



First Capital



Strategy Report 2021

January 2021

The second leg of 'W' ; Bumpy road to 'Recovery'

SRI LANKA

FIRST CAPITAL RESEARCH

Analysts

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The second leg of 'W'; Bumpy road to 'Recovery'

2



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07	Possible positives preventing our 85% probability	63

The second leg of 'W'; Bumpy road to 'Recovery'

Executive Summary

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Pressure on Bonds yields to rise from 1Q2021 onwards, but rise may be slower due to higher liquidity

- With the rise in Govt borrowing requirement, rising consumer demand and private credit, we expect a gradual increase in pressure on bond yields during 1Q2021 and afterwards gradually move up further during 2021.
- On a base case First Capital Research expects a stable policy environment upto Jun 2021 followed by policy rates reverting upwards with potential 2 policy hikes in 3Q/4Q.

Banking Rates (AWPR) to gradually trend upwards and readjust above the 5Yr Bond yield

- With the lack of credit, AWPR fell below the 5-Yr bond, breaking the historical trend of moving in line with the 5-Yr Bond. As private credit picks up AWPR may return to the historical trend. We expect the AWPR to have bottomed out and is likely to rise amidst competition for debt from Govt and Private Sector as Private credit picks up. We expect AWPR to fall to a range of 6.5%-7.0% by Jun-2021 and further move towards 7.0%-8.0% by Dec-2021.

Exchange Rate target for 1H2021 narrowed down to LKR 196.0-202.0 with 2021 Year End target at LKR 205.0-215.0

- With the weak foreign currency reserve position, high foreign currency debt repayment and possible spike in consumer demand triggering higher imports are likely to result in a steep depreciation in 2021. We expect LKR to depreciate approximately c.12.0% during the year.

ASPI fair value for 2021E maintained at range of 7,000-7,500 for 2021E; Cut Equity Portfolio to 90% and increase cash allocation to 10%

- We believe market is attractive when the market trades below a forward PER of 14.0x-14.5x. In the Bull Run the ASPI has surged well over our expected fair value justifying a gradual reduction in equity portfolio. Thereby, we raise our cash allocation in the equity portfolio to 10% from the previous 0%.

The background of the slide is a light blue gradient. Overlaid on this is a faint, semi-transparent image of a hand holding a pen, poised to write on a document. The hand and pen are positioned on the left side of the frame, with the pen pointing towards the center. A dark blue horizontal bar spans the width of the slide, partially obscuring the background image. The title text is written in a bold, dark blue font on this bar.

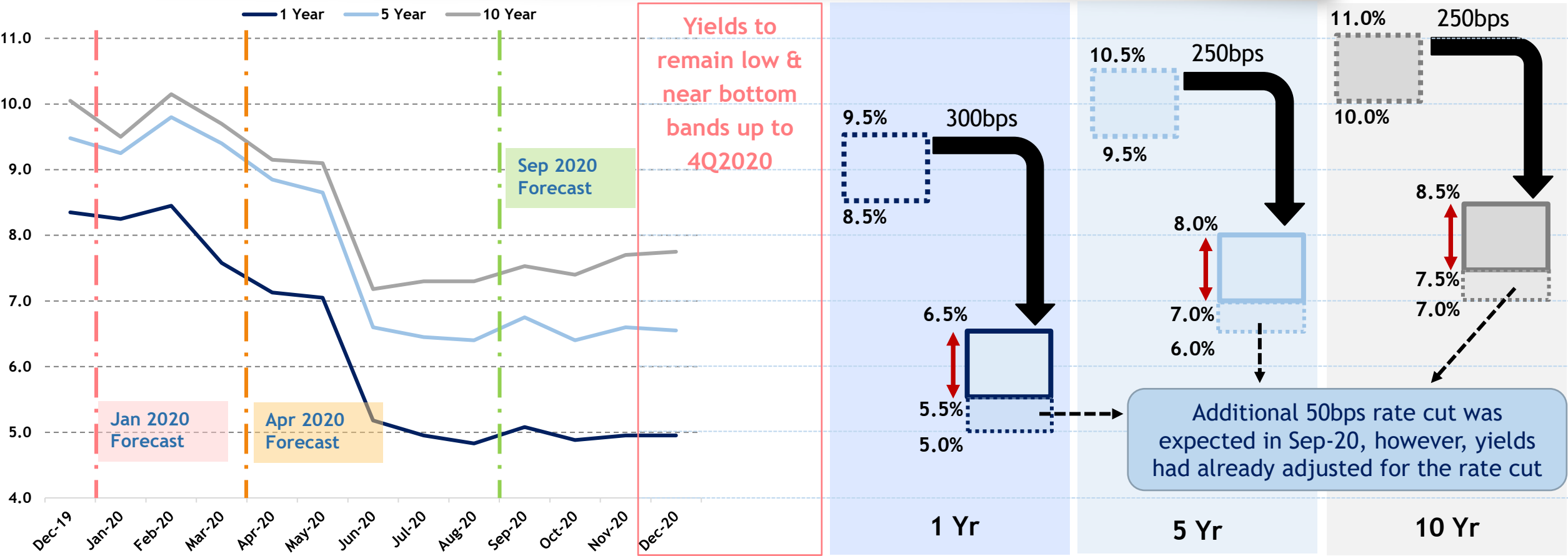
Track Record [Apr 2020 Revisions & Sep 2020]

Section 1.0

Bonds - Apr-20 Post Covid-19 Re cap: Accuracy Maintained

1Q2020 Bond Yield Expectations extended upto 4Q2020 and adjusted downwards, 1Yr by 300bps and 5Yr, 10Yr by 250bps

6

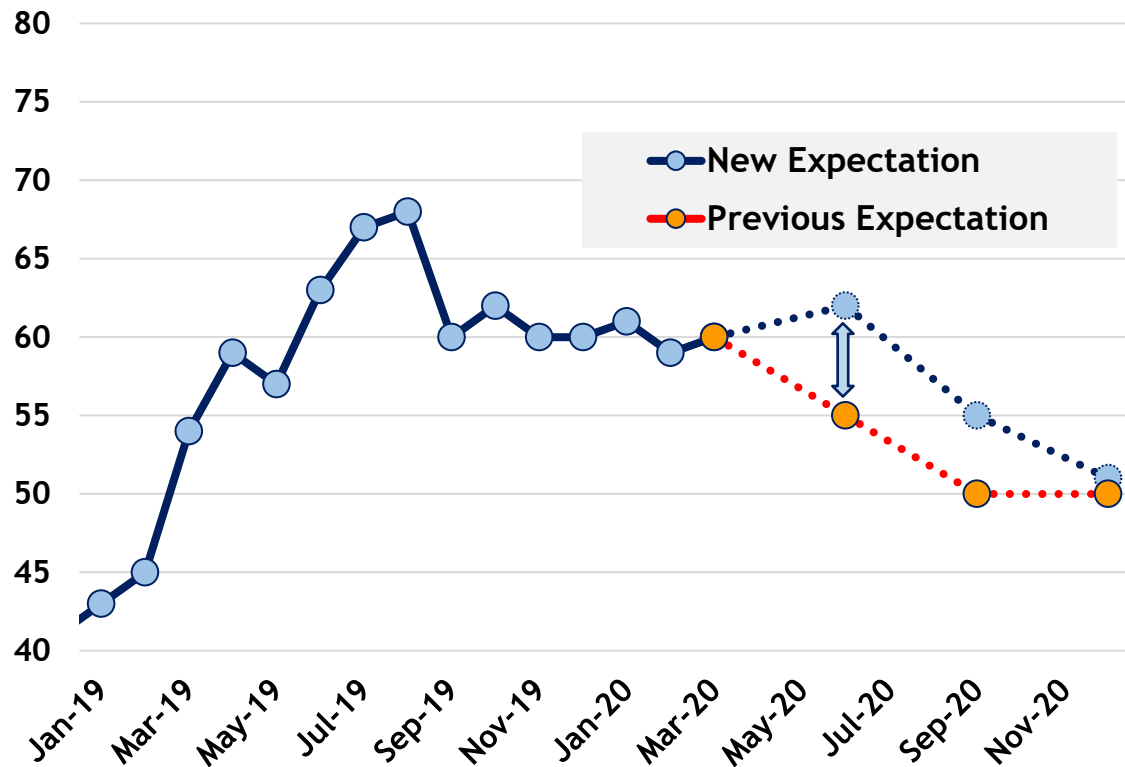


Recap: 14th May & 18th Jun 2020:

*Revision of Bond Yield Expectations following COVID-19
and expansion of 1-5Yr spread and 1-10Yr Spread*

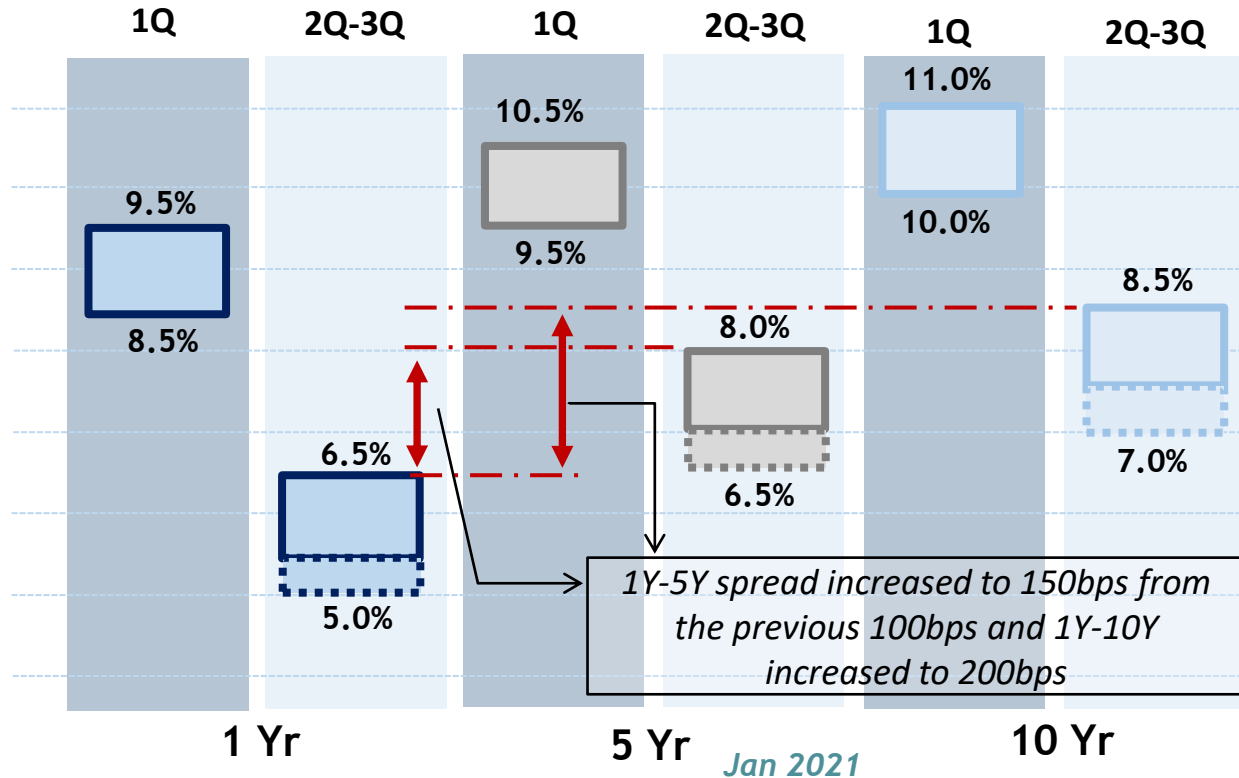
7

First Capital Fixed Income Health Score



Source: First Capital Research

Despite the temporary improvement in the Health Score, considering the future risk, we have expanded 1Y-5Y spread and 1Y-10Y spread by an additional 50bps



“

Bond Yields to gradually trend up from 1Q2021 onwards

”

Bonds - Sep 2020 Re cap: Accuracy Maintained

8

Jan, Apr Revision & Sep-20 AWPR Re cap: Mostly Accurate

AWPR unusually declines below the 5Yr Bond

9

Jan 2020
Expectation

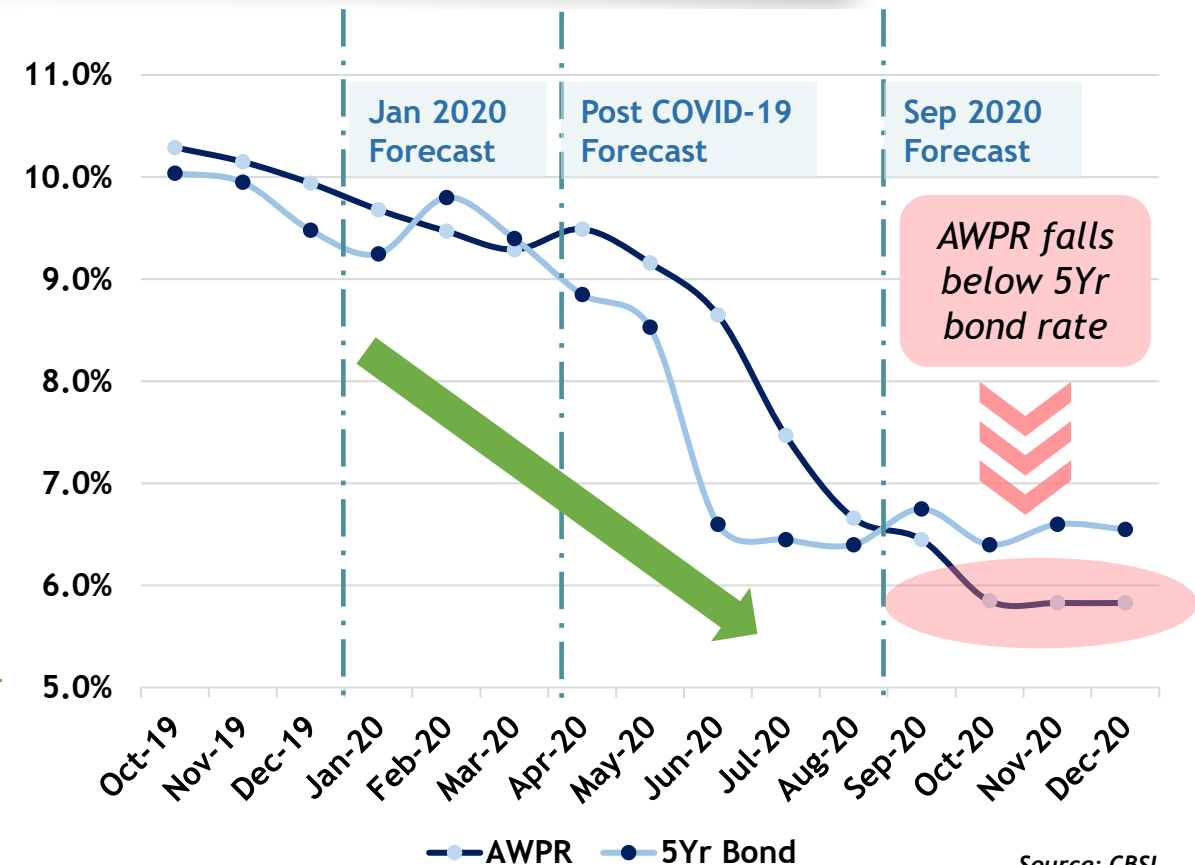
Banking Rates (AWPR) to remain low c.9.5% in 1H and range from 9.5%-10.5% over next 12 months

Post
Covid-19
Expectation

AWPR may fall below 9.0% to c.8.5% amidst the lack of lending

Sep 2020
Expectation

AWPR to have bottom out around 6.5%-7.0% and remain below c.7.0%

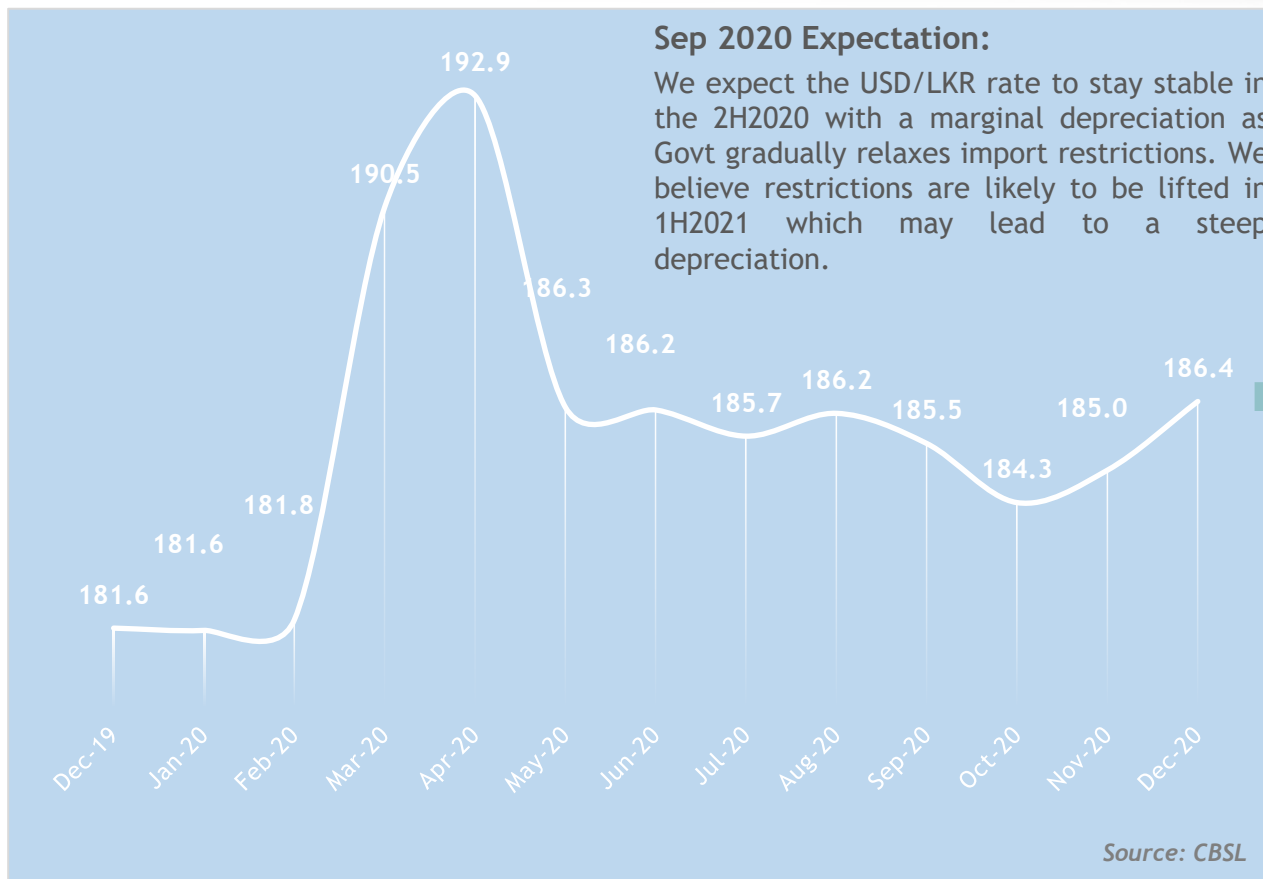


Source: CBSL

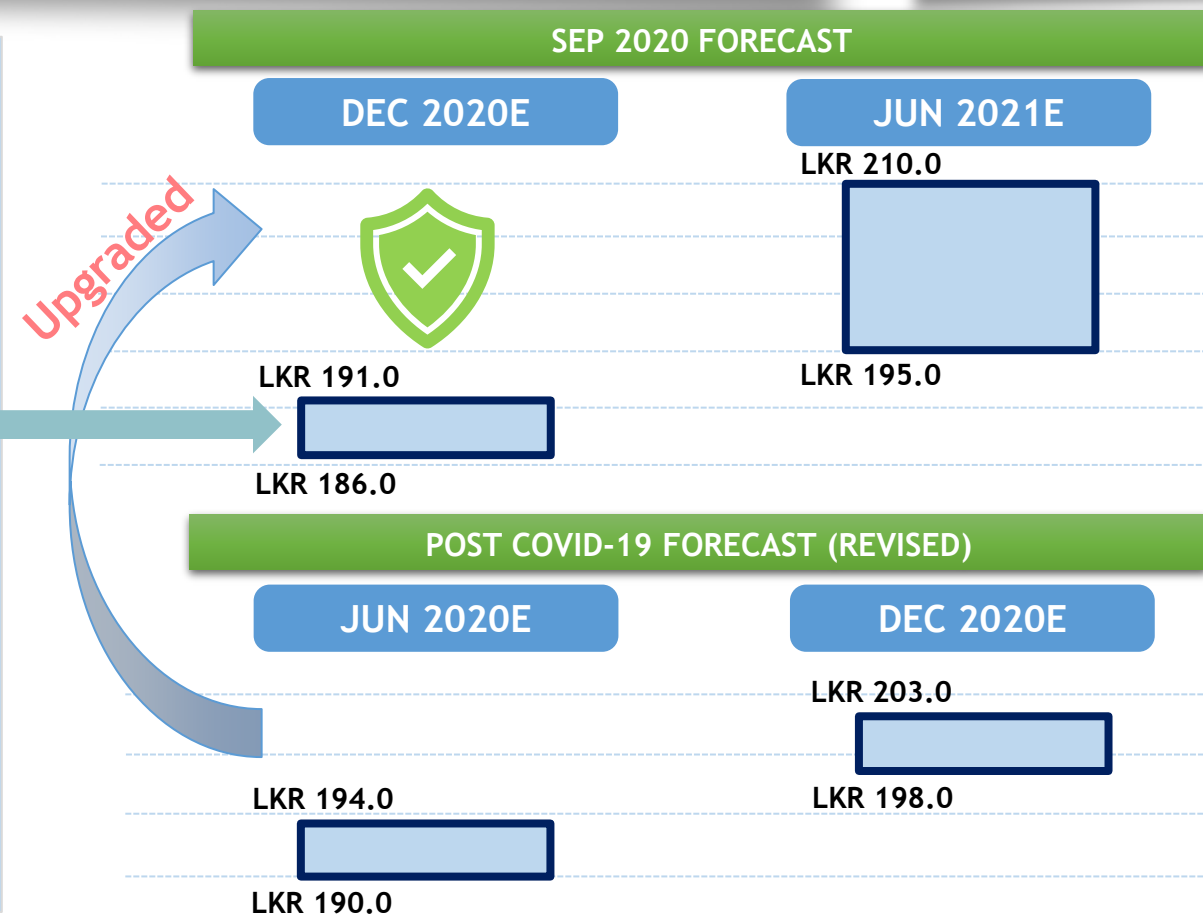
Sep 2020 Ex-Rate Re cap: Accurate

Exchange Rate 2020 target of LKR 183.0-188.0 [Jan Forecast] downgraded to LKR 190.0-194.0[Post Covid-19 target]

