



First Capital  
A Janashakthi Group Company

# *EQUITY STRATEGY*

*“EARNINGS TO CRIPPLE AS FISCAL  
CONSOLIDATION SPOOKS”*

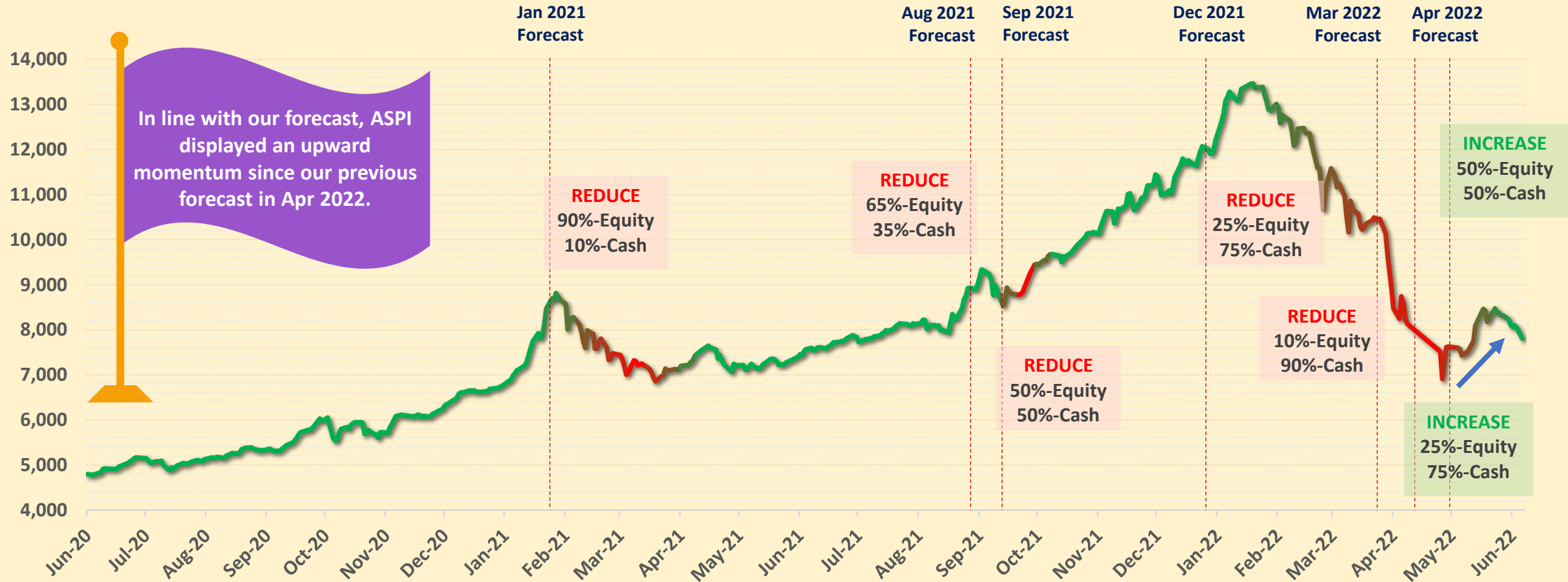
06<sup>th</sup> JUN 2022

**FIRST CAPITAL RESEARCH**

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Dimantha Mathew**

