First Capital
A Janashakthi Group Company

“Worries Over Rupee Debt Restructuring Creates Volatility”

17th Aug 2022

FIRST CAPITAL FIXED INCOME RECOMMENDATION

FIRST CAPITAL RESEARCH

Analysts: Hiruni Perera
Dimantha Mathew

1.0 Previous Recommendation

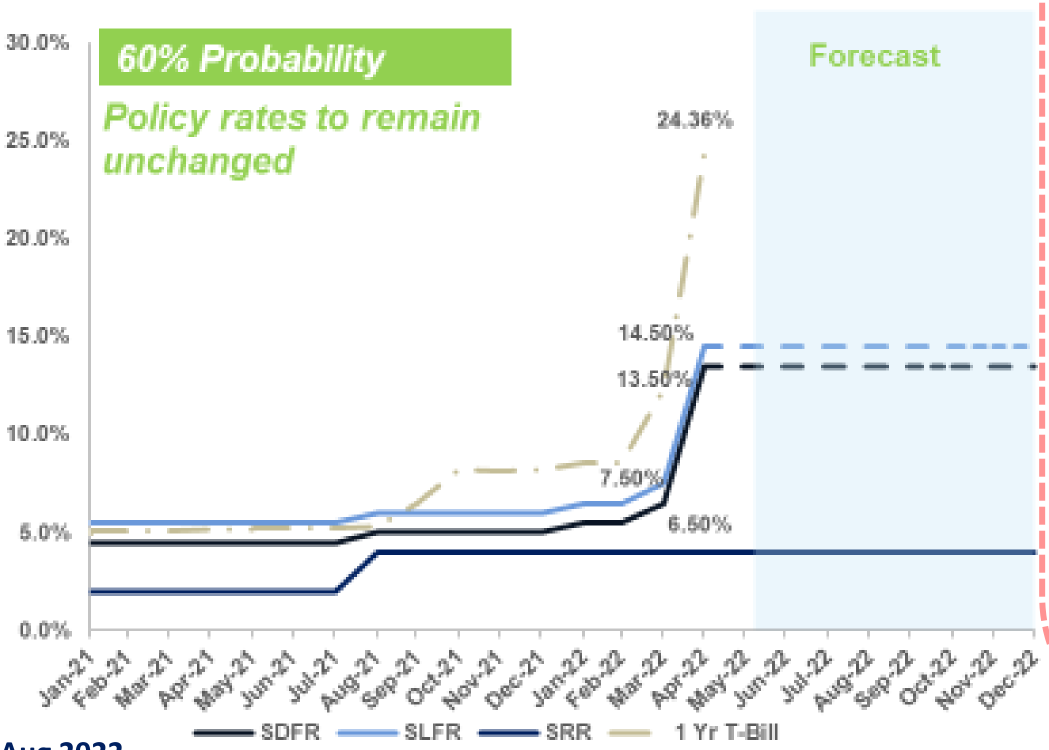
"Yields overshot our worst-case scenario in the midst of political instability and uprise in civil unrests"

Recap : Our 40% Probability occurred amidst the uncertainty created in the system