10



First Capital Research

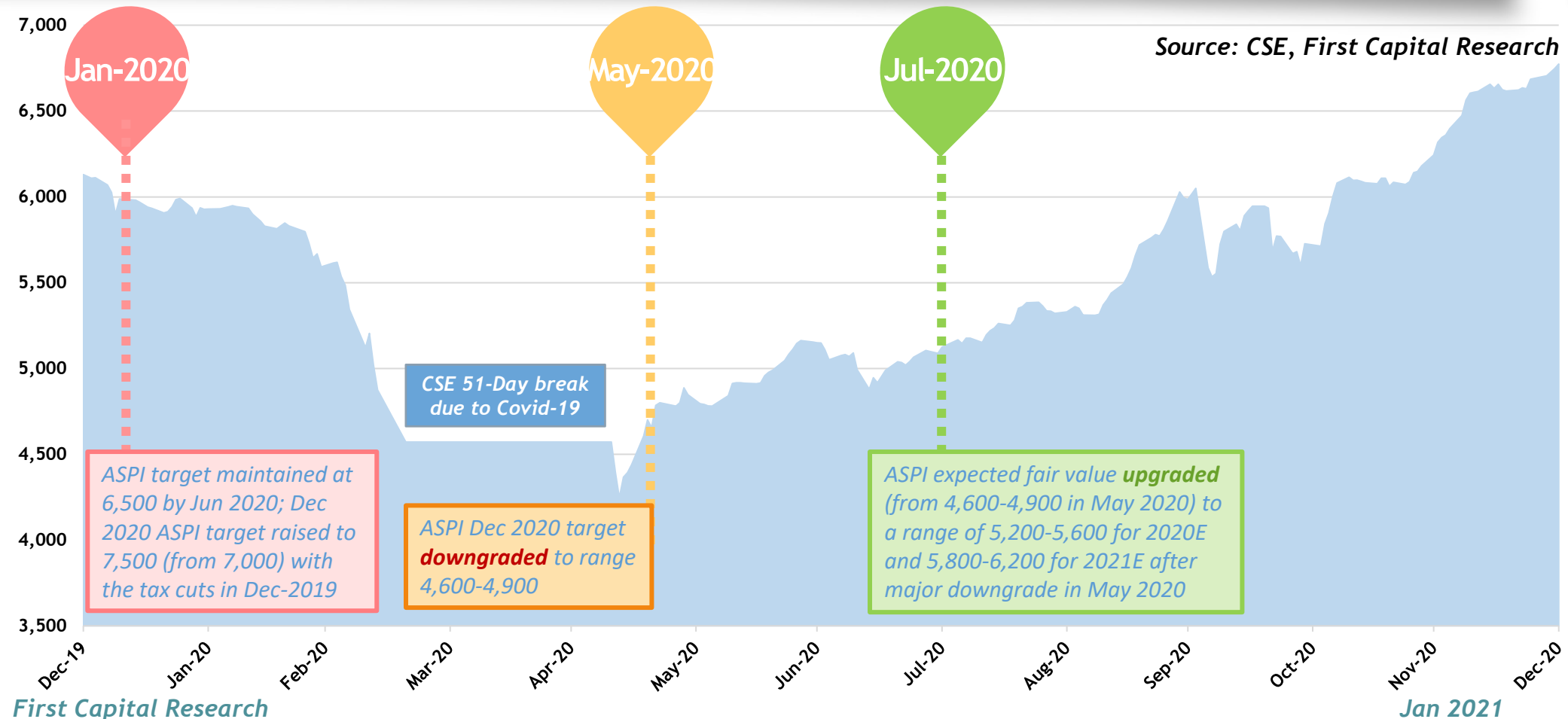


Jan 2021

Jan, Apr Revision & Sep-20 Equity Re cap: Accuracy Mixed

ASPI initial (Jan) target for year end was 6,500, revised post Covid-19 to 4,600-4,900 in May and upgraded to 5,200-5,600 in Jul 2020

11



A background image showing a hand holding a small metal bolt. The hand is positioned on the left side of the frame, with the thumb and index finger gripping the bolt. The bolt is a small, dark metal fastener with a hexagonal head. The background is a solid blue color. A semi-transparent blue horizontal bar is overlaid across the middle of the image, containing the title text. A thick vertical blue line is positioned to the left of the title text.

Factors to Consider for 2021 Outlook

Section 2.0

Factors to make decisions

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Political
Factors

Economic Factors

External Factors

Political Stability

Low GDP
Growth

Low Foreign
Reserves

Liquidity
Surplus

Lack of
Credit

Debt
Repayment

Ratings on
Sri Lanka

Ability to
raise foreign
borrowings

Global fund
flow for
emerging
markets

A background image showing a hand holding a pen, with a blue overlay. The hand is positioned on the left side of the frame, and the pen is held horizontally across the middle. The blue overlay is a semi-transparent rectangle that covers the right two-thirds of the image.

Political & Policy Stability remains healthy: *Low Risk*

Section 3.0

With the Govt maintaining its 2/3 majority, for investors, it provides confidence in relation to policy stability important for long term investments

With the Govt maintaining its 2/3 majority, for investors, it provides confidence in relation to policy stability important for long term investments



We expect Provincial Council Elections to be held possibly towards 2H2021. The PC Elections are also likely to provide a similar trend to the General Election potentially providing majority for the ruling party for most of the Councils. In such a situation it is likely to further strengthen the stability on the political front favouring long term investments.

We expect Provincial Council Elections to be held possibly towards 2H2021. The PC Elections are also likely to provide a similar trend to the General Election potentially providing majority for the ruling party for most of the Councils. In such a situation it is likely to further strengthen the stability on the political front favouring long term investments.

SEE REST OF THE STUDY ONLINE 

Approved for Release by NSA on 08-25-2013 pursuant to E.O. 13526

SEE REST OF THE STORY ON **A2** 

ilawegaya (SiB)
ich has checks
ce, Leader of
hemadasa told
erday.

version 30 story

**20TH AMENDMENT
PASSED
BY TWO-THIRDS MAJORITY**

CROSSFIRE ON WIMAI AND D

A background image showing a hand holding a small metal bolt. The hand is positioned in the center-left, with fingers slightly curled around the bolt. The bolt is a small, dark metal fastener with a hexagonal head. The background is a solid light blue color. A semi-transparent dark blue horizontal bar spans across the middle of the image, containing the text.

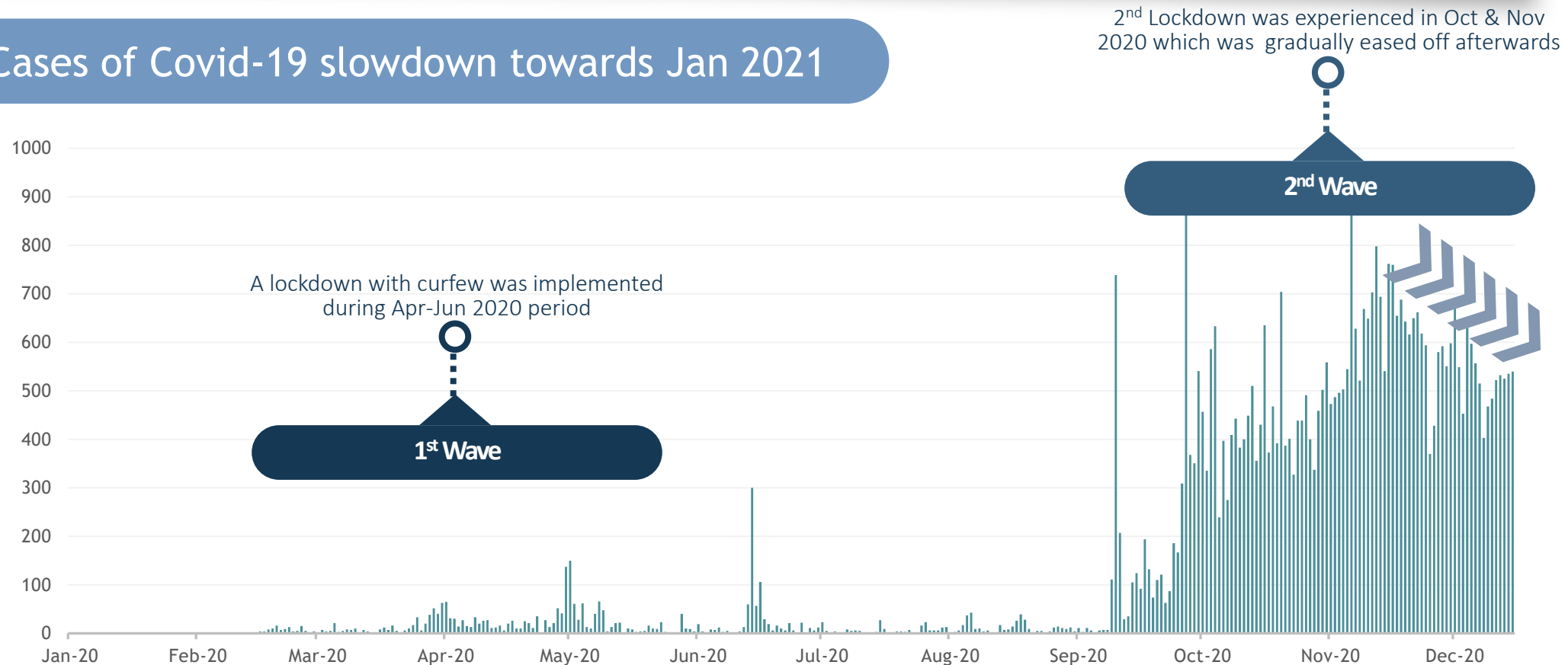
Bouncy Road Ahead: *Moderate Risk*

Section 4.0

Covid-19 2nd Wave forces a 2nd lockdown in 4Q2020, but minimises impact for 2021 with the number of new Covid patients coming under control...

17

New Cases of Covid-19 slowdown towards Jan 2021



First Capital Research

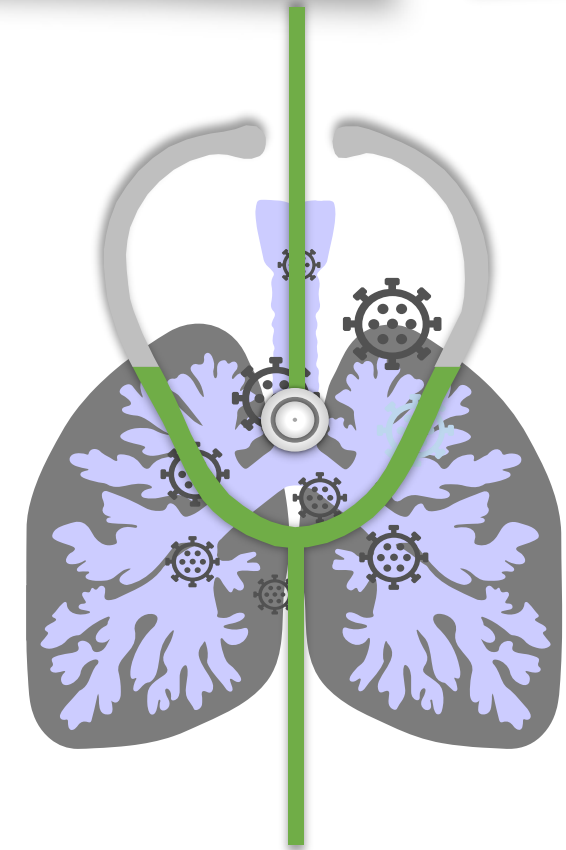
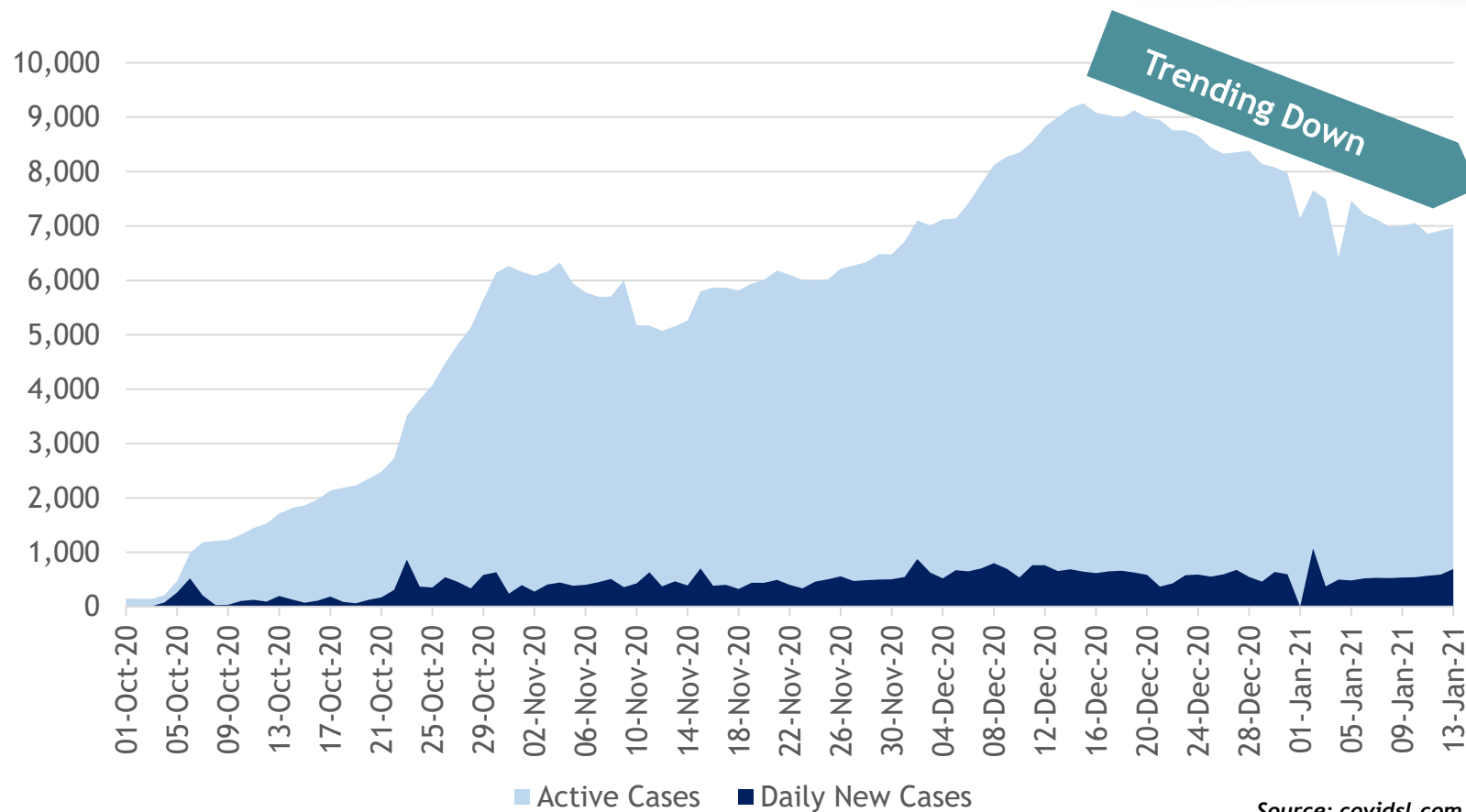
Source: covidsl.com

Jan 2021











...improving the number of active cases to a manageable level

18



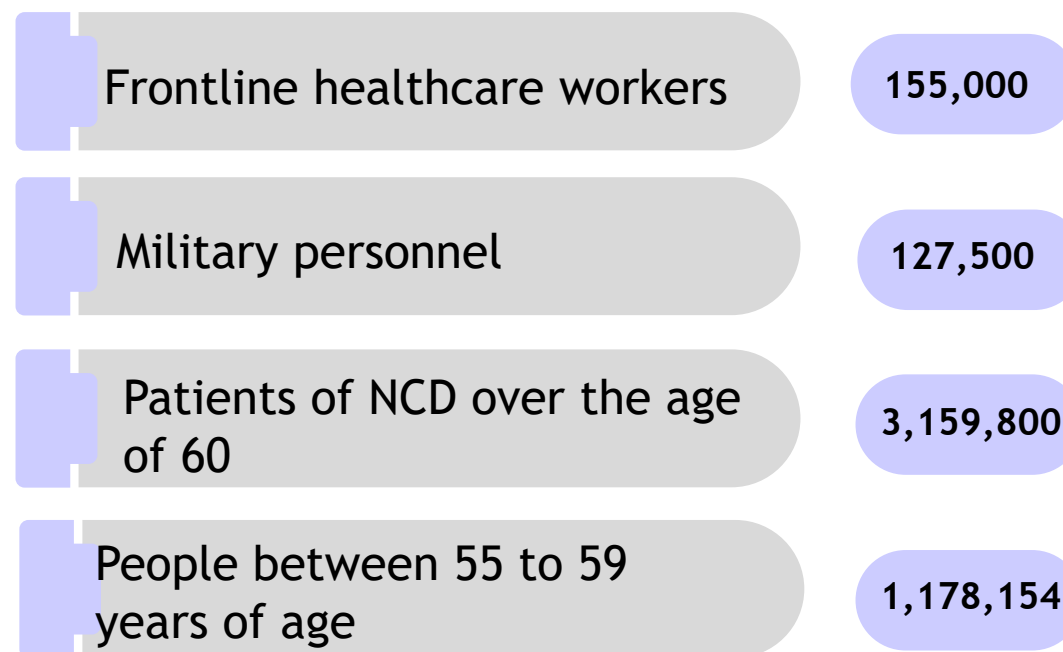
Vaccinations are likely to start, as early as Feb 2021