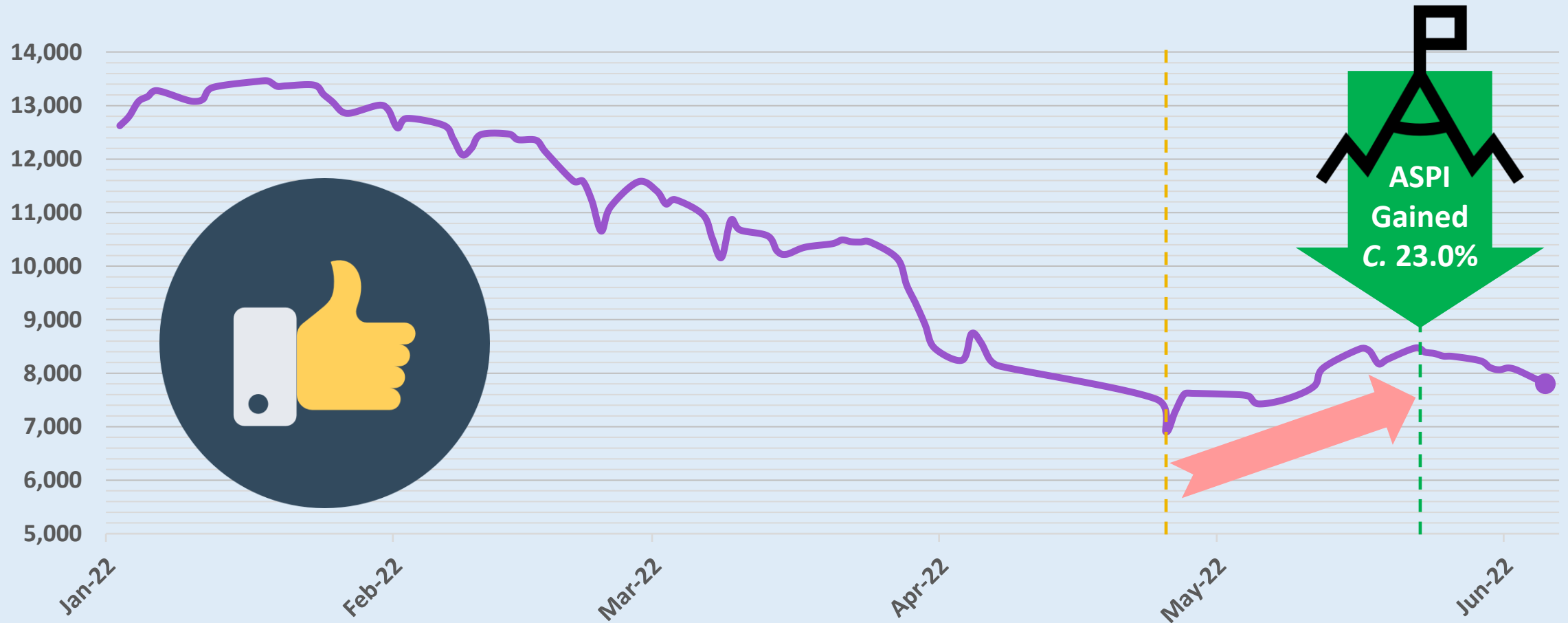
# RECAP: 26 APR 2022

Increase exposure to 50% from 25%; Cash 50%



Source: CSE, First Capital Research

Since our last report in Apr 2022 (updated), ASPI gained 23.0% at its peak on 23<sup>rd</sup> Mar 2021