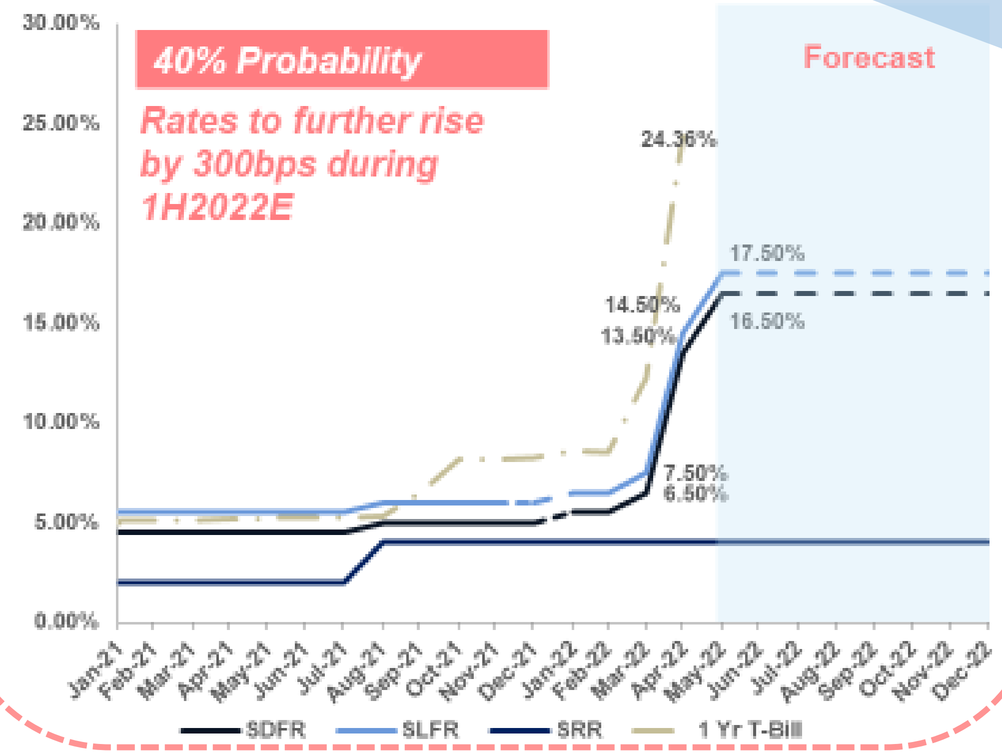
…while policy rates may depend on political outlook

As, forecasted in Economic Outlook Report dated 25th Apr-22, SL headed to scenario 02 while creating another political deadlock