19

Company	Type	Doses	How effective*	Storage	Cost per dose
 Oxford Uni-AstraZeneca	Viral vector (genetically modified virus)	x2 	62-90%	Regular fridge temperature	£3 (\$4)
 Moderna	RNA (part of virus genetic code)	x2 	95%	-20C up to 6 months	£25 (\$33)
 Pfizer-BioNTech	RNA	x2 	95%	-70C	£15 (\$20)
 Gamaleya (Sputnik V)	Viral vector	x2 	92%	Regular fridge temperature (in dry form)	£7.50 (\$10)

Source: BBC

SL Covid-19 vaccine eligibility groups



Source: DailyFT

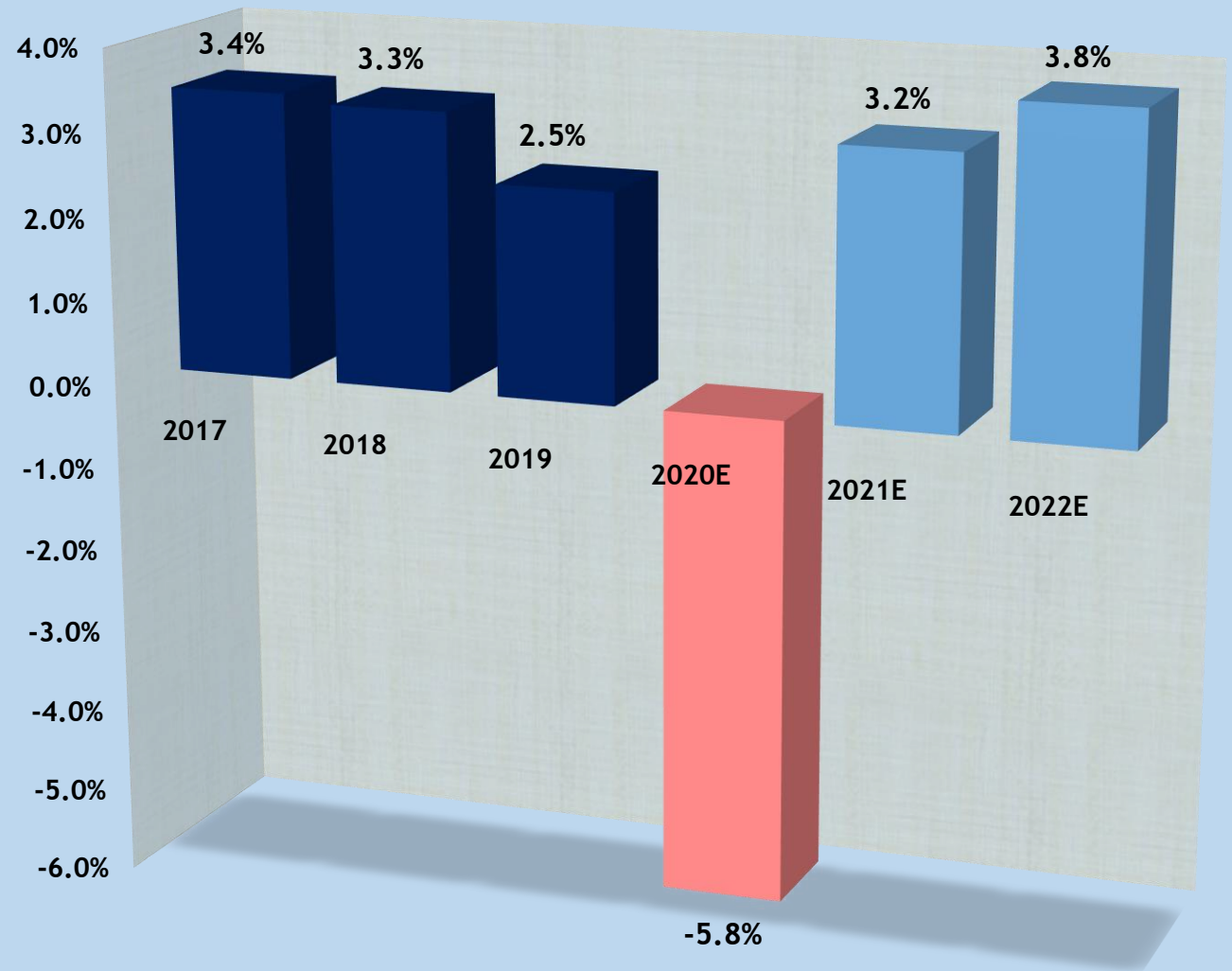
“First Capital factored in a 2nd wave in 3Q2020, thereby we maintain our annual expectations for 2020E while upgrading 2021E

With the 2nd wave lockdown materializing in 4Q (instead of 3Q), we revise our 4Q2020 GDP expectations downwards to a range of (4.5%)-(5.0%) from our previous expectations of (-0.8%)-2.0%

GDP growth for 2020E maintained at -5.8%; 2021E upgraded to 3.2%

20

GDP growth expectations improved to 3.2% [2021E] & 3.8% [2022E]



Source: First Capital Research, Dept. Census and Statistics

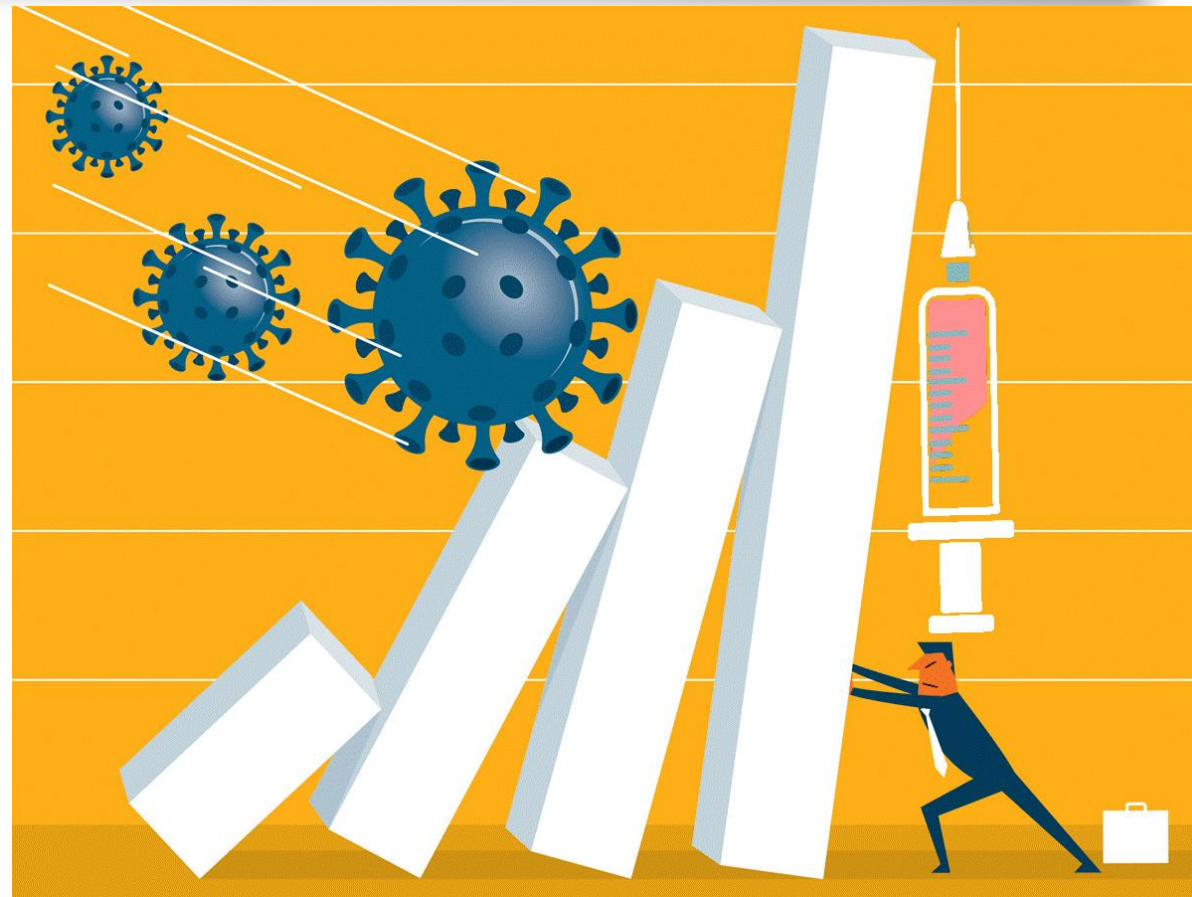
The second leg of W; *Bumpy road to 'Recovery'*

22

As you are well aware considering the dip in 2020E, SL's recovery outlook seems to be well intact. But the sluggish growth is expected continue.

Sri Lanka's surge in CBSL Holdings and foreign debt payment requirements may lead to a major depreciation in currency possibly leading to a spike in interest rates towards 2Q2021, illustrating a "Bumpy road to Recovery".

Considering the shocks, we expect SL to go through a W-shaped recovery as explained in Our Sep 2020 Mid-Year Outlook. Amidst the possible shocks, we believe SL to be in the second leg of "W".



Globally, Central Banks are using every tool in the book...

Jan 2021

In response to COVID-19, measures have included:



Cutting interest rates



Increasing loans to states and businesses

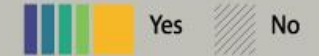


Easing restrictions on commercial banks

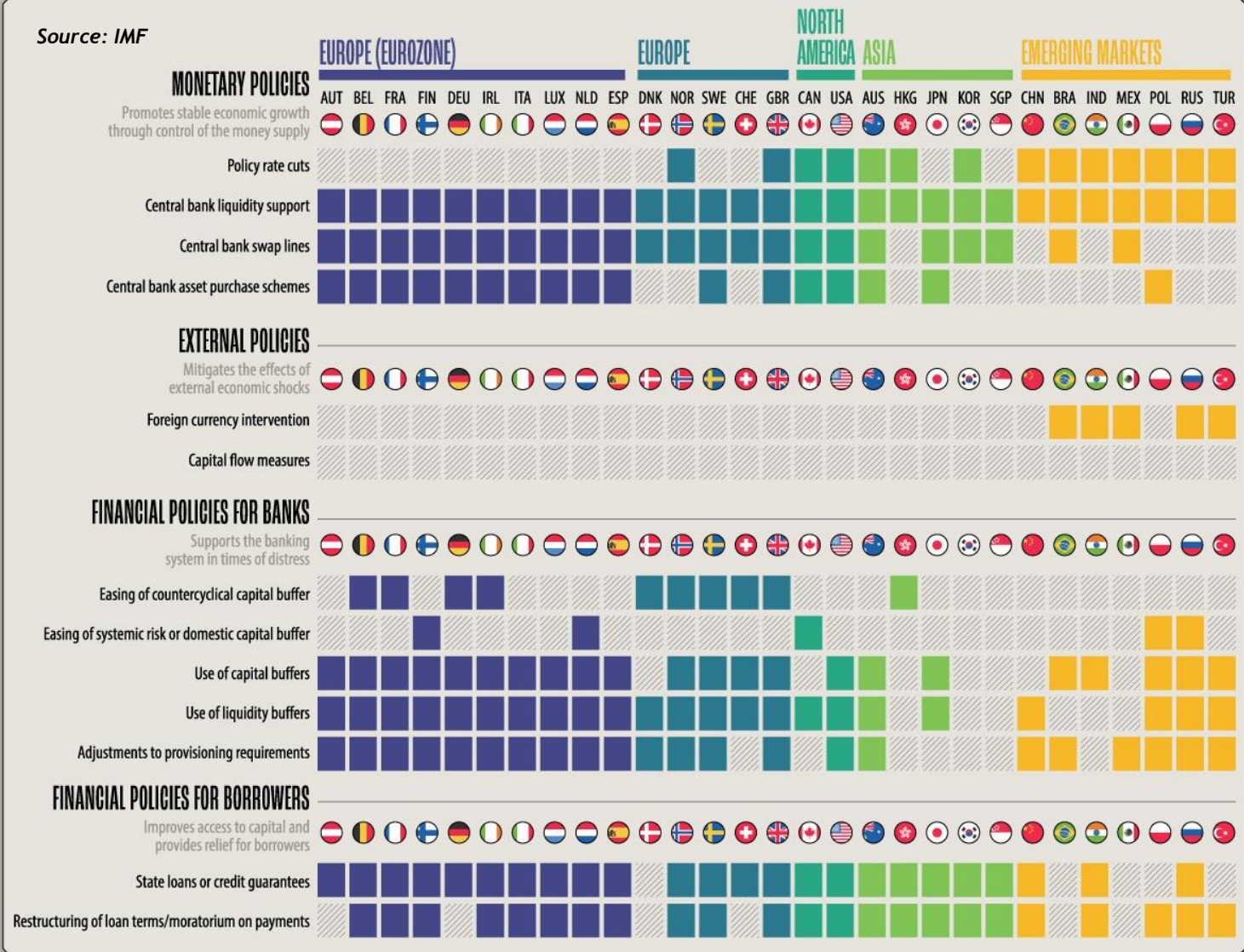
However, these represent just a subset of a central bank's full toolkit.

Below is a broad comparison of policy responses from some of the world's most systemically important economies:

How to Read This

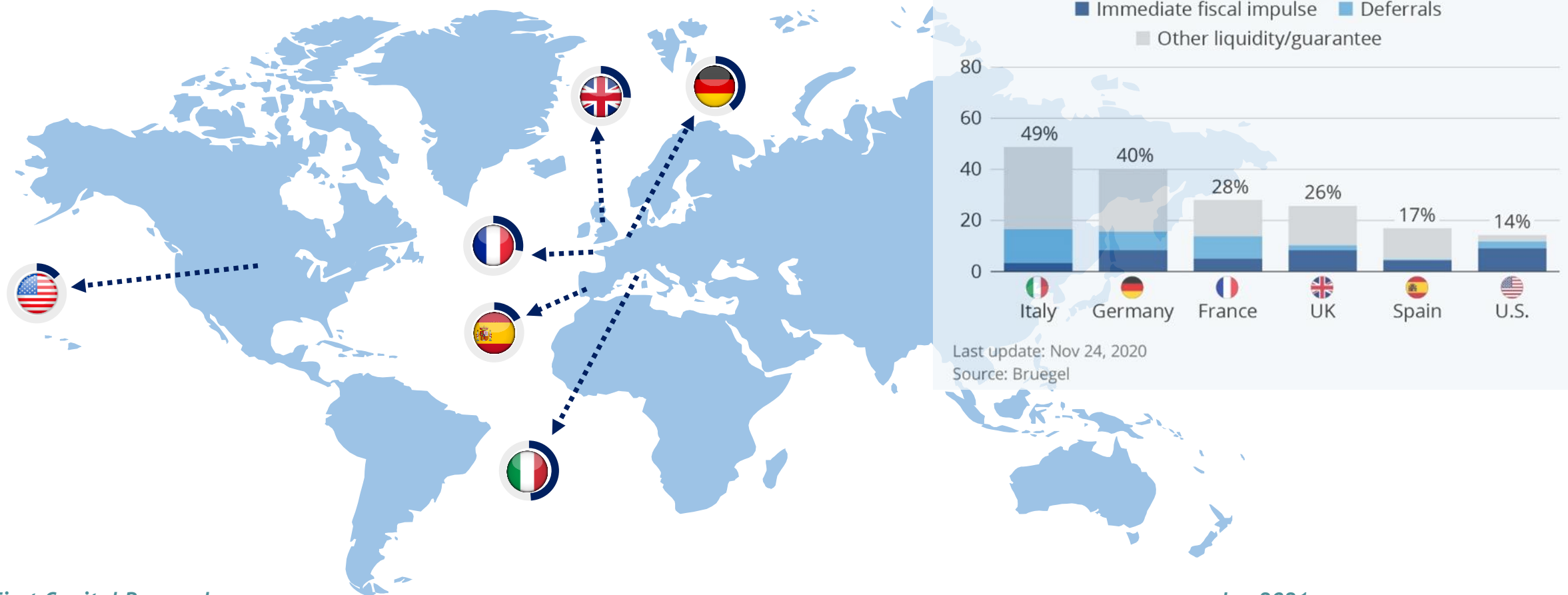


Source: IMF



...printing their way out of the mess is the mantra heard worldwide...The case is backed by the Modern Monetary Theory

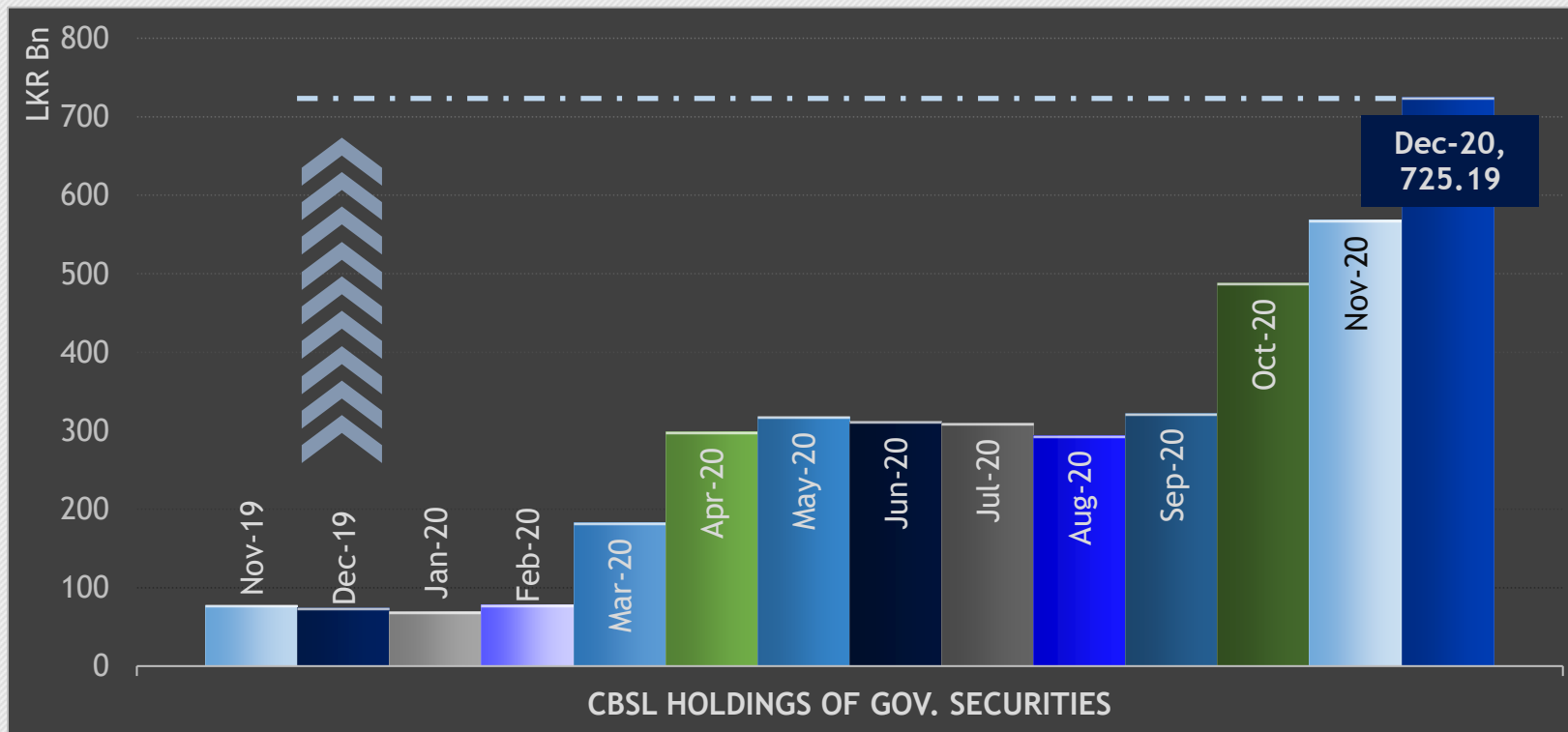
24



Sri Lanka too, is following course, illustrated by the unprecedented surge in CBSL Holdings...

