Access Engineering	AEL.N0000	20.00	40.00
 Nestle Lanka	NEST.N0000	996.25	1,300.00
 Ceylon Tobacco	CTC.N0000	725.00	1,150.00
 LVL Energy Fund	LVEF.N0000	7.90	16.00
 Windforce	WIND.N0000	17.40	25.00



# Top Picks 2022



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# THANK YOU

“Successful Investment Is About Managing Risk...”

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