Scenario 01
Political deadlock resolves



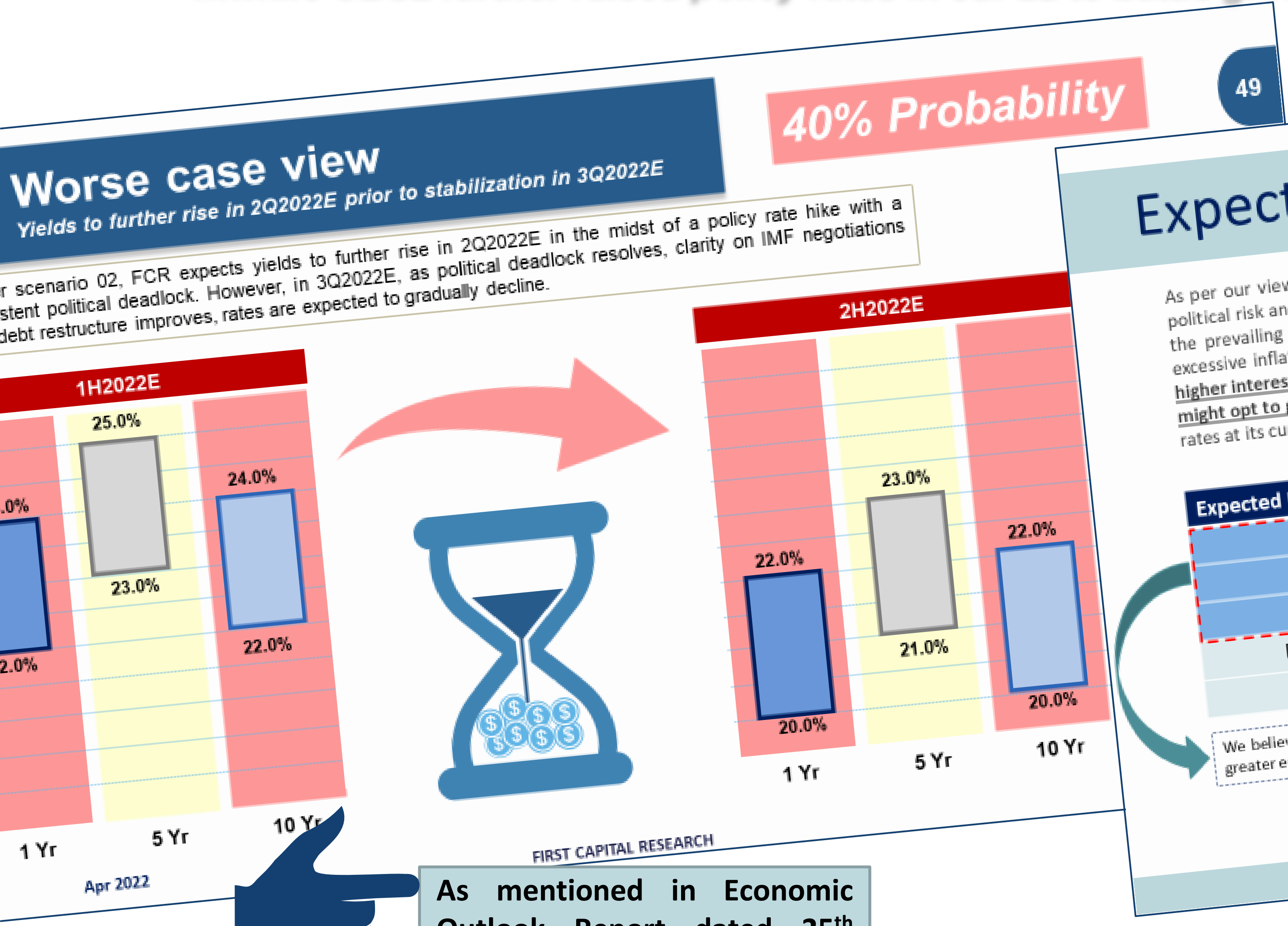
Scenario 02
Political deadlock persists



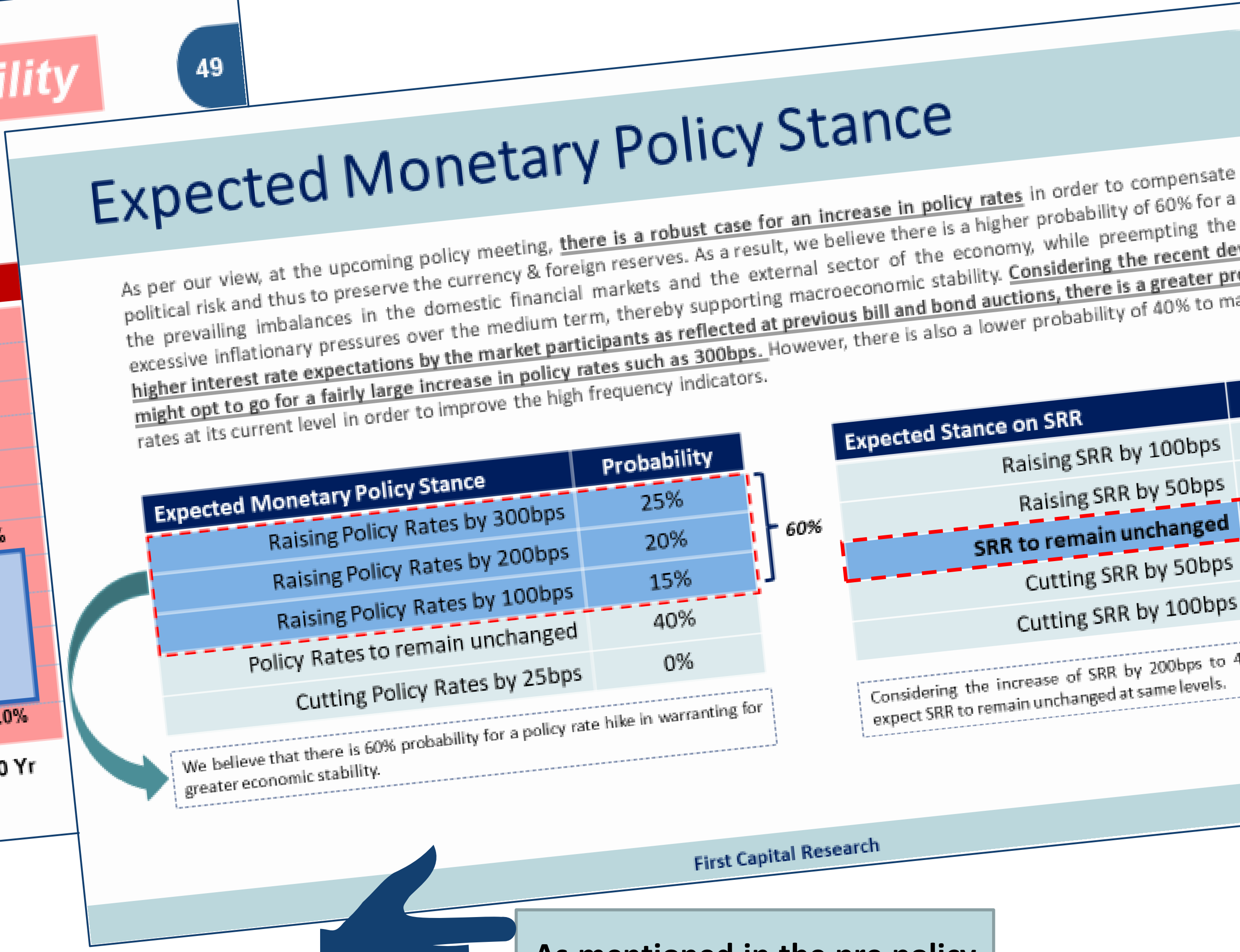
Recap : Political uncertainty and delay in ensuring debt sustainability...

Recap: …led to surge in yields as expected in worse case scenario

…while CBSL further raised policy rates in Jul-22 to battle growing macro pressures