25

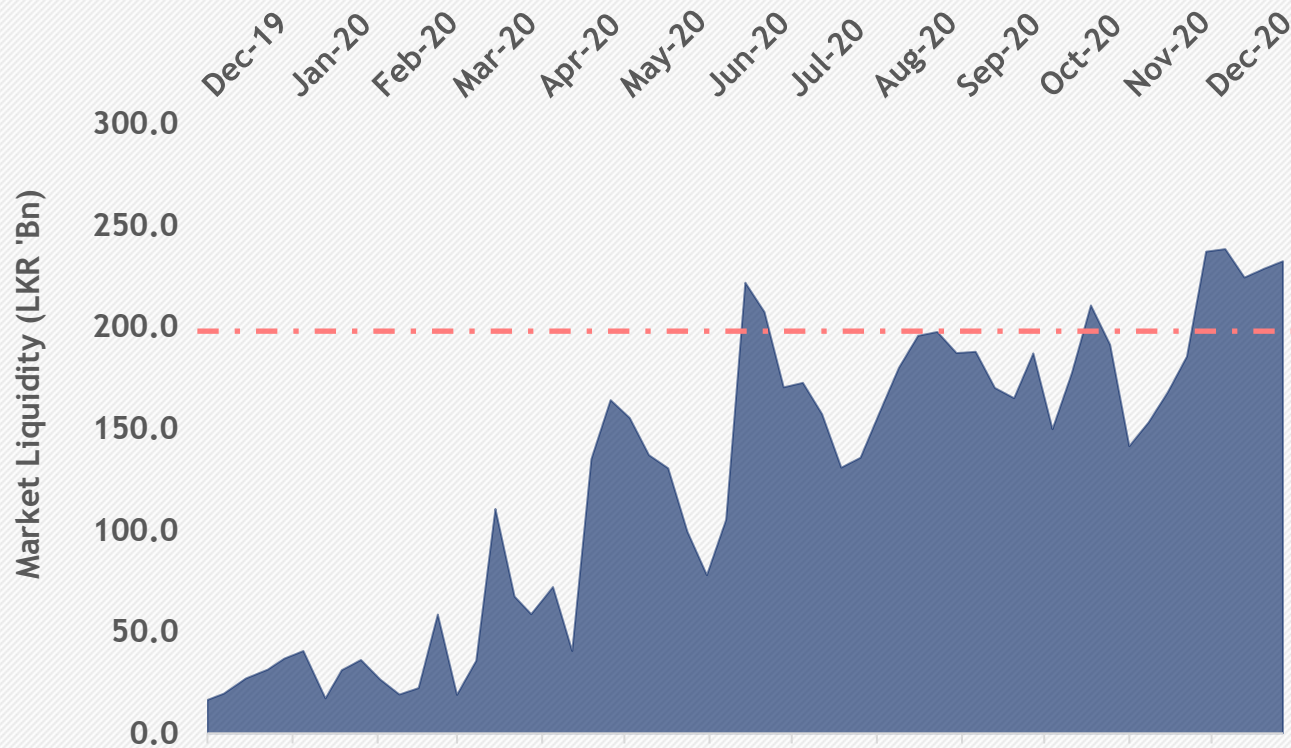
Source: First Capital Research, CBSL



First Capital Research

Jan 2021

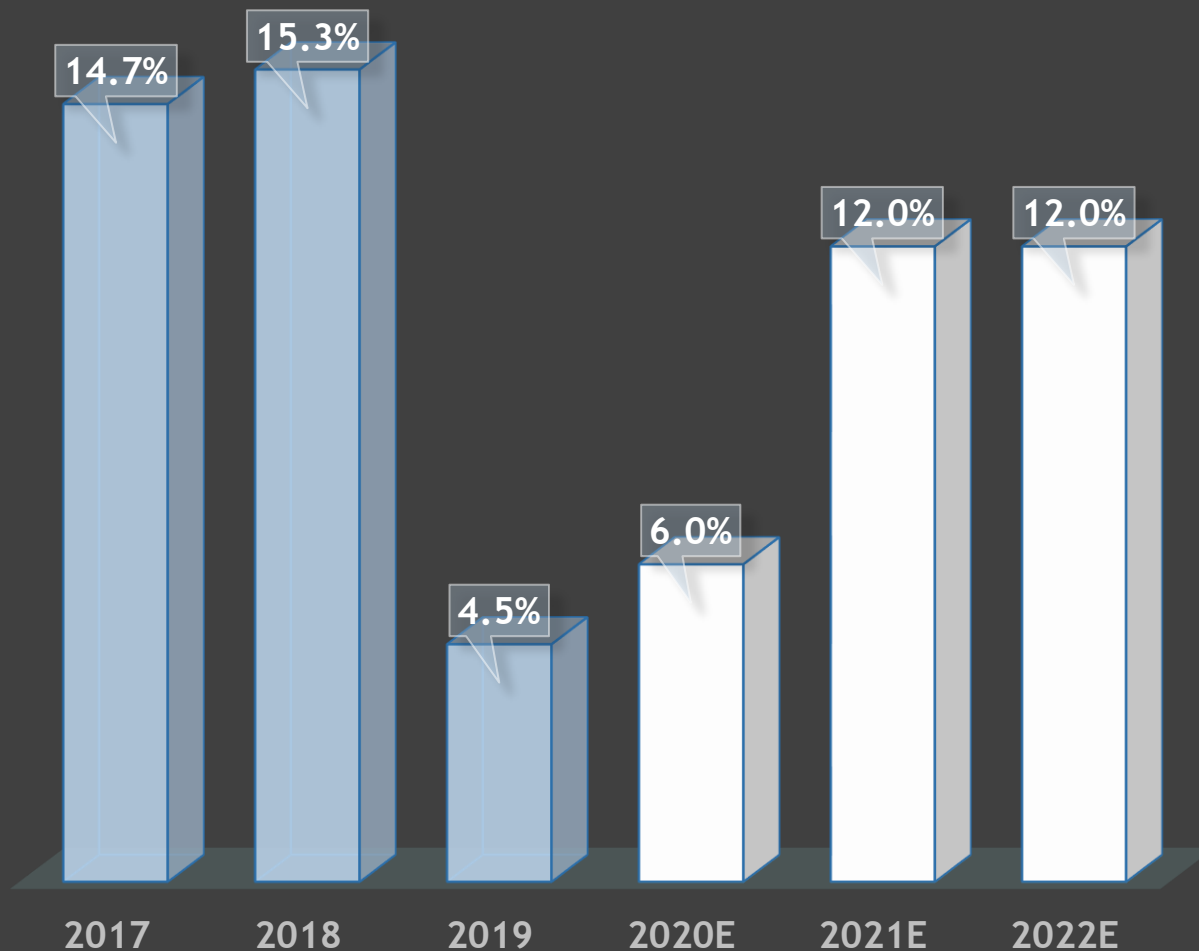
...pushing market liquidity to
above LKR 200Bn



First Capital Research

Source: First Capital Research, CBSL

Jan 2021



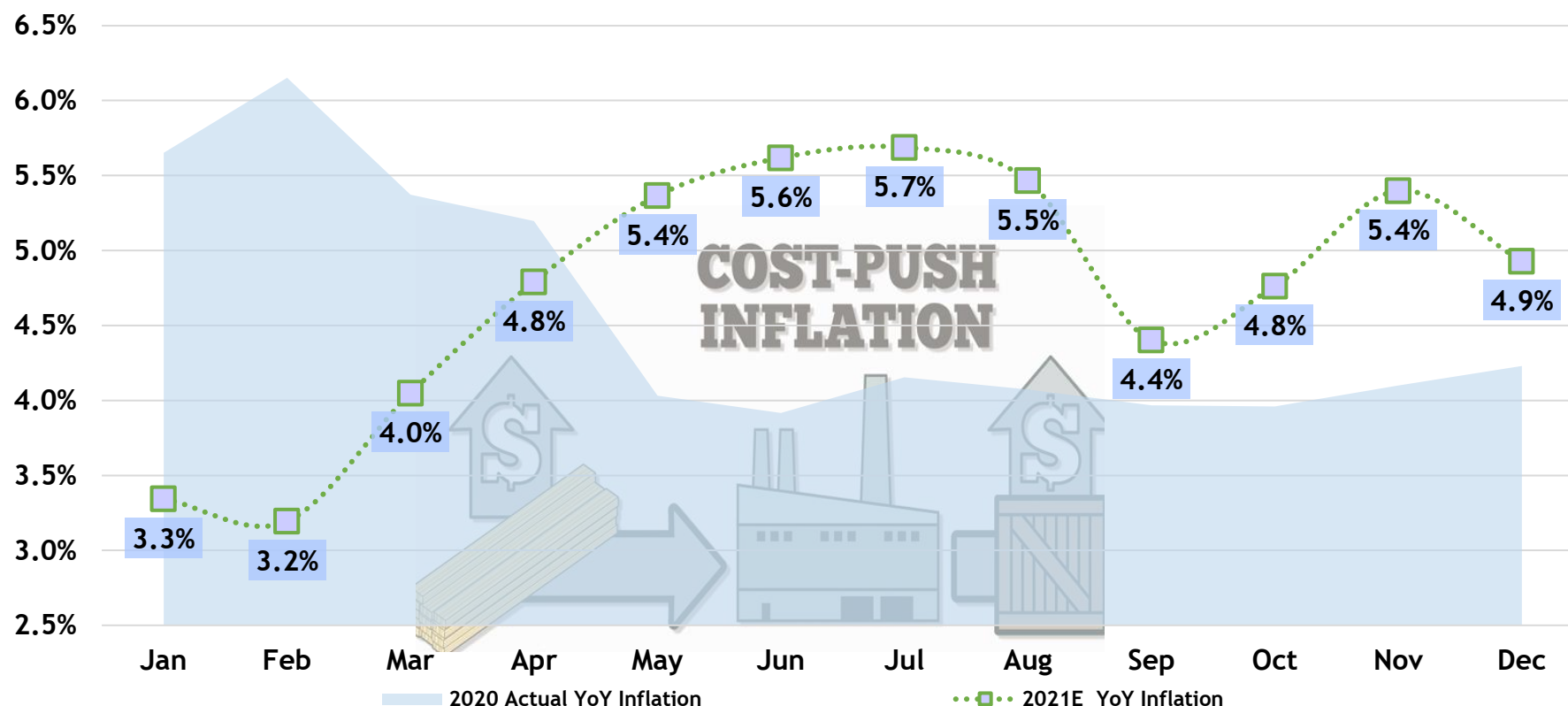
Source: CBSL

Decade low lending rates and rising consumer demand may accelerate private sector credit growth to c.12% in 2021E

Inflation though may trend upwards is likely to continue to remain under check

With the potential currency devaluation we may experience cost push inflation towards the middle of the year

28

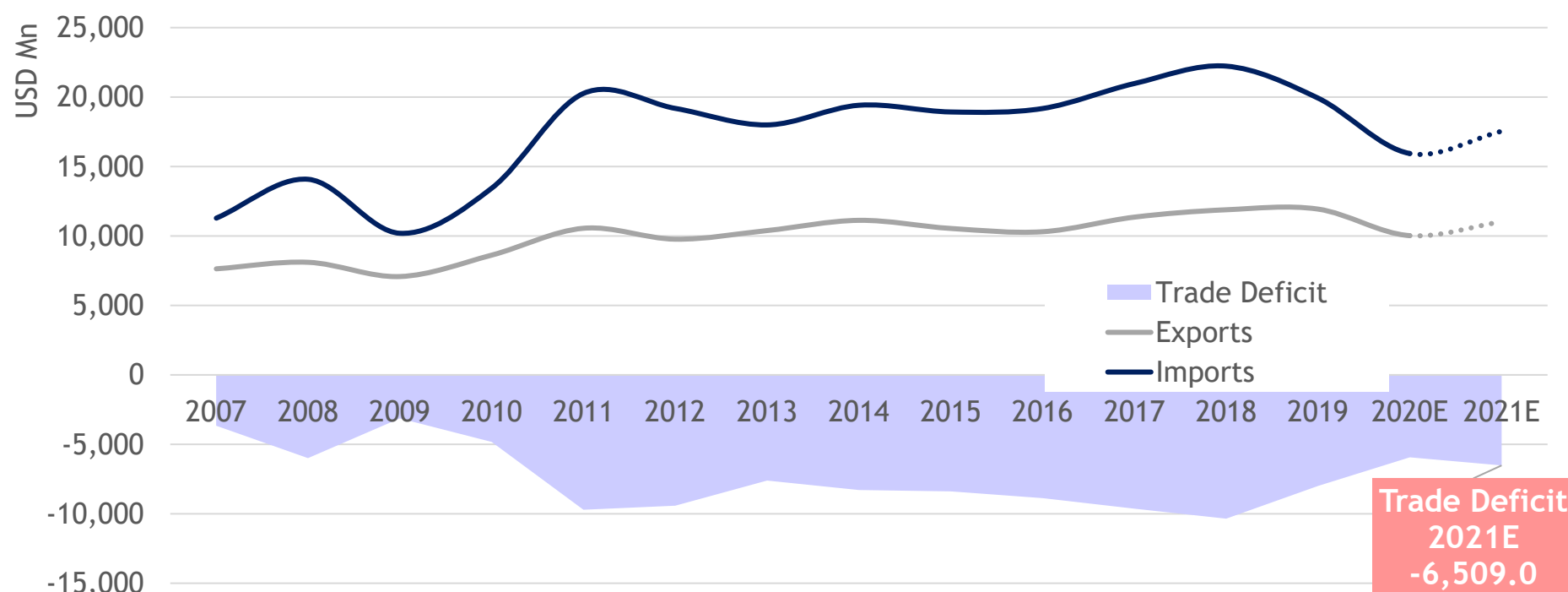


Source: First Capital Research, Dept. Census and Statistics

Trading activity may recover back in 2021E to at least 90% of 2019 level, provided the Govt allows a gradual relaxation of trade restrictions...

29

Trade deficit may climb to above USD 6.5Bn in 2021E

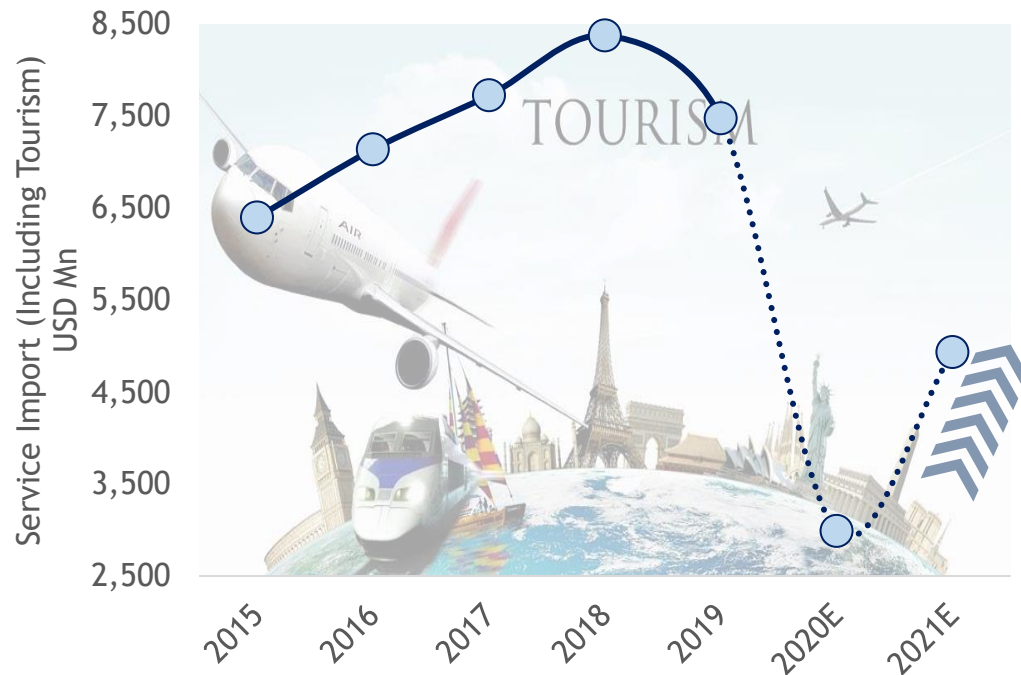


Source: First Capital Research, CBSL

...yet, recovery in Tourism Earnings may pull the current account balance to a surplus...

30

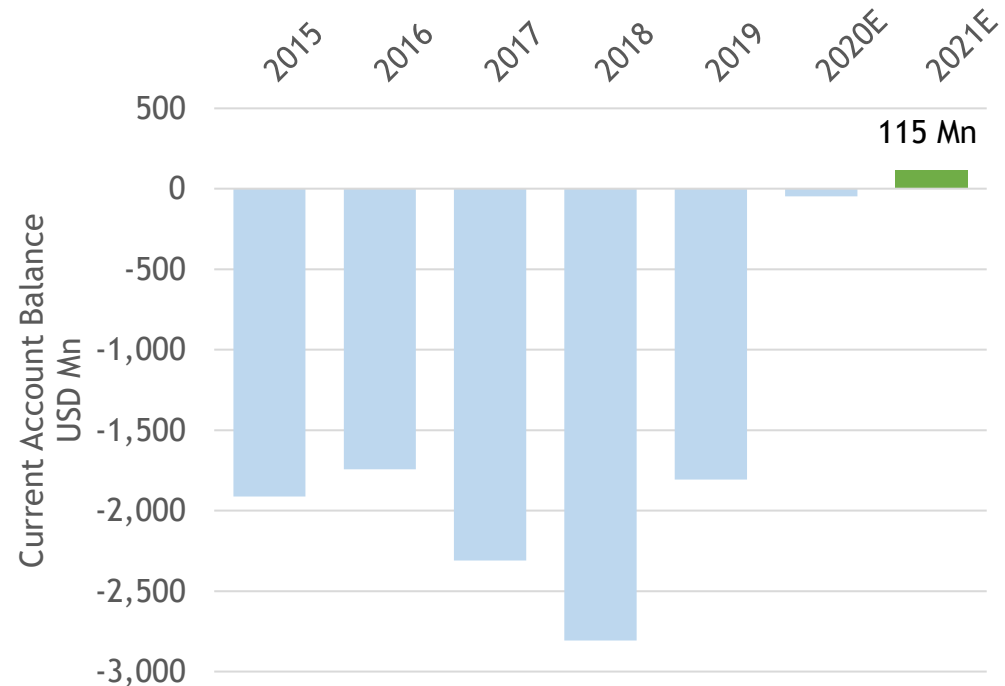
Back by Tourism Earnings, Services Exports to spike by 65%