Source: CSE, First Capital Research

However, with the ongoing  
crises and near-term fiscal  
consolidation,

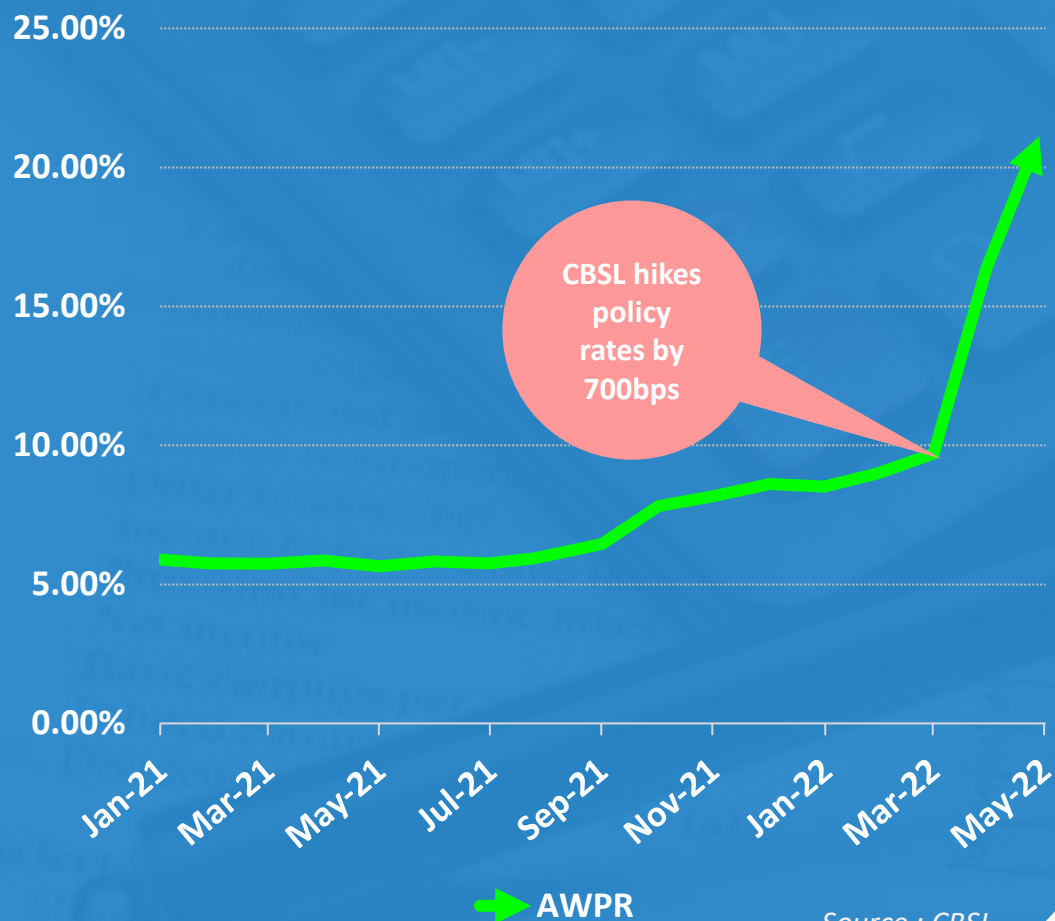
Investors  
need to  
brace for  
major shocks  
ahead...