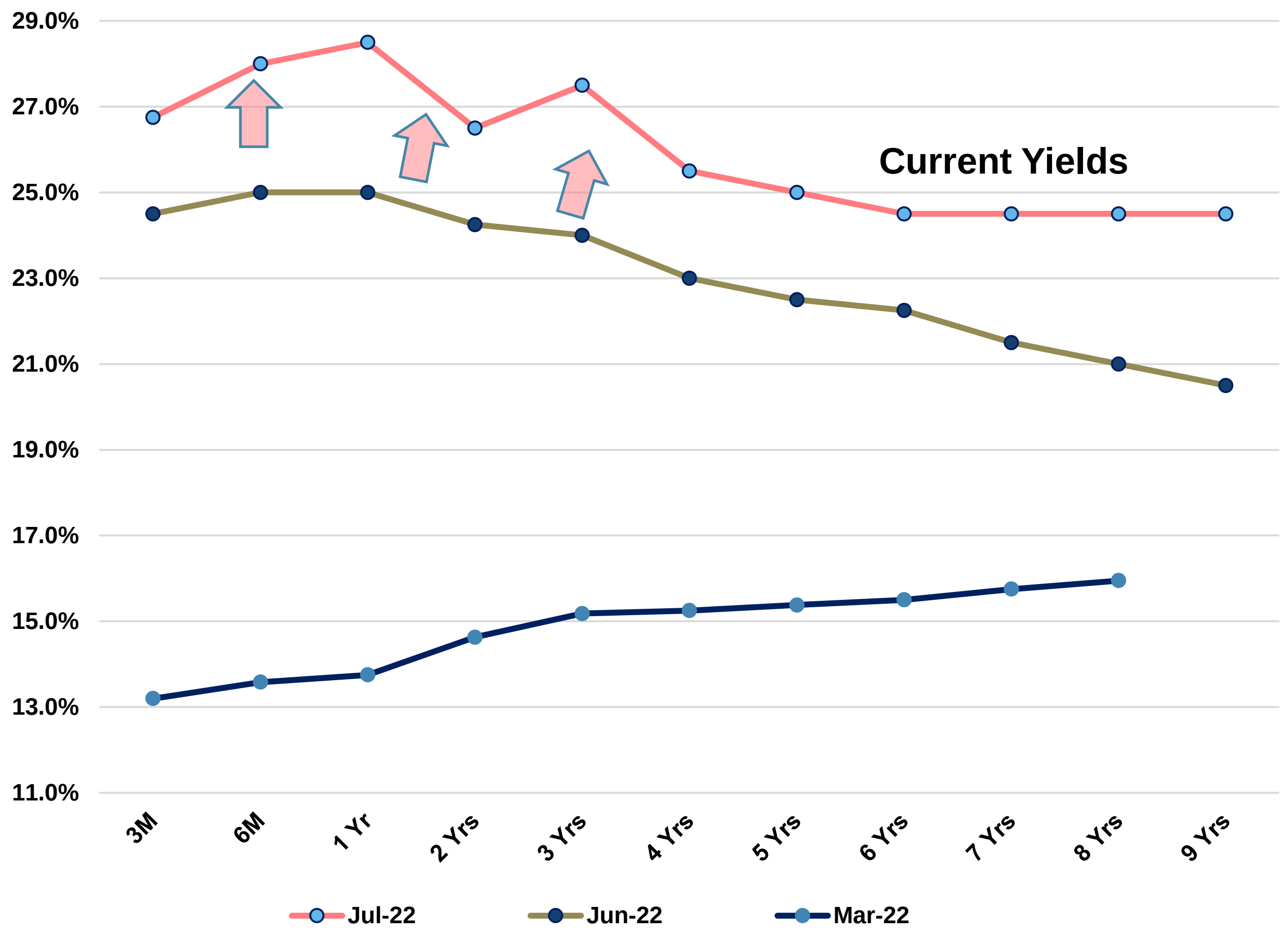
As mentioned in Economic Outlook Report dated 25th Apr-22