Source: First Capital Research, CBSL

First Capital Research

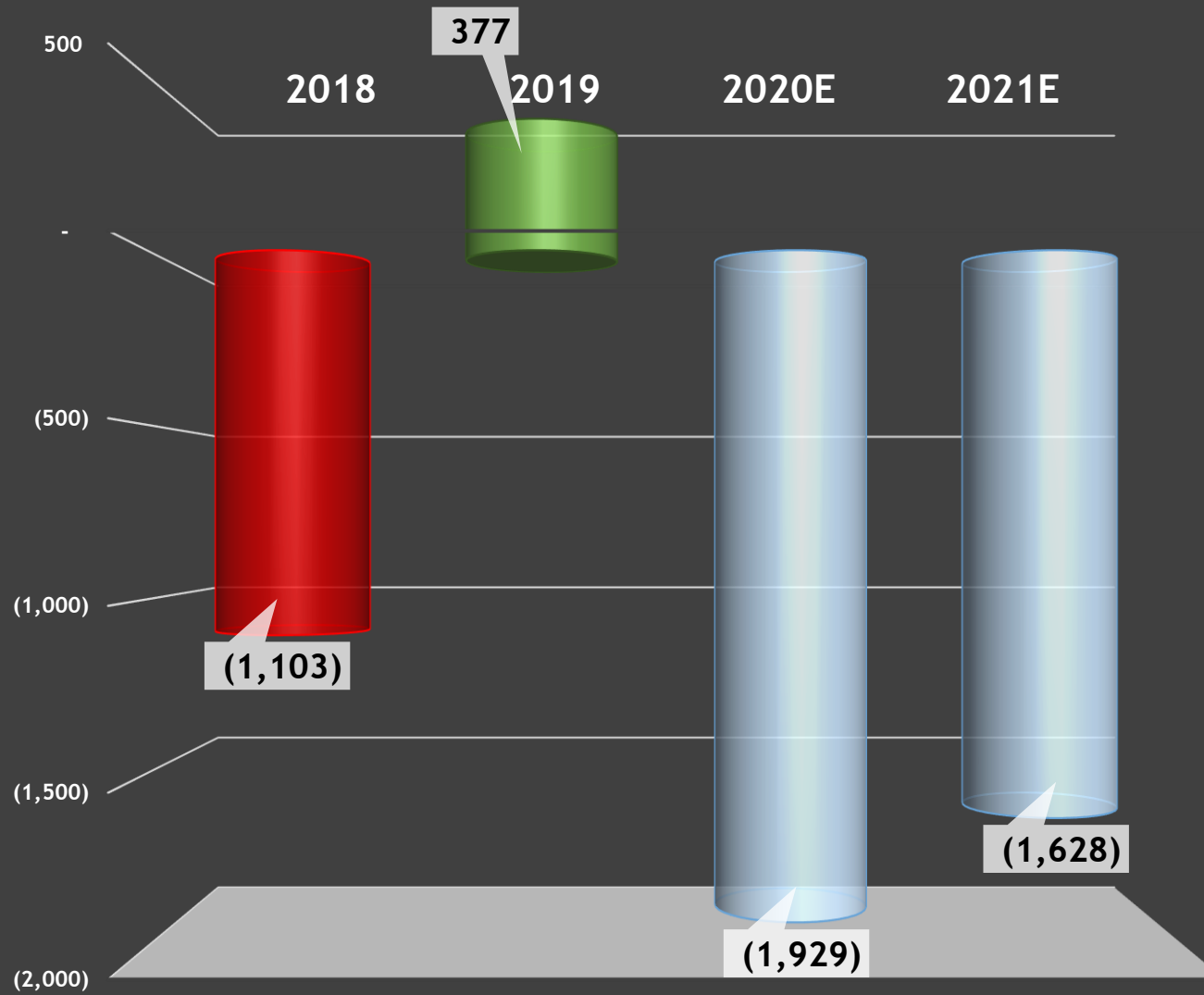
Current Account to record a surplus



Source: First Capital Research, CBSL

Jan 2021

Balance of Payments to reach a deficit of USD 1.6Bn

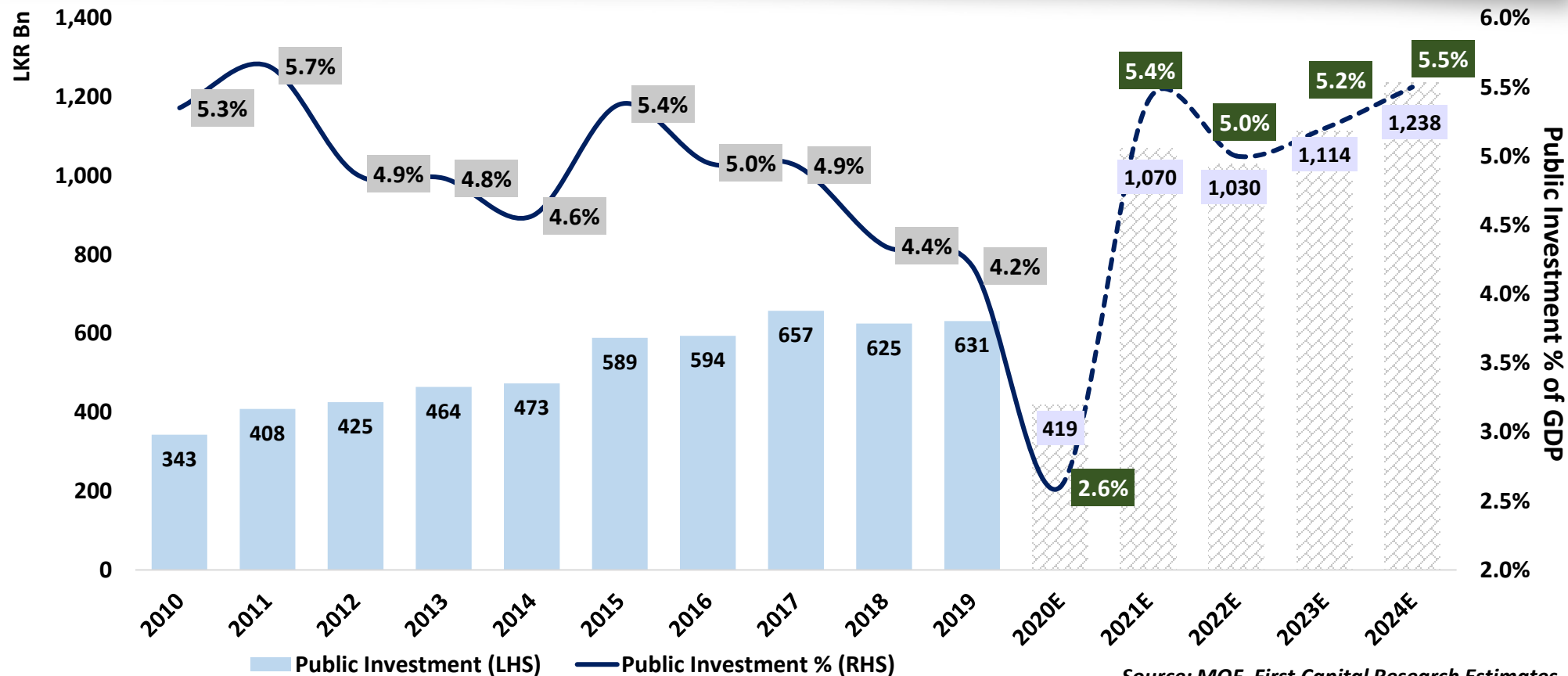


Source: First Capital Research

However, Balance of Payment may improve on short term funding but may continue in negative territory

A surge in capex with the resumption of Govt's infrastructure drive may curtail any expectations of a lower budget deficit...

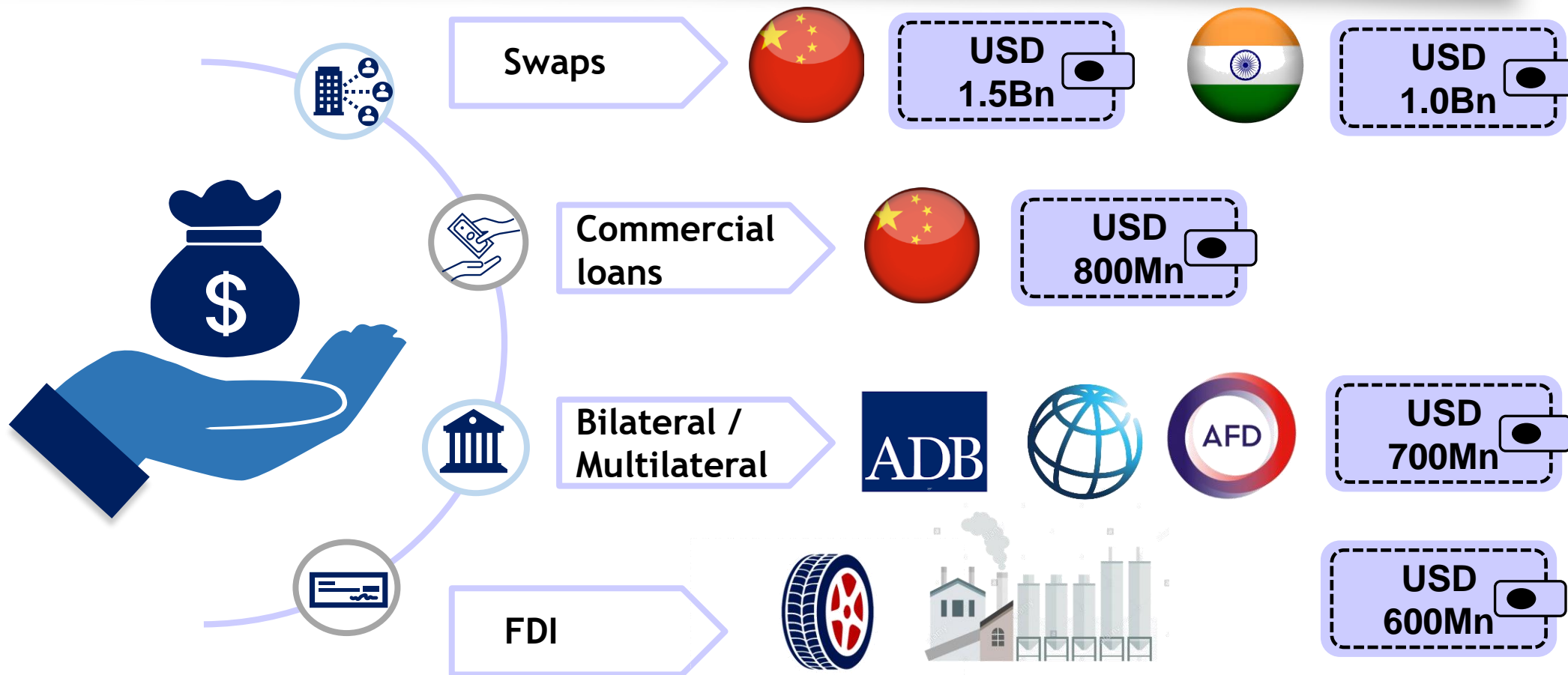
32



Source: MOF, First Capital Research Estimates

...while foreign currency borrowing options continue to be limited to short term funding...

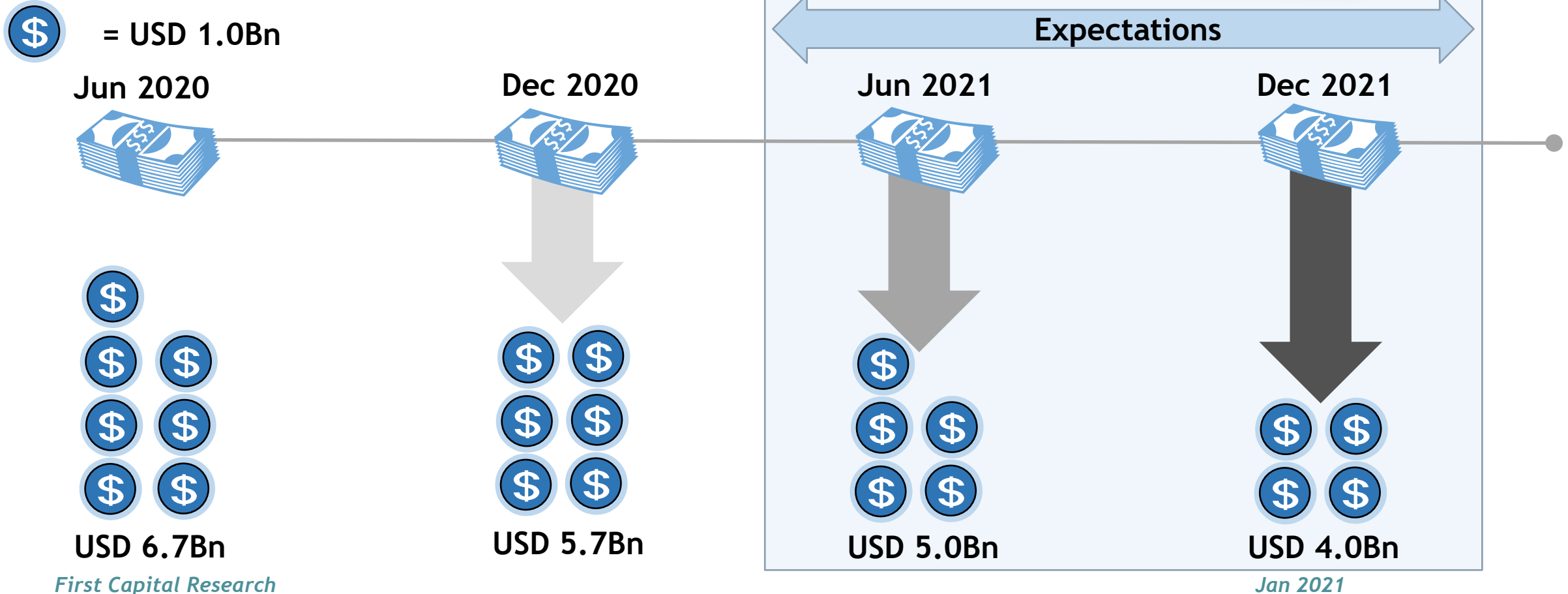
33



...risking foreign reserves to fall below comfortable levels

34

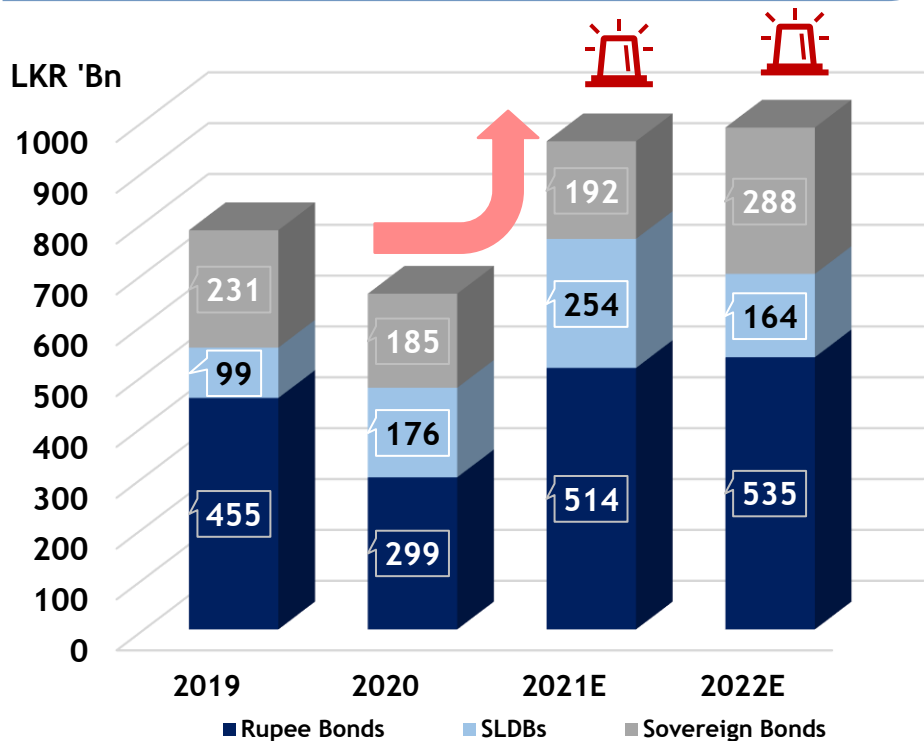
Source: CBSL, First Capital Research



Debt Repayment stands tall...

35

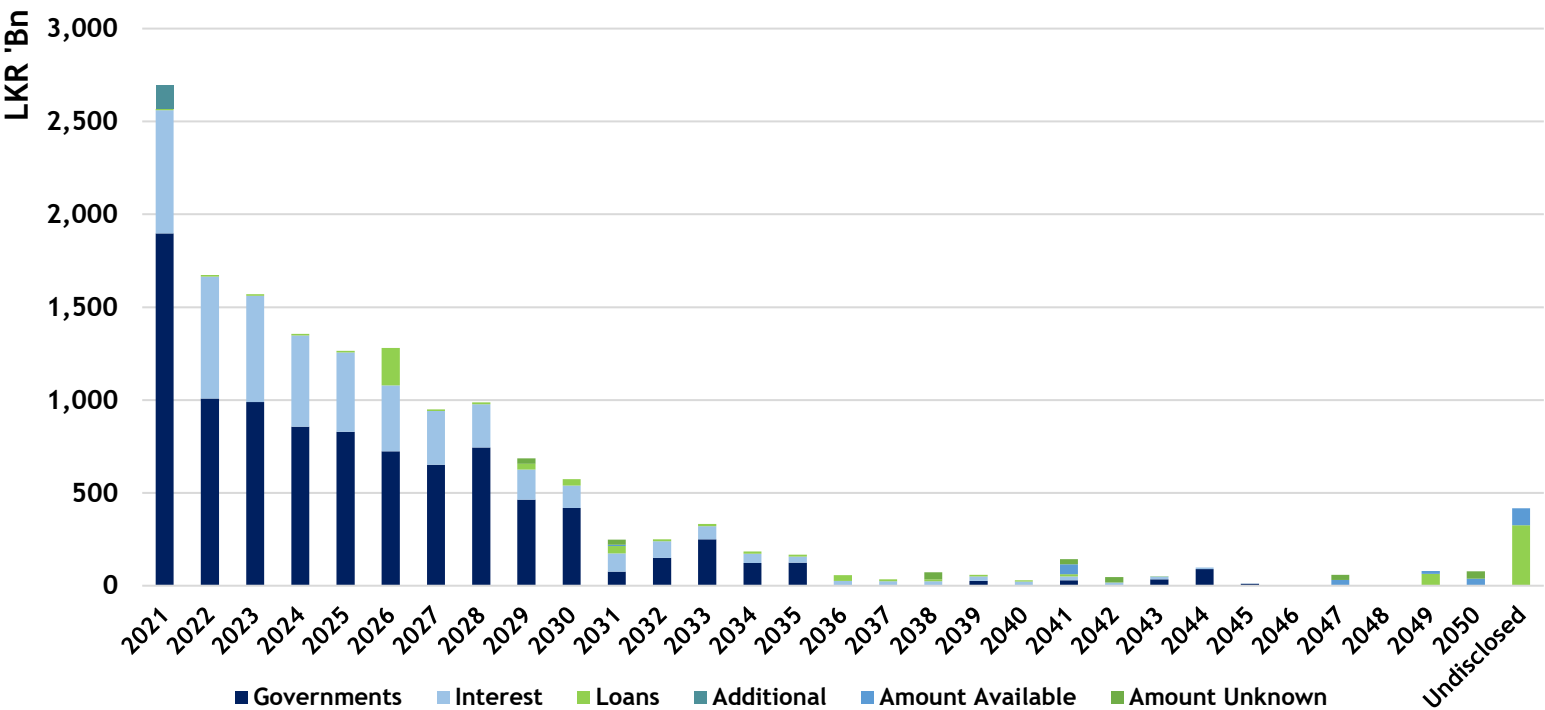
Total Rupee and USD Bond obligations spike in 2021E



Source: CBSL

First Capital Research

Total debt maturity for 2021 including Project Loans is c. LKR 2.7Tn of which c.41% is foreign currency debt