# Ballooning Finance Cost

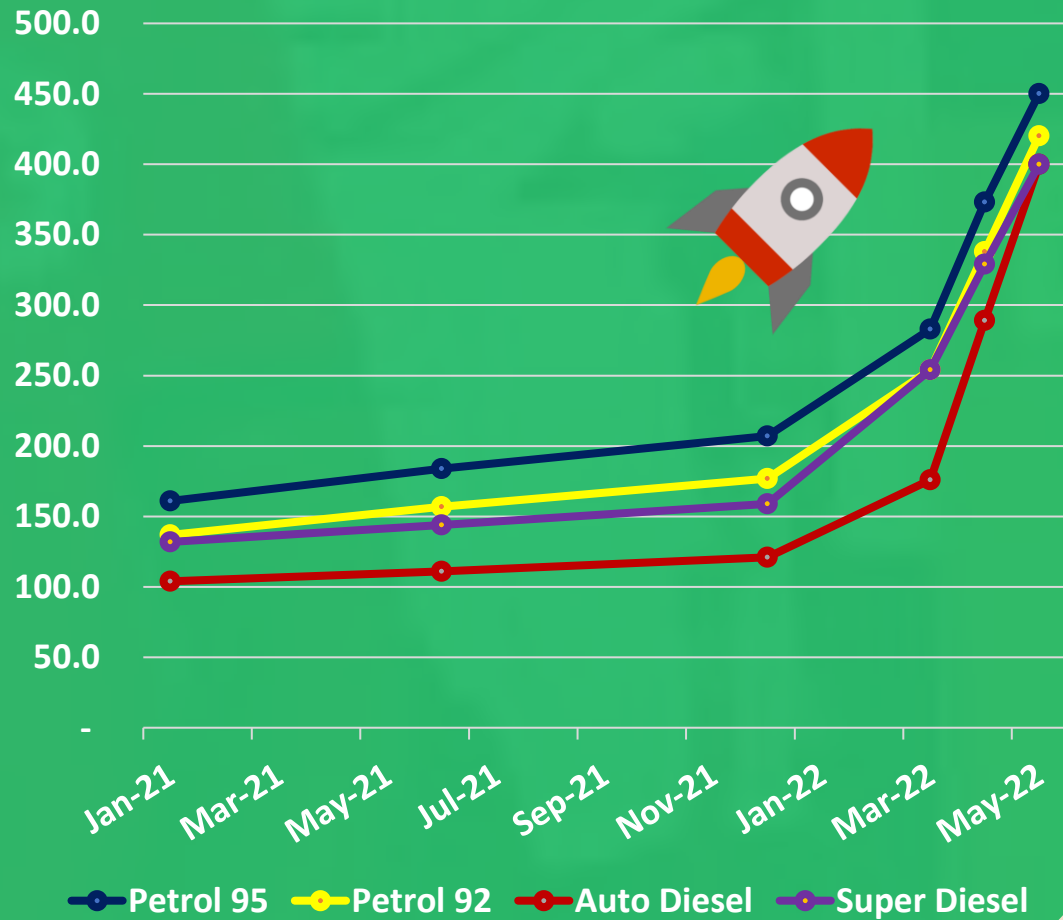
## Movement in AWPR



Source : CBSL

- Market **interest rates** witnessed an **upward trajectory** since the latter part of 2021.
- **End of the monetary easing era** that prevailed for a prolonged period during the pandemic which allowed corporates and individuals to bask in the lower cost of financing.
- **Back-to-back policy rate hikes by CBSL** which accounted for a total of 850bps hike in 2022 caused lending rates to immediately reprice.
- **AWPR nearly quadrupled** to 21.1% (as of end May 2022) from its levels prevailed in Jan 2021 hitting our expectations ahead of time.
- Severe impact on corporate earnings by **elevating the value of the finance cost** by approximately the same magnitude.
- The effect of this **shock is expected to reflect in the financials of the current and upcoming quarters.**
- We anticipate **interest rates to stay on the high side** and hover around 18.0% - 22.0% by end of 2022.