As mentioned in the pre policy report dated 01st Jul- 22

Aug 2022

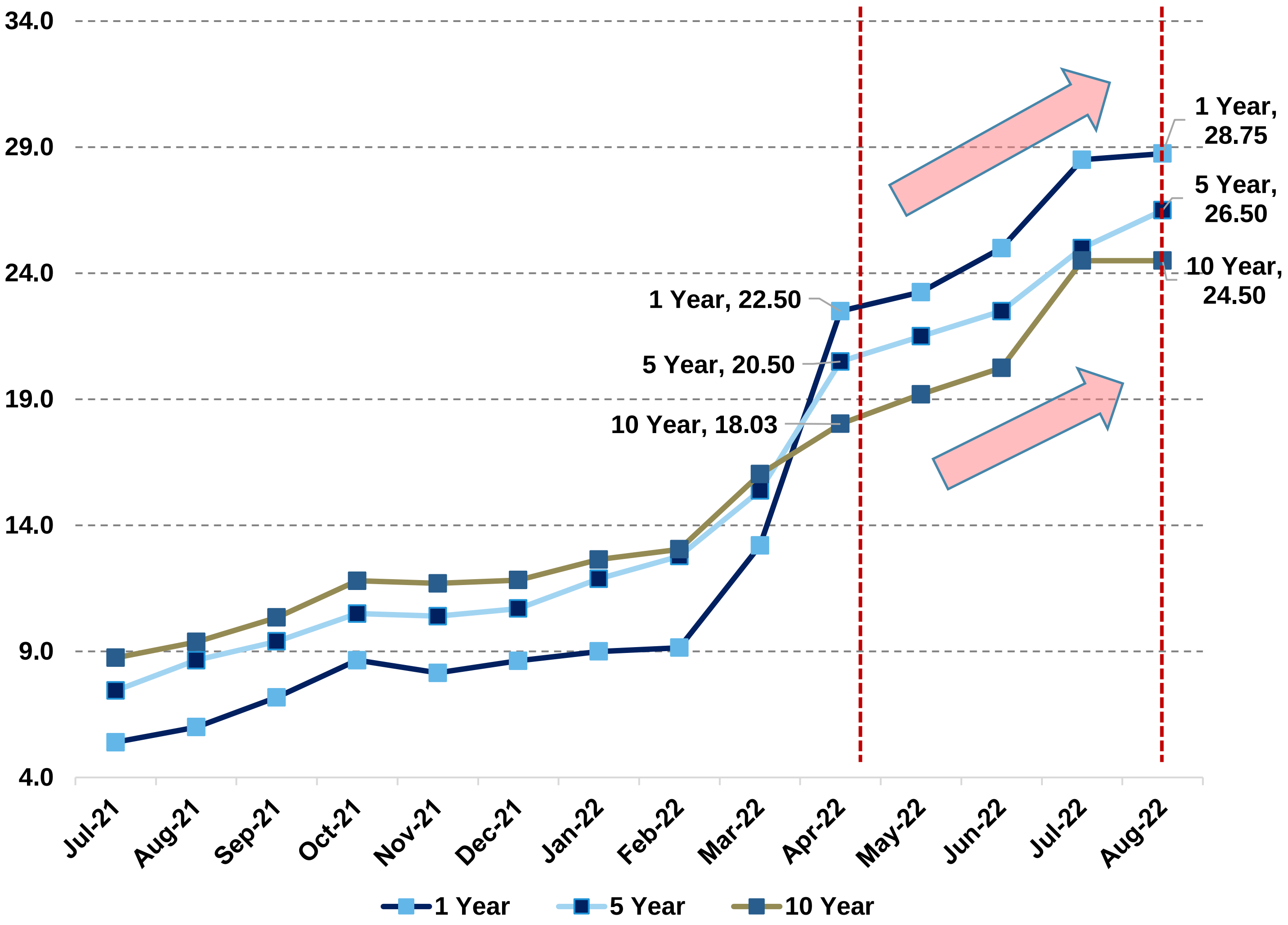
Overall yield curve movement



Source: First Capital Research

Interest Rate Change (bps)					
Tenure	Jul-22	Jun-22	Change (bps)	Mar-22	Change (bps)
3M	26.75%	24.50%	225	13.20%	1355
6M	28.00%	25.00%	300	13.58%	1442
1 Yr	28.50%	25.00%	350	13.75%	1475
2 Yrs	26.50%	24.25%	225	14.63%	1187
3 Yrs	27.50%	24.00%	350	15.18%	1232
4 Yrs	25.50%	23.00%	250	15.25%	1025
5 Yrs	25.00%	22.50%	250	15.38%	962
6 Yrs	24.50%	22.25%	225	15.50%	900
7 Yrs	24.50%	21.50%	N/A	15.75%	875
8 Yrs	24.50%	21.00%	N/A	15.95%	855
9 Yrs	24.50%	20.50%	N/A	N/A	N/A
10 Yrs	N/A	N/A	N/A	16.03%	N/A
12 Yrs	N/A	N/A	N/A	16.13%	N/A
15 Yrs	N/A	N/A	N/A	16.23%	N/A
20 Yrs	N/A	N/A	N/A	16.33%	N/A

25th Apr-22 to 29th Jul-22 bond yields spike by nearly 600bps



Source: First Capital Research

Previous Recommendations

15th Feb 2022

"Macro woes to impel bond yield expectations higher"- **Accurate**

10th Mar 2022

"Yields to head north as market brace for macro setbacks"- **Accurate**

25th Apr 2022

Under scenario 01 (60% probability), FCR expects current level of yields to be the peak and then stabilize by early 3Q2022E as political deadlock resolves, clarity on IMF negotiations, debt restructure and overall fiscal consolidation improves and slowdown in inflation happens - **Inaccurate**