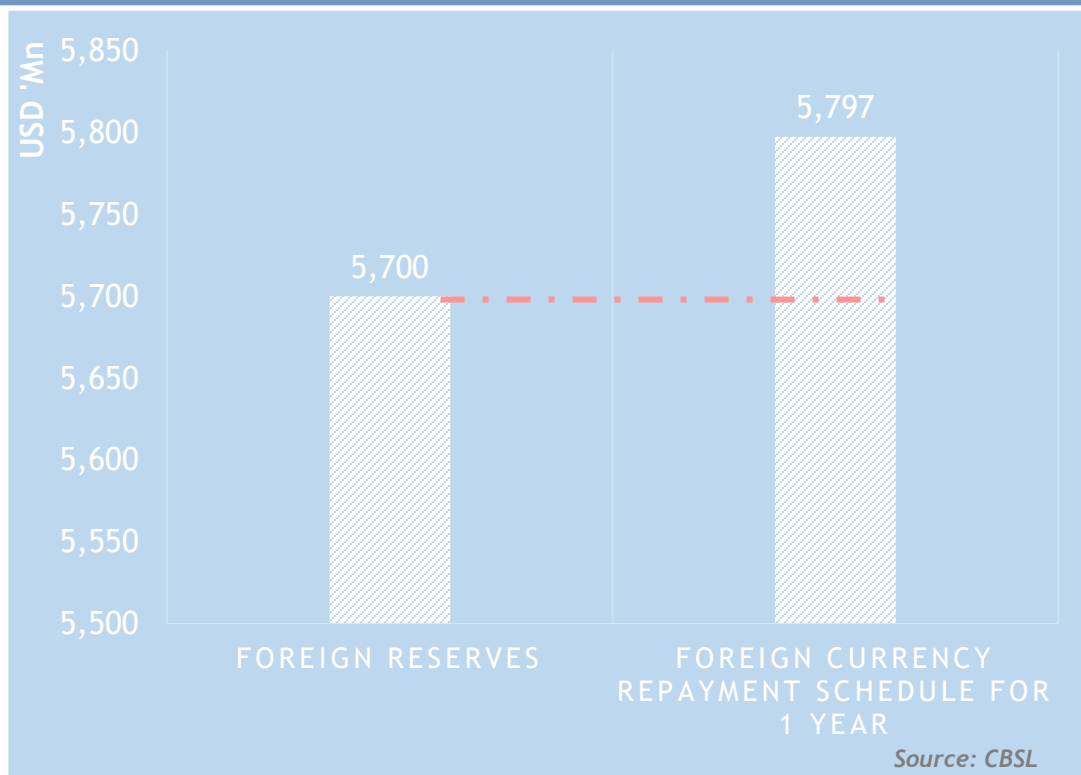
Source: Bloomberg

Jan 2021

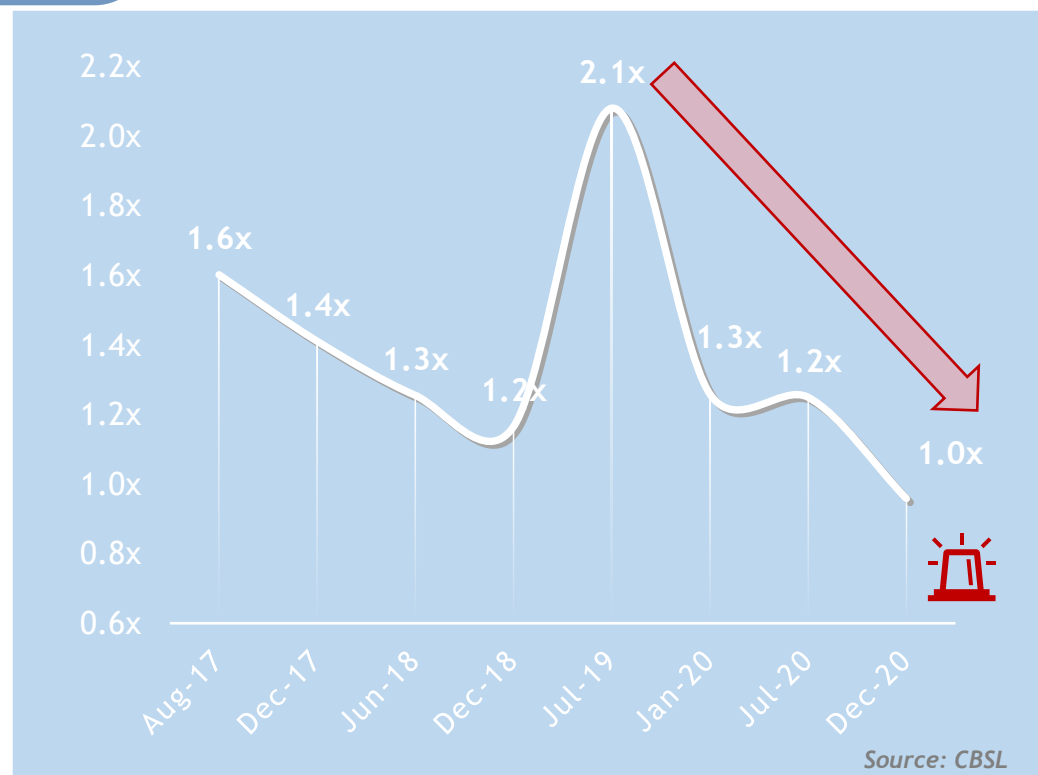
...with foreign currency reserves falling below the debt obligations for the first time in the recent past...

36

Foreign Currency Reserve Cover falls below 1.0x



First Capital Research

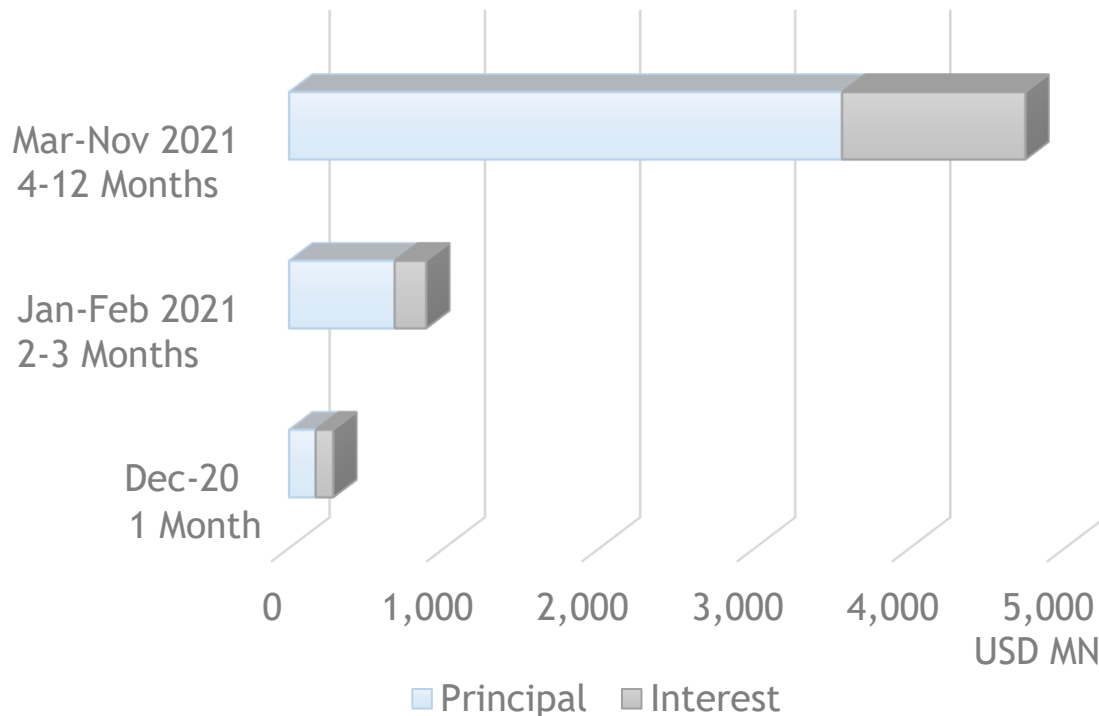


Jan 2021

...with foreign currency bond repayments spiking in 2Q & 3Q

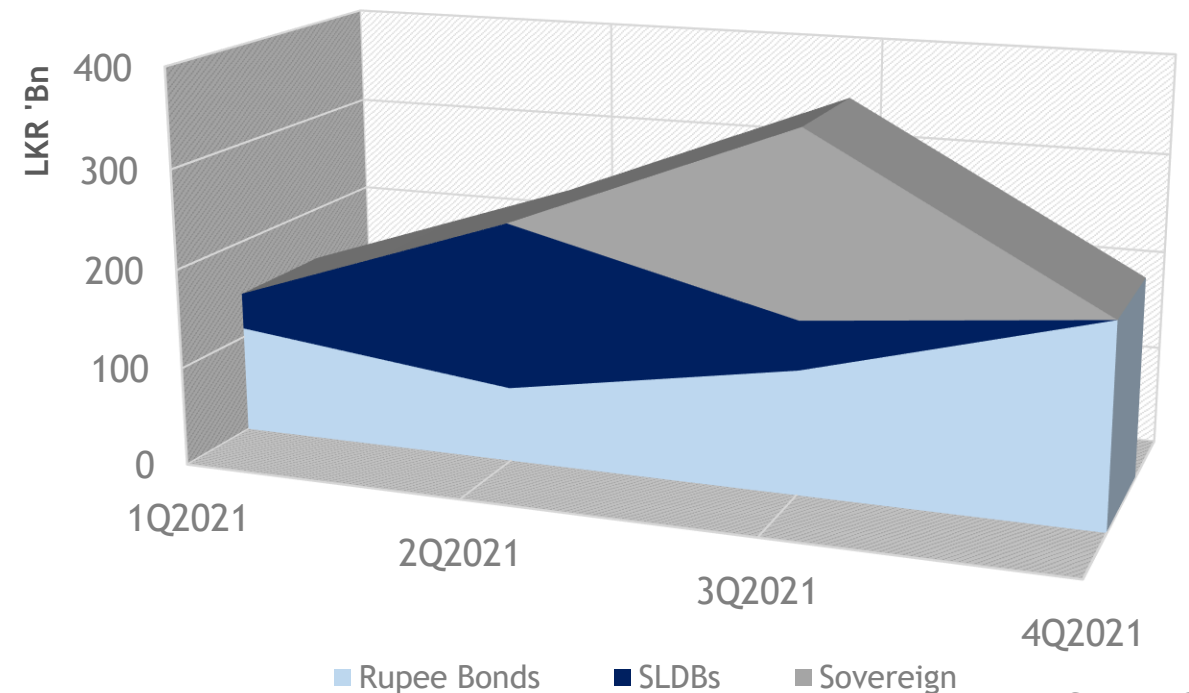
37

Foreign Currency Debt for next 12 months amounts to USD 5.7Bn



Source: CBSL

Rupee debt maturity spikes in 4Q while foreign debt maturity is high in 2Q & 3Q with an ISB maturity in Jul 2021

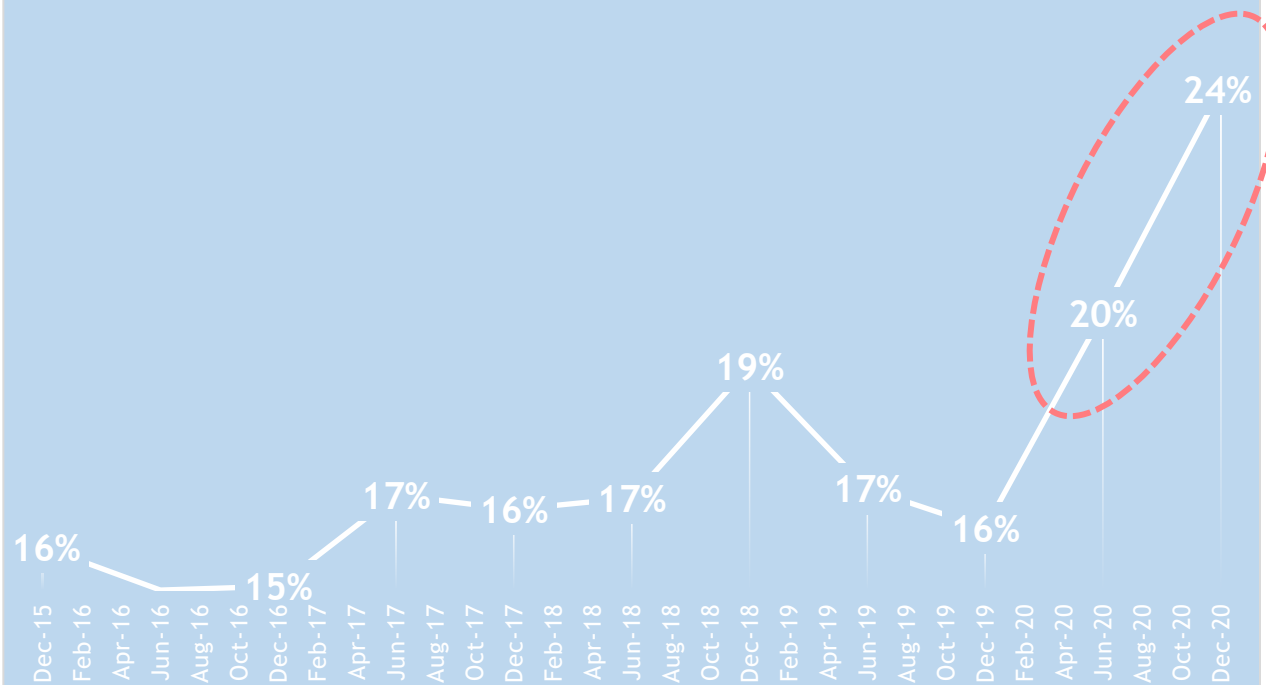


Source: CBSL

Shorter tenors continues its climb in the GS portfolio illustrating the risk

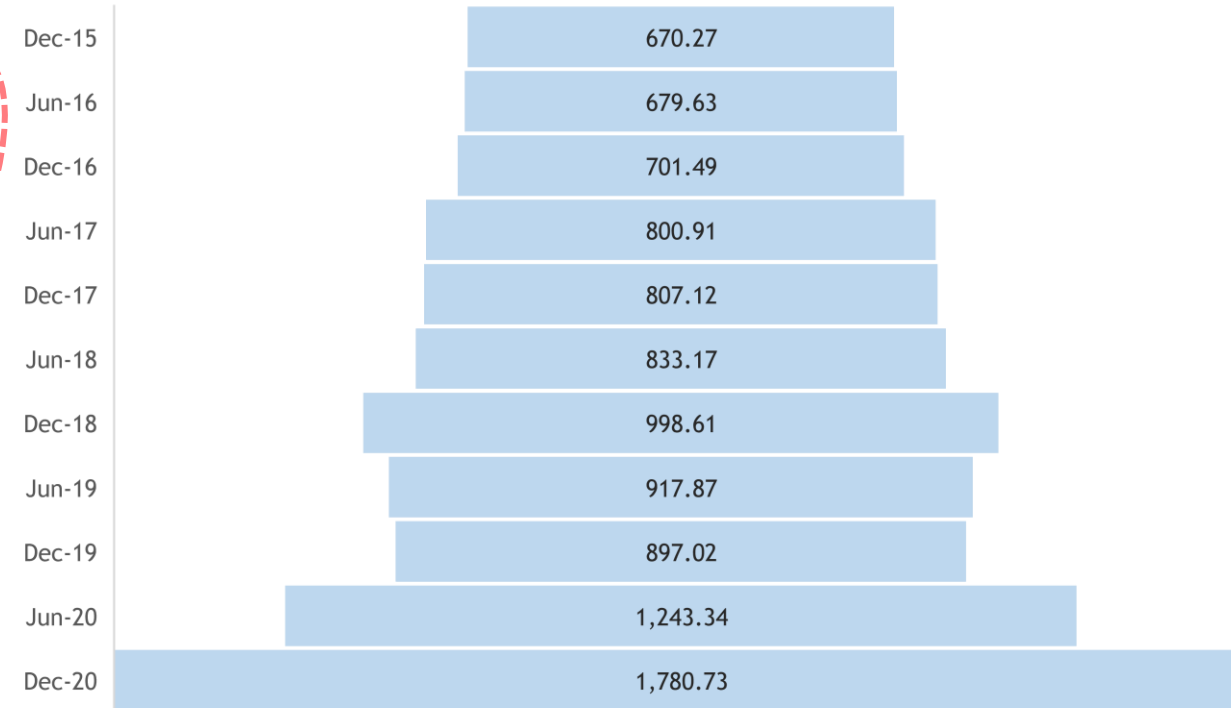
38

T-BILL SURGE PASSED 24% OUT OF THE GOVERNMENT SECURITIES PORTFOLIO



Source: First Capital Research, CBSL

TREASURY BILLS STOCK OUTSTANDING [LKR BN]



Source: First Capital Research, CBSL

Summary of the Economic Indicators for next 12 months

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Positives

- GDP on a slow, but gradual recovery process
- High liquidity
- Low lending rates
- Inflation rising but under control

Negatives

- High budget deficit may increase Govt borrowing requirement
- Rising Credit Growth
- Potential further surge in CBSL Holdings
- Steep LKR depreciation
- High Rupee and Dollar debt maturities
- Difficulty in raising foreign debt

Economic Outlook:
Moderate Risk



External Outlook remains weak: *Moderate Risk*

Section 5.0

Expected Downgrades materialize

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CCC

FitchRatings

Fitch downgrades SL Credit Rating to CCC

27 Nov 2020



CCC+
Stable

S&P Global
Ratings

S&P downgrades SL Credit Rating to CCC+

11 Dec 2020



Caa1
Stable

MOODY'S

Moody's downgrades SL Credit Rating to Caa1

28 Sep 2020



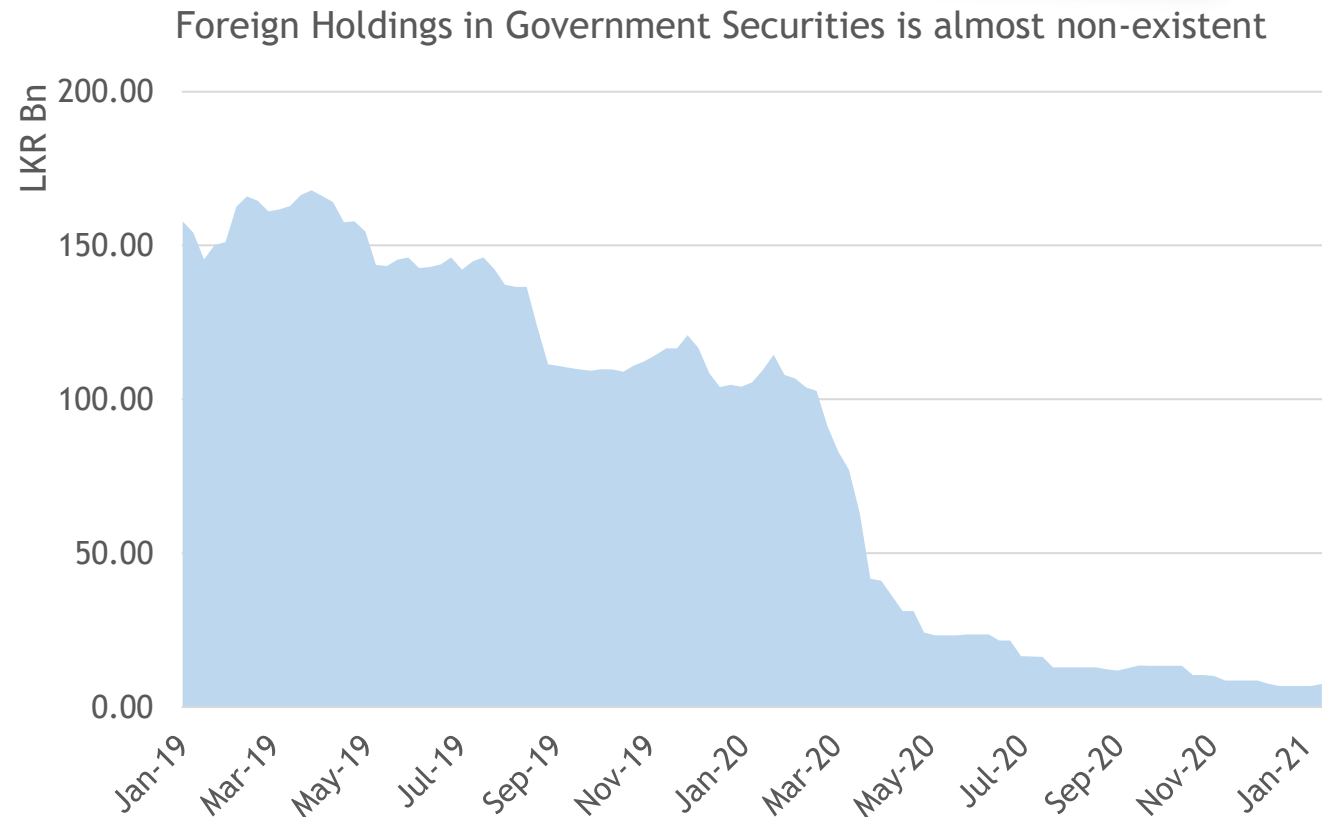
Global fund flows may continue in developed markets

Foreign outflow risk is minimized with historical low foreign holding

42

- Foreign flows into Sri Lanka as portfolio investments has virtually been non-existent for a long period amidst weak macro environment in Sri Lanka leading to multiple downgrades over the past 3-4 years. Foreign Holding in Government Securities has fallen to LKR c.7Bn. However, on a positive note it reduces the risk of further outflows from the system.
- Fund flow into Emerging Markets are unlikely to improve during 2021. With the global pandemic potentially easing off towards 2H2021, developed markets are likely to raise interest rates and / or reverse quantitative easing to prevent inflation in the system which may attract portfolio funds reducing attraction for more riskier assets.