## Movement in Fuel Prices



Source : ceypetco.gov.lk



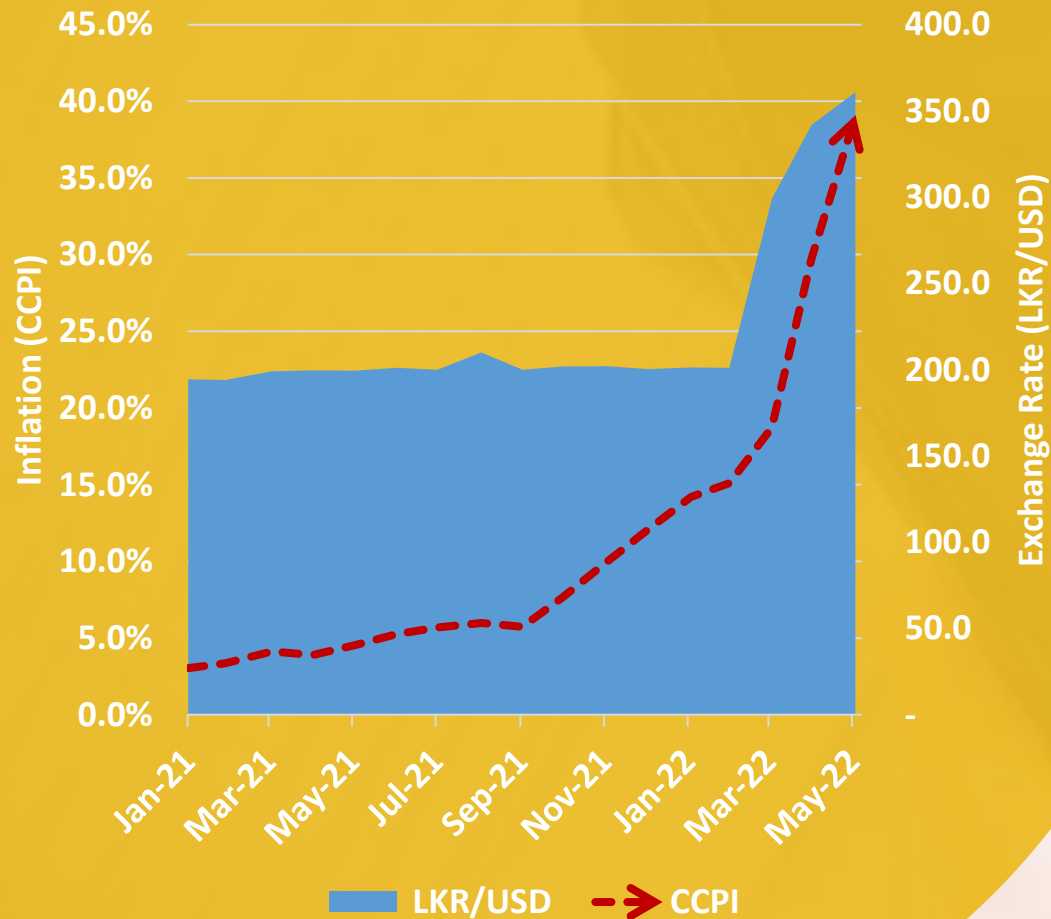
## Uprising Energy Cost

- Sri Lanka is facing its **worst economic crisis in the history** with uprising fuel and energy prices.
- **Global commodity prices are on a rising trend** as supply shortages intensified by the war in Ukraine and pandemic disruptions that **continued to wreak havoc on supply chains**.
- This has urged inevitable price revisions in the local market as well. Thus, authorities have **revised the prices of petrol and diesel upward for the 5<sup>th</sup> time since Jan 2021** adding to a cumulative price increase of 185%-285% across main supply categories.
- Increase in fuel cost impacts every aspect of the businesses while making it **unbearable mainly for manufacturing and distribution companies** of which the fuel cost plays a significant portion of their direct/indirect costs.
- Failing to increase the selling prices to setoff against the rising transportation costs, overall **corporate profit margins are expected to experience a significant contraction** and may even leave with the option to run on losses.



# Eroding Buying Power

## Movement in Inflation & Exchange Rate



Source : CBSL

- The YoY inflation (CCPI) has risen to an unforeseen level since Jan 2021 witnessing an accelerated uprise from Sep 2021.
- Global supply shortages coupled with the steep depreciation in LKR have led to an unaffordable hike in prices of goods and services in the local market.
- Having a stagnant stream of income, majority of the consumers are shifted to a **lifestyle with essential-only spending**.