External Outlook: *Moderate Risk*



Source: CBSL & First Capital Research

Priority Criteria Outlook

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Foreign Reserves

Declining to below comfortable levels

Risk Level: **High**



Foreign Activity

No activity, weak inflows, but potentially large outflows which could be rolled over

Risk Level: **Medium High**



Liquidity

Very High

Risk Level: **Low**



CBSL Holdings

Extremely High

Risk Level: **High**



Inflation

Cost push inflation may occur, but is likely to remain under control

Risk Level: **Medium Low**



Credit Growth

Remains moderate, may accelerate with consumer demand

Risk Level: **Medium**



Secondary Criteria Outlook

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Rating Outlook

All 3 rating agencies downgrade SL

Risk Level: High



External Environment

Rising consumer demand, lower appetite for SL sovereign debt and high repayments may significantly weaken Rupee

Risk Level: High



BOT & BOP

Trade deficit is expected to rise with trade activities normalizing and release of trade restrictions. Difficulty in raising long term foreign currency debt also increases risk

Risk Level: Medium High



Political Risk

With the 2/3 Majority in Parliament and Executive President from same party, political and policy stability remains high

Risk Level: Low



Investor Confidence

Business confidence is low, but is expected to rise with the recovery in business activity while the prevailing low interest rates and preference to local manufacturers has significantly boosted investor confidence

Risk Level: Medium Low

A background image showing a hand holding a screwdriver, with the hand and tool slightly out of focus. The image is overlaid with a semi-transparent blue rectangle.

Recommendations

Section 6.0



First Capital Research View on Bond Market 2021

Section 6.1

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View Maintained

Pressure on Bonds yields to rise from 1Q2021 onwards, but rise may be slower due to higher liquidity

47

Pressure on Bond yields are likely to mount, but the high level of liquidity in the system may slowdown the spike



Foreign Debt Repayments

Foreign debt repayments are high during 2021. Lower foreign reserve position may push local yields higher

High budget deficits

Lower revenue and higher infrastructure spending may lead to a continued higher budget deficit in 2021 resulting in strong rupee borrowing requirement

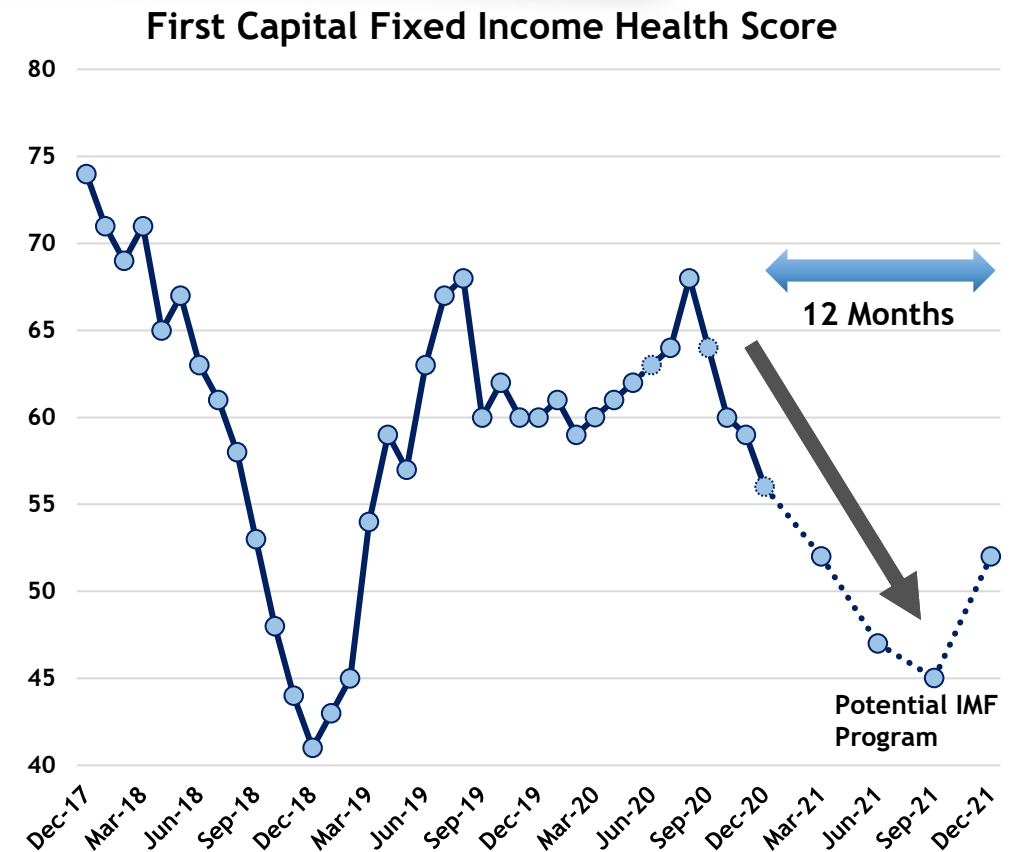
Rising Private Sector Credit Growth

Stronger private sector credit growth may push yields higher amidst Govt's focus to borrow from domestic market

Fixed Income Health Expectations may register a steep depreciation; A potential IMF program towards Jun 2021 cannot be ruled out

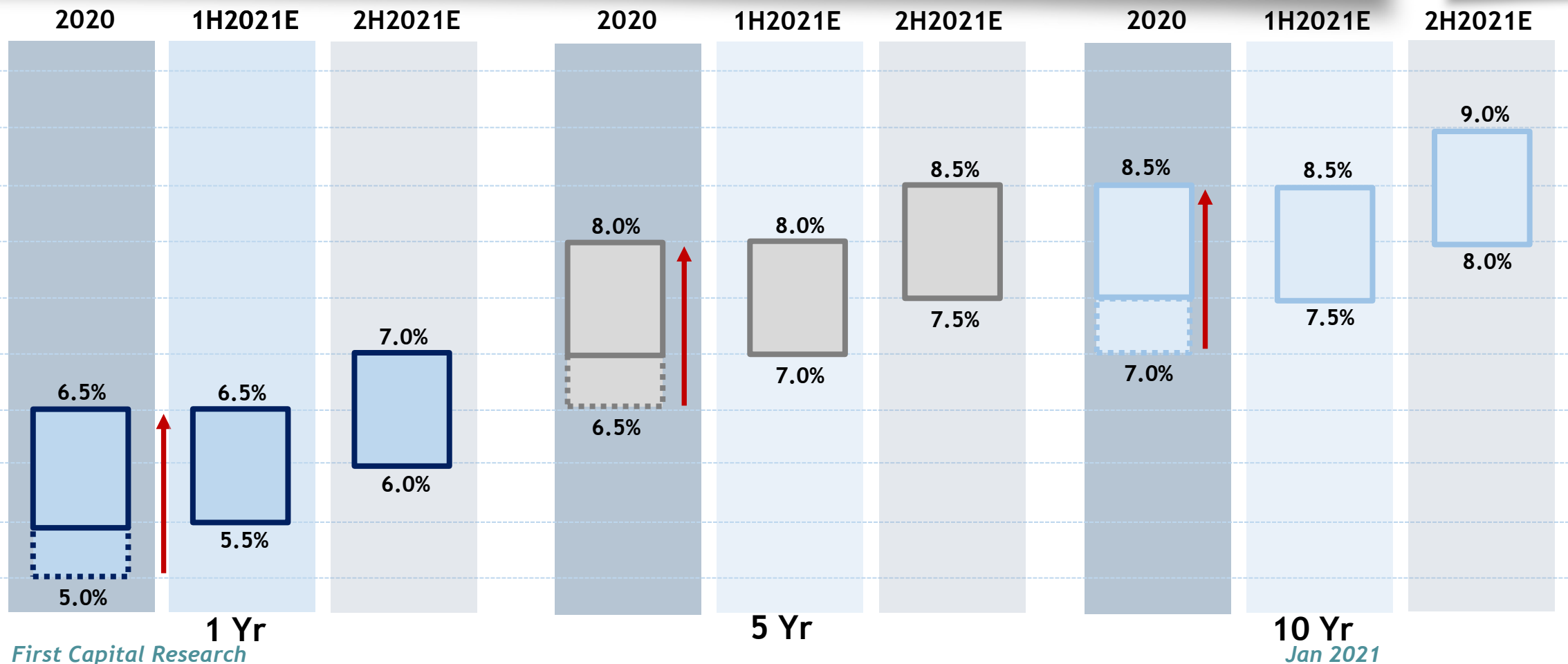
48

	3 Months Outlook Jan-Mar 2021	3-6 Months Outlook Apr-Jun 2021	6-9 Months Outlook Jul-Sep 2021	9-12 Months Outlook Oct-Dec 2021
Health Score Estimate	50-55	45-50	45-50	50-55
Risk Level - Jan 2021	Medium-High	High	High	Medium-High
Previous Expectations - Sep 2020	Medium-High	High		



Yield Curve may rise by 150-200bps and reach our upper bands of the yield curve

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Bond Yields to gradually trend up from 1Q2021 onwards followed by 2 policy rate hikes in 2H2021 (12 months)

50

Jan 2021 - Dec 2021	Probability	Impact
Bond yields are expected to be bearish from 1Q2021 onwards	85%	Bearish
Better than expected foreign inflows may allow bond rates to fall below our bands	15%	Stable / Bullish

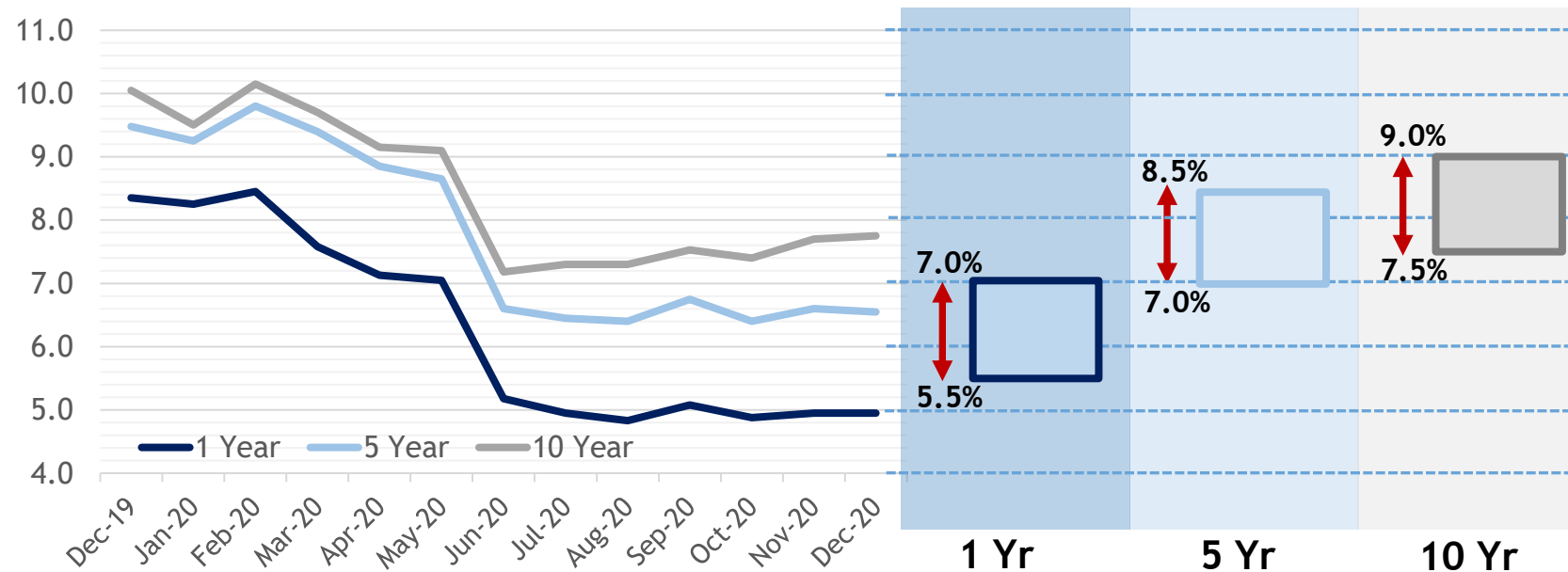
Expectations: **Bearish** 1Q2021 onwards

Policy Rate Expectations

On a base case First Capital Research expects a stable policy environment upto Jun 2021 followed by policy rates reverting upwards with potential 2 policy hikes in 3Q/4Q.

2021 Outlook - Base Case (85% Probability)

With the rise in Govt borrowing requirement, rising consumer demand and private credit, we expect a gradual increase in pressure on bond yields during 1Q2021 and afterwards gradually move up further during 2021



First Capital Research

Source: CBSL, First Capital Research

Jan 2021



First Capital Research View on Banking Rates 2021

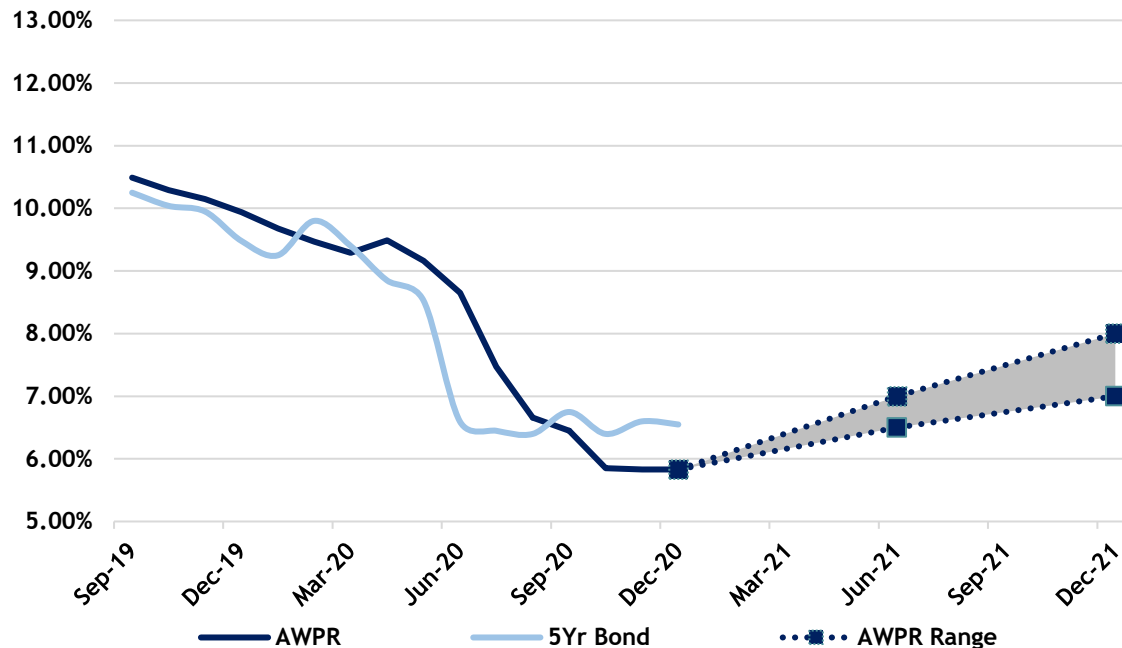
Section 6.2

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Banking Rates (AWPR) to gradually trend upwards and readjust above the 5Yr Bond yield

AWPR may gradually move up amidst competition for debt from Govt and Private Sector as Private credit picks up

Expectations for AWPR



Source: First Capital Research, CBSL

AWPR falls below 5Yr, but may adjust

- With the lack of credit, AWPR fell below the 5-Yr bond, breaking the historical trend of moving in line with the 5-Yr Bond. As private credit picks up AWPR may return to the historical trend.

2021 Outlook

We expect the AWPR to have bottomed out and is likely to rise amidst the rise in credit growth. With bond yields expected to move up, we expect AWPR to fall to a range of 6.5%-7.0% by Jun-2021 and further move towards 7.0%-8.0% by Dec-2021.



First Capital Research View on Exchange Rate 2021

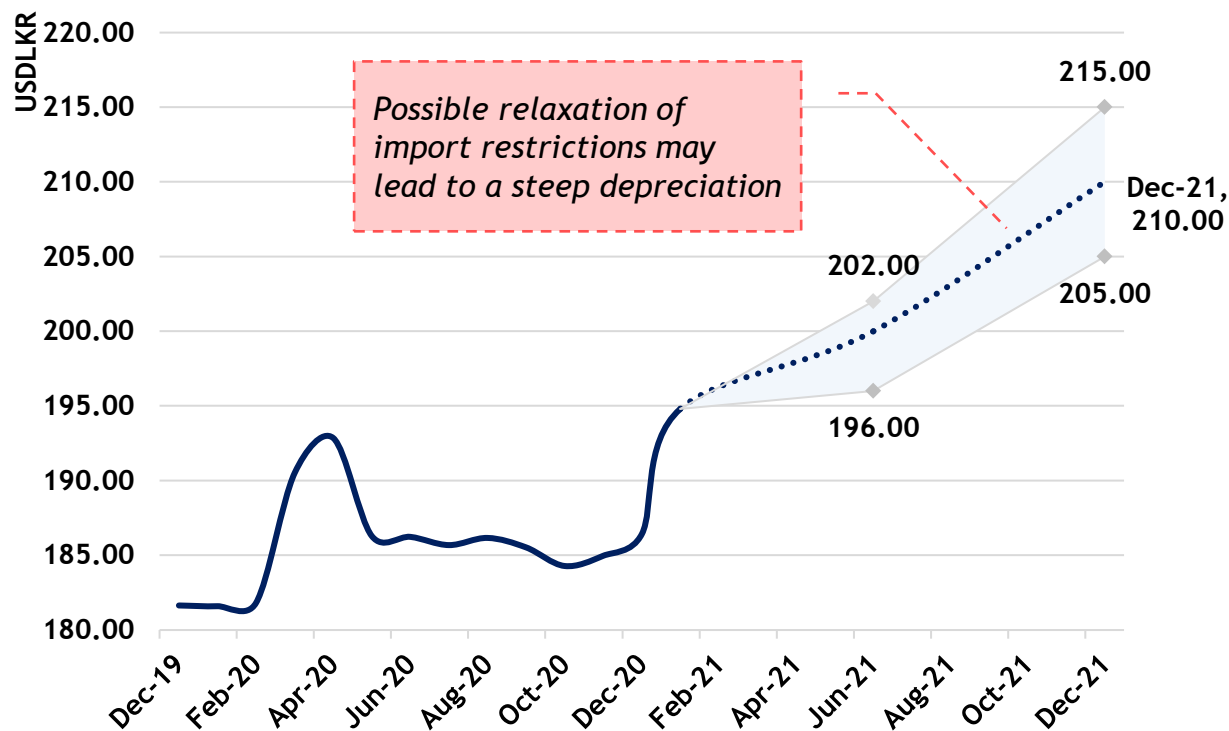
Section 6.3

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Exchange Rate target for 1H2021 narrowed down to LKR 196.0-202.0 with 2021 Year End target at LKR 205.0-215.0

54

Steep depreciation in 1H while a partial stabilization could be expected towards 4Q2021 possibly amidst higher local yields



First Capital Research

Source: CBSL, First Capital Research

JUN 2021E

DEC 2021E

LKR 202.0

LKR 196.0

LKR 215.0

LKR 205.0

2021 Outlook

With the weak foreign currency reserve position, high foreign currency debt repayment and possible spike in consumer demand triggering higher imports are likely to result in a steep depreciation in 2021. We expect LKR to depreciate approximately c.12.0% during the year.

Jan 2021 - Dec 2021	Probability	Impact
Currency expected to depreciate to the band	75%	Stable / Bearish
Import restrictions may hold the currency with lower depreciation	25%	Bullish



First Capital Research View on Equity Market 2021

Section 6.4

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Earnings Outlook Upgraded

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Earnings recover faster than anticipated

The earnings dip in the 1Q and 2Q was quite steep, but 3Q2020 has shot up amidst the strong recovery in Food and Beverage, Capital Goods, Transportation and Material sectors. Genuine recovery was witnessed in the F & B sector while selected companies in the Capital Goods and Transportation sectors had a major benefit with a spike in demand for their products and services due to Covid-19.



Potential rise in Consumer Demand

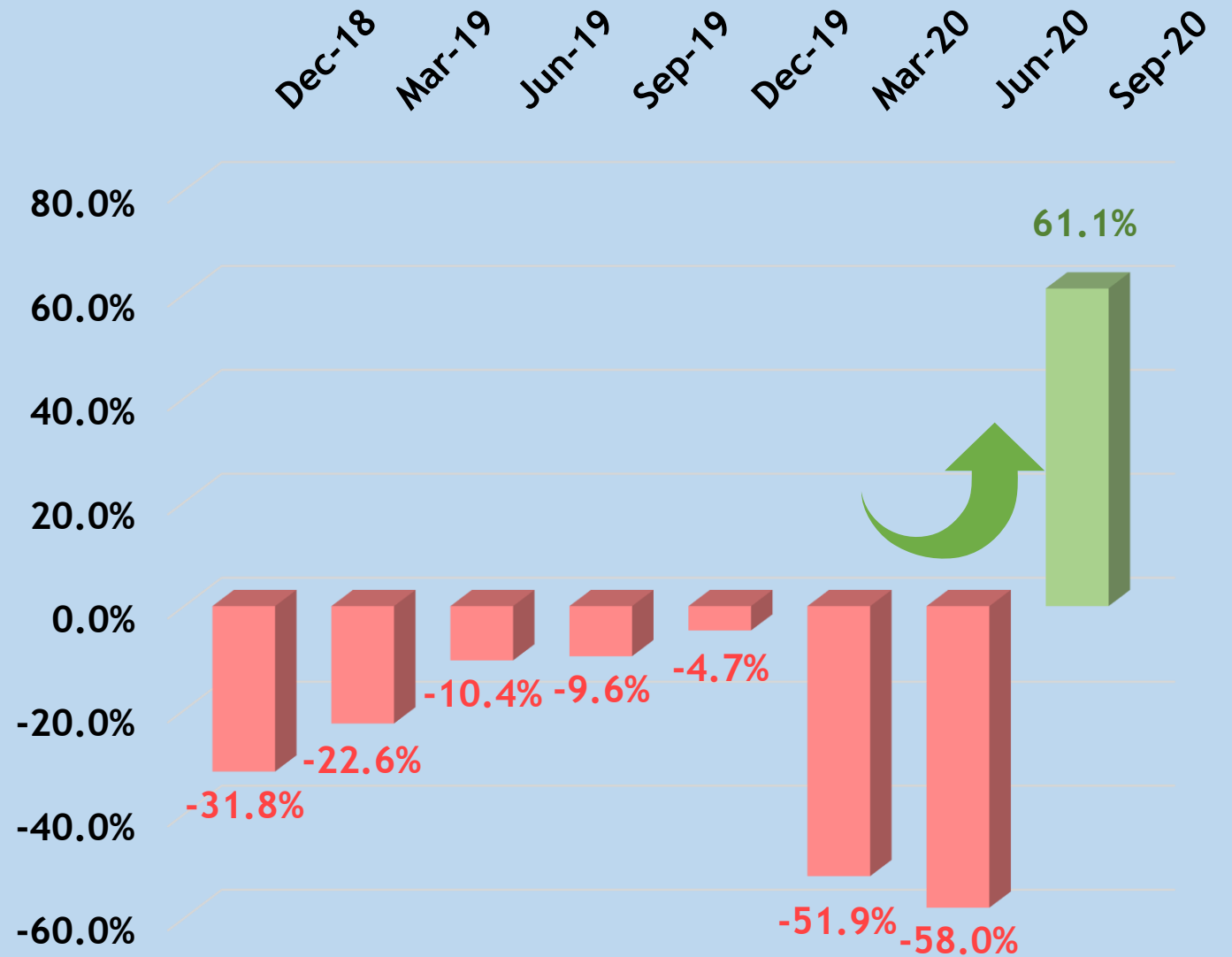
We are unlikely to witness any pressure on banking rates during 1H2021 as well, supported by the 6-month lag effect between Government Securities and bank interest rates. The extended period of lower interest rates would have a favourable impact towards consumers. We expect a rise in consumer demand during 1H2021 to positively influence earnings.



Earnings for 2020E upgraded to -16% and growth of +19% for 2021E

With the improved earnings outlook, we upgrade overall earnings expectations for 2020E improving to -16% on the back of stronger than expected outlook. Nevertheless, earnings growth expectations are maintained at +19% for 2021E. Despite growth for 2021E being similar with the upgrade of 2020E earnings, absolute earnings for 2021E improve closer towards 2019, indicating a strong recovery for companies.

With the
steep spike in
3Q2020
earnings...



Source: First Capital Research, CSE

...we revise our Market Earnings forecast upwards despite a partial lockdown in 4Q2020

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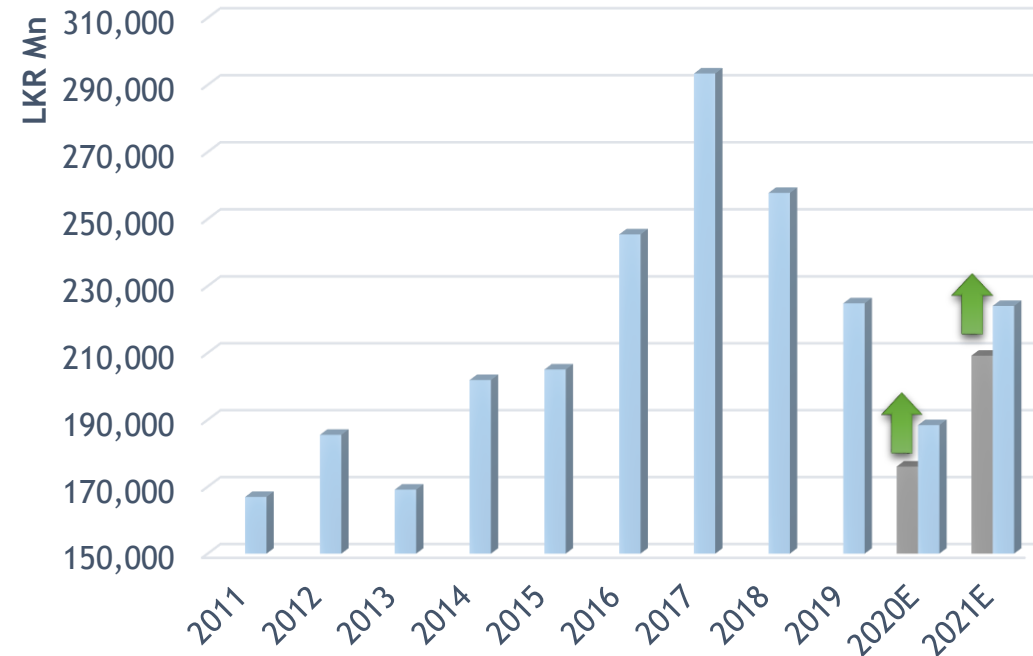
4Q2020 adjusted upwards...



Source: First Capital Research, CSE

First Capital Research

...pushing 2021E Market Earnings closer towards 2019



Source: First Capital Research, CSE

Jan 2021

Jan 2021 Expectation

Market returns likely to be stronger in 1H2021 with an ASPI target of 7,000-7,500 for 2021E

Market Return of 11% for 2021E with possible shocks towards 2H2021

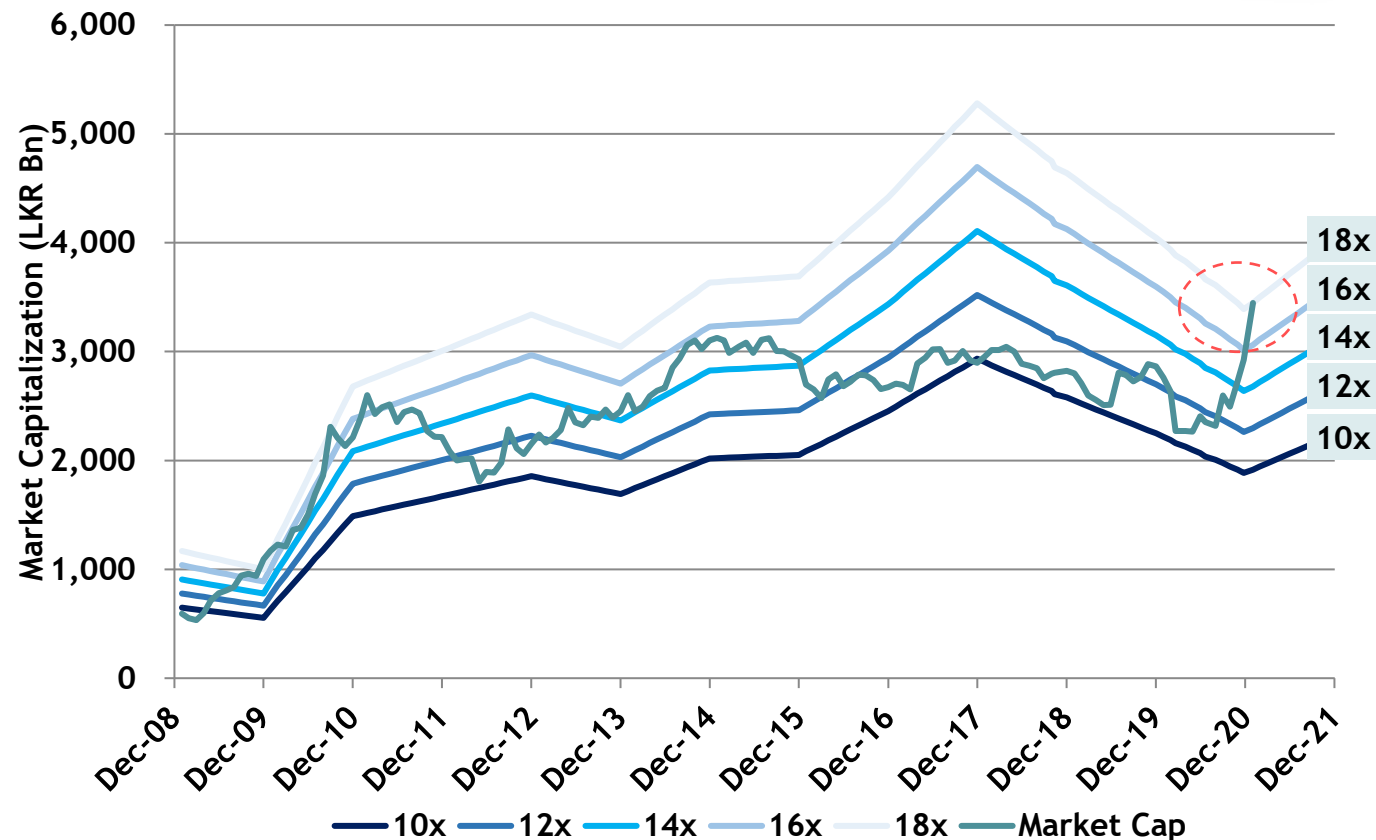
Despite the temporary lockdown in early Oct 2020, business activity is expected to continue its upward trajectory amidst the lower interest rates prevailing in the market. We expect credit growth to gradually improve activating consumer demand in the market. As indicated in Slide 10, we have upgraded our 2020E earnings amidst the stronger than expected recovery has automatically pushed our earnings expectations for 2021E as well. Supported by the strong earnings growth especially in 1H2021, we expect the ASPI to provide a market return of c.11% to reach a range of 7,000-7,500 indicating forward PER of 14.0x-14.5x 2021E earnings. However, a possible steep depreciation in the currency may dampen sentiment from 2Q2021 onwards. It is likely to have an adverse impact on banking rates towards 2H2021 with potential increase in banking rates by about 200bps during 2H2021.



Market Valuations stretched

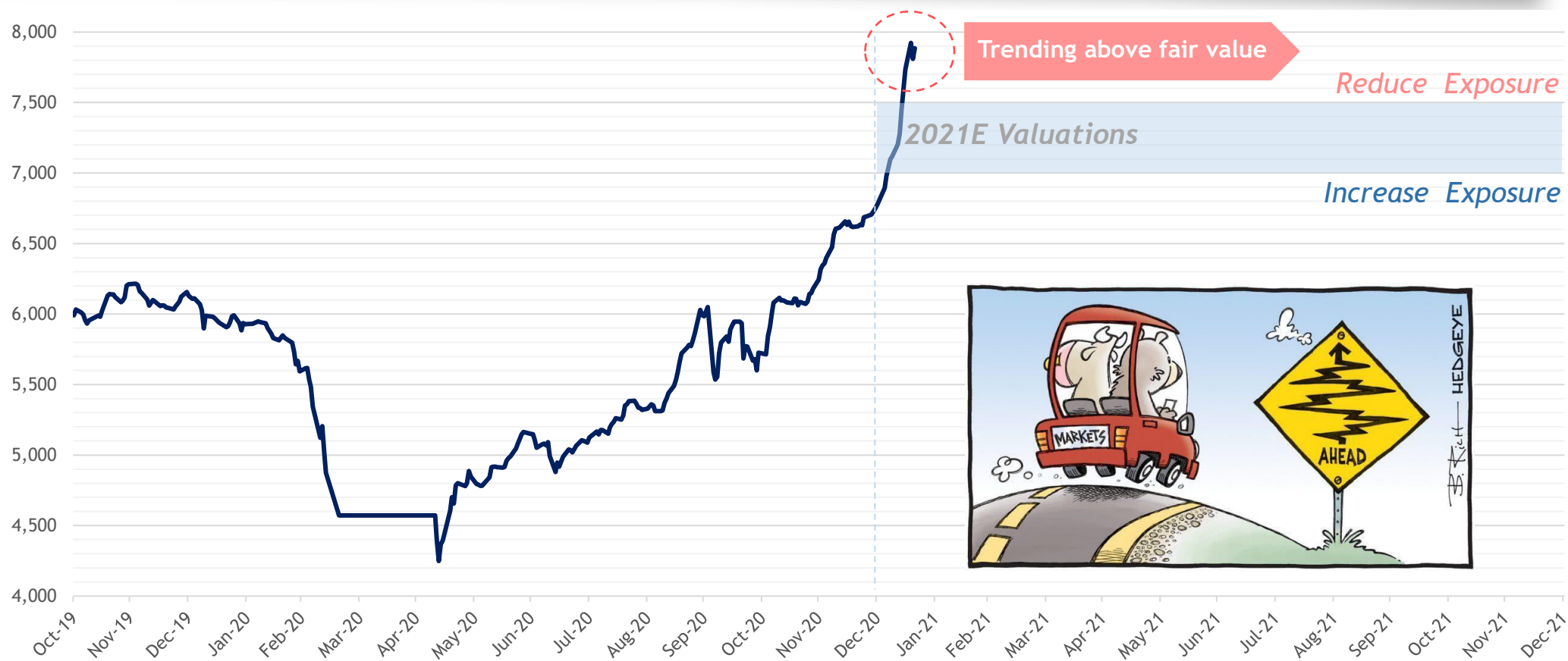
60

We believe market is attractive when the market trades below a forward PER of 14.0x-14.5x

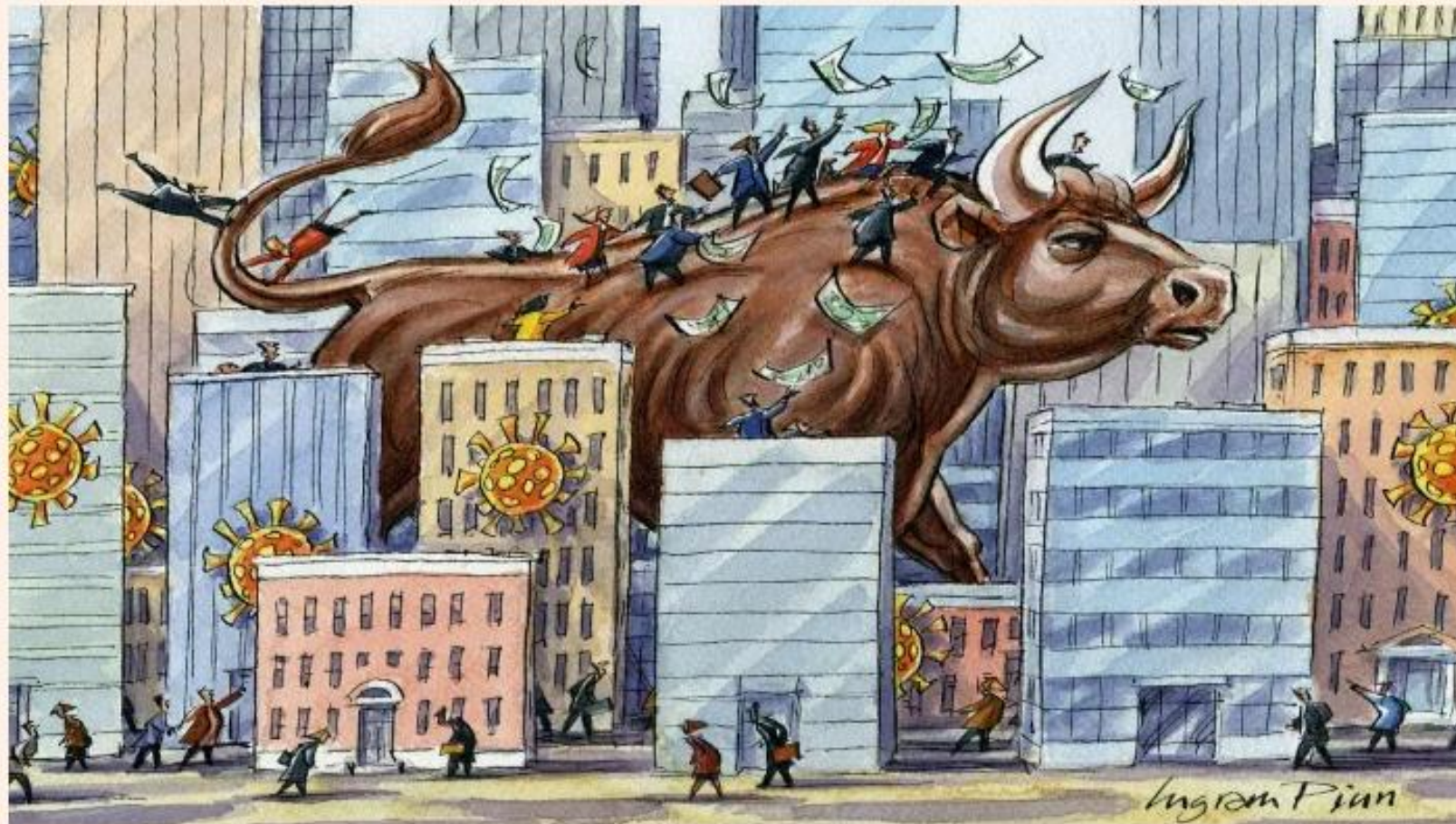


ASPI fair value for 2021E *maintained* at a range of **7,000-7,500** for 2021E

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Source: CSE, First Capital Research



Reduce Equity Exposure by '10%' to 90% (from 100%)

We recommended investors to increase equity exposure in their equity portfolios (equity allocated funds) to 100% in our Equity Strategy Reports released 12 months ago in Jan 2020. That was in a period where the ASPI was trading well below the expected fair value.

However, in the Bull Run the ASPI has surged well over our expected fair value justifying a gradual reduction in equity portfolio. Thereby, we raise our cash allocation in the equity portfolio to 10% from the previous 0%.

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**Cut Equity
Portfolio to
90%...**

**...Cash
allocation
increase to
10%**

Jan 2021

A background image of a hand holding a pen, overlaid with a semi-transparent blue rectangle. A thick dark blue vertical bar is on the left side of the rectangle.

Possible events preventing our 85% probability

Section 7.0

Possible extraordinary events that could completely reverse our expectations for 2021

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

- Re-emergence of another shock to the system similar to Covid-19
- Significant net foreign inflows of USD 2-3Bn is achieved above our estimates during 2021
- External sector significantly improves with rating outlook upgrade and Global fund flows trend towards Sri Lanka

“
The second leg of **W**
Bumpy road to Recovery ”

Disclaimer

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Thank You

“Successful Investment Is About Managing Risk...”