- Corporates are going to experience a **slump in the top line with dampened demand** for their goods and services.
- During the period from Jan 2021-May 2022, inflation has spiked from 3.0% to 39.1%. Adding further pressure on the situation, LKR witnessed a severe devaluation of c. 86.0% leaving cost of imported goods at a level higher than ever before. We expect **inflation to hover around c. 24.0% in Dec 2022**.
- Corporates are compelled to undertake inevitable price hikes in their products and services to safeguard the margins while **letting go of the volumes anyhow causing a major impact on earnings**.





# Operational Disruptions

- The CEB has implemented planned blackouts at various locations across Sri Lanka since Jan 2022. Inability to source required fuel to run the power plants due to the dwindled foreign reserves in the country and reduced power generation via hydropower have forced **for more than 13-hour power cuts per day for certain locations**.
- Businesses without backup generators had to suspend operations during this period while bearing irrecoverable losses. Incapacity to source a stable energy supply to date, most manufacturing companies were continued to face **operational challenges as well as losing clients** due to the failure in fulfilling the orders as promised.
- **Disruption to delivery channels** due to fuel shortages were also pressurising the smooth function of businesses over a prolonged period of time.
- **Restaurants & hotels are experiencing state of mayhem with severe operational worries** such as short supply of cooking gas and rising prices of key ingredients. We expect this situation to continue in SL until the external sustainability is achieved.



A man in a dark suit, white shirt, and striped tie, wearing black-rimmed glasses, is looking up with a concerned expression at a massive stack of dark grey binders. The binders are stacked high, with the top ones clearly labeled 'TAX' in large black letters, preceded by a dollar sign symbol (§). The binders are overflowing with papers. The background is a solid teal color. A large, white, wavy banner is superimposed over the lower half of the image, containing the text 'TAX HIKES to decimate earnings potential!!!' in red.

**TAX HIKES** to decimate earnings  
potential!!!

# Impact of Fiscal Consolidation on Businesses



***Revenue based fiscal consolidation to bring massive tax hikes***  
Proposed tax reforms to be implemented with an immediate and near-term basis are expected to deploy a massive hit on corporate earnings. Accordingly, the tax regime is expected to restore back to the levels prevailed during 2019.

***So far, revisions to VAT, Personal Income Tax and Corporate Income Tax were announced***

Accordingly, VAT is increased from 8.0% to 12.0% with immediate effect and the VAT threshold will be reduced to LKR 120.0Mn from LKR 300.0Mn w.e.f. 01 Oct 2022. Moreover, corporate income tax is expected to increase from 24.0% to 30.0% while concessionary tax rates are to be increased from 14.0% to 15.0%, along with several other reforms.

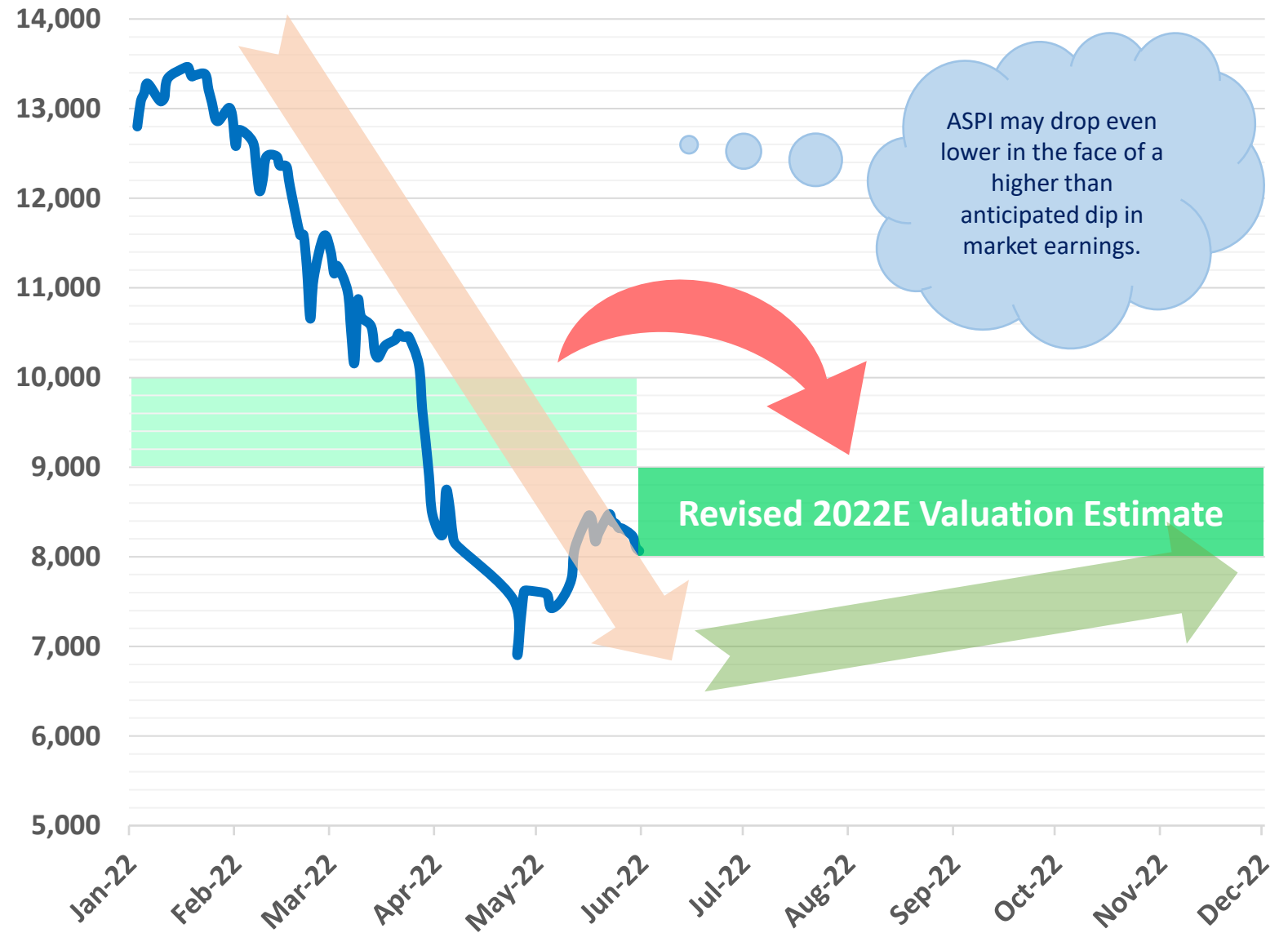
***Substantial Tax burden on corporates and reduced consumer demand***  
Tax burden on corporates are expected to consume a substantial portion of the taxable profits. Individuals will also be subjected to tax burden impacting their disposable income while further slashing the purchasing power, thus weakening the overall demand. Moreover, further policy reforms intended to achieve fiscal consolidation to ease the budget deficit and accumulated debt is anticipated in the upcoming relief budget which may also have a sizable impact on businesses.



We forecast market earnings to compress by -7.0% in 2022E and thereafter grow by 4.0% in 2023E

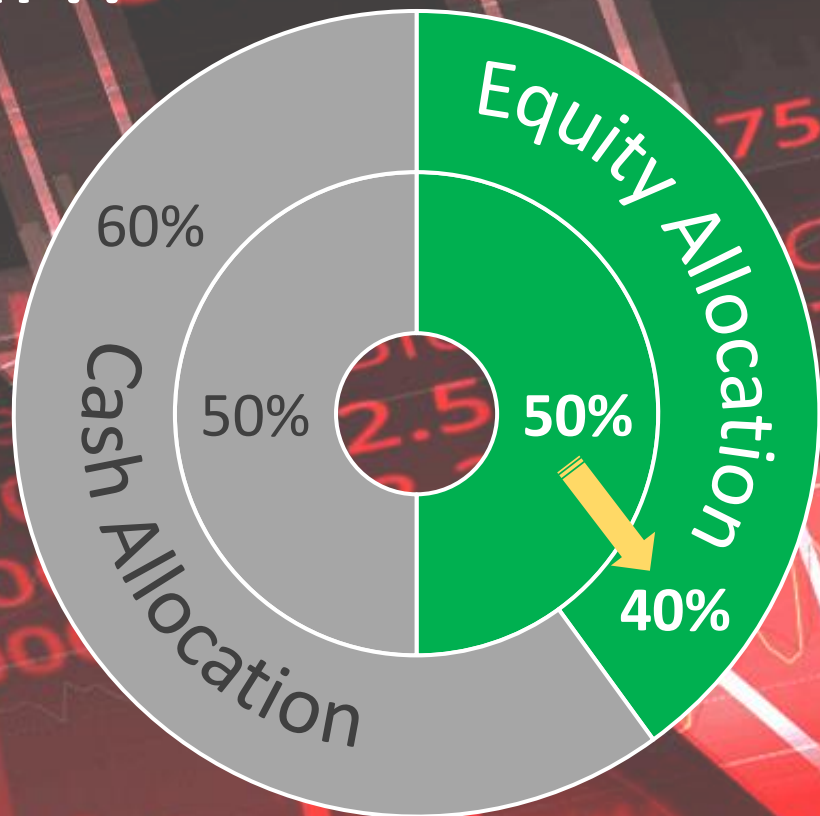


Considering the  
looming earnings  
plunge, we revised  
our ASPI target to  
**8,000-9,000**  
range from our  
previous forecast of  
9,000-10,000 points.



Source: CSE, First Capital Research

BE CAUTIOUS ABOUT  
HEADWINDS ON THE  
WAY!!



“Investors are  
Advised to **Reduce**  
the Equity  
Exposure by **10%**  
(from 50% to  
40%)”

# Multiple shocks to push stocks lower?

## What Investors should do?

Jun 2022

### *View Maintained: Negative returns to be expected in 2H2022*

As iterated in our previous reports, given the current economic adversities undergoing in the country and tough structural changes that come as remedial actions, the stock market returns in 2H2022 appear to be **NEGATIVE**. Multiple challenges in terms of tripling finance costs, rising energy prices, eroding purchasing power, power cuts, fuel shortages and the massive tax hikes are expected to lead to a plunge in the Corporate Earnings for 2022E. Corporate Earnings are expected to record a -7% dip, being negative for the 1<sup>st</sup> time in 3 years. The lower decline is thanks to the dollar income companies especially led by EXPO.

### *Risk-free rate of 20%+ discourages higher risk investments such as Equity*

Investors are expecting a higher return on equity to compensate for higher risk they undertake with risk-free interest rates going beyond 20%. Looming negativities may cause a shift in funds from equity to lesser risky, guaranteed return instruments such as Government Securities and other high rated corporate debt securities.

### *Reduce equity exposure and/or move towards defensive counters.*

We advise risk averse investors to cut equity portfolio to 40% from 50% and safe keep cash for future buying when declines. **"Buy when there's blood in the streets, even if the blood is your own"**. With a high likelihood of the market providing negative returns amidst the current crisis resulting in lower corporate earnings, investors should be having a high cash allocation and BUY into the market as and when the market is declining. Considering the negativity, ASPI may even dip sharply before reverting to positivity. Investors who are not willing to reduce exposure, we highly recommend to switch to defensive counters such as, **Dollar Earning Companies, Life Insurance Companies and Banks, High Dividend Yielding Companies; Utilities Sector Companies, and Tourism Sector Companies.**



Stock	Stock Code	Price as at 06.06.2022
LKR		
 Teejay Lanka	TJL.N0000	40.10
 Hayleys Fabric	MGT.N0000	31.60
 Hayleys	HAYL.N0000	63.70
 Expolanka Holdings	EXPO.N0000	192.50
 Commercial Bank of Ceylon	COMB.N0000	52.50
 Hatton National Bank	HNB.N0000	78.10
 Sampath Bank	SAMP.N0000	34.50
 National Development Bank	NDB.N0000	36.00
 HNB Assurance	HASU.N0000	35.00
 Softlogic Life Insurance	AAIC.N0000	53.60
 Access Engineering	AEL.N0000	11.30
 Royal Ceramics	RCL.N0000	26.60
 Nestle Lanka	NEST.N0000	979.50
 Ceylon Tobacco	CTC.N0000	640.75
 LVL Energy Fund	LVEF.N0000	7.20
 Windforce	WIND.N0000	13.60
 Aitken Spence Hotel	AHUN.N0000	31.00
 John Keells Hotels	KHL.N0000	11.00
 Asian Hotels & Properties	AHPL.N0000	31.00



First Capital Research

# Top Picks 2022

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# Thank you!

*“SUCCESSFUL INVESTMENTS IS ABOUT  
MANAGING RISKS”*

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