Under scenario 02 (40% probability), FCR expects yields to further rise in 2Q2022 in the midst of a policy rate hike with a persistent political deadlock. However, in 3Q2022E, as political deadlock resolves, clarity on IMF negotiations and debt restructure improves, rates are expected to gradually decline - **Partly Accurate**

2.0 Economic Outlook

"Indicators provide glimmer of hope after hitting the rock bottom"

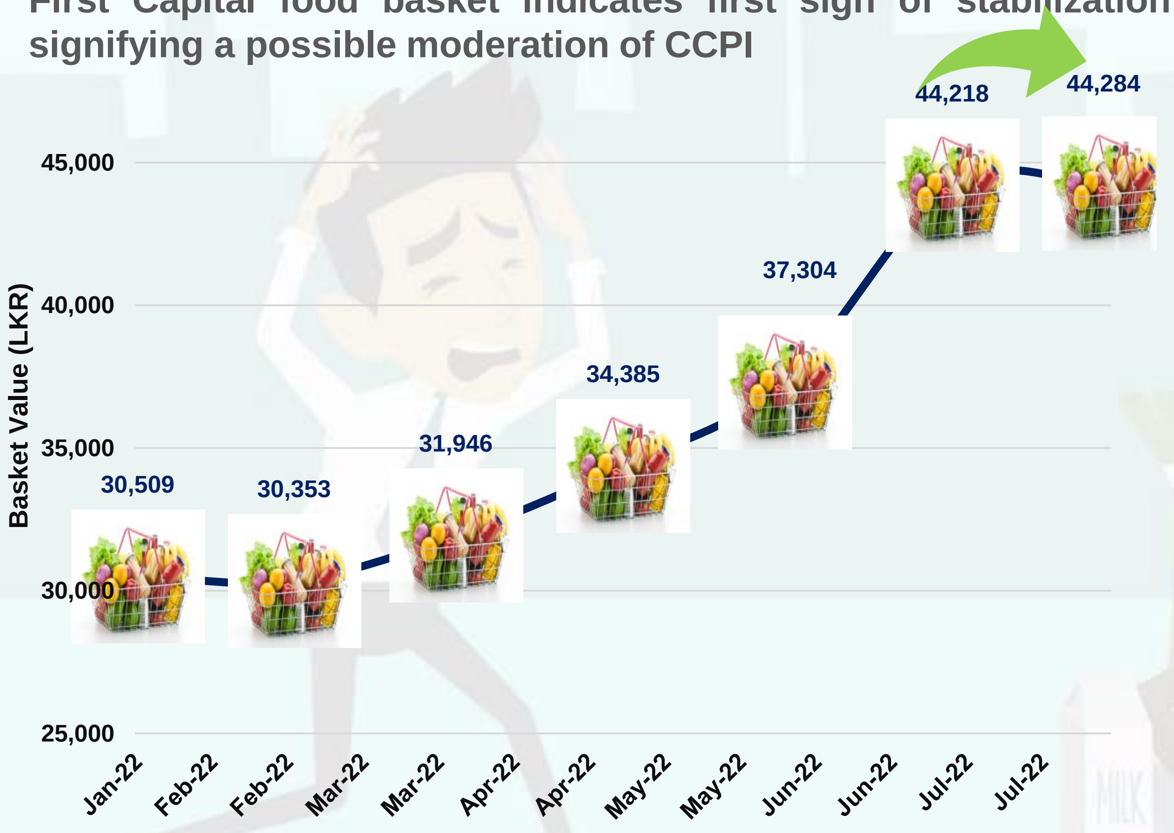
Political stability is presumed to be created through the newly established government

Aug 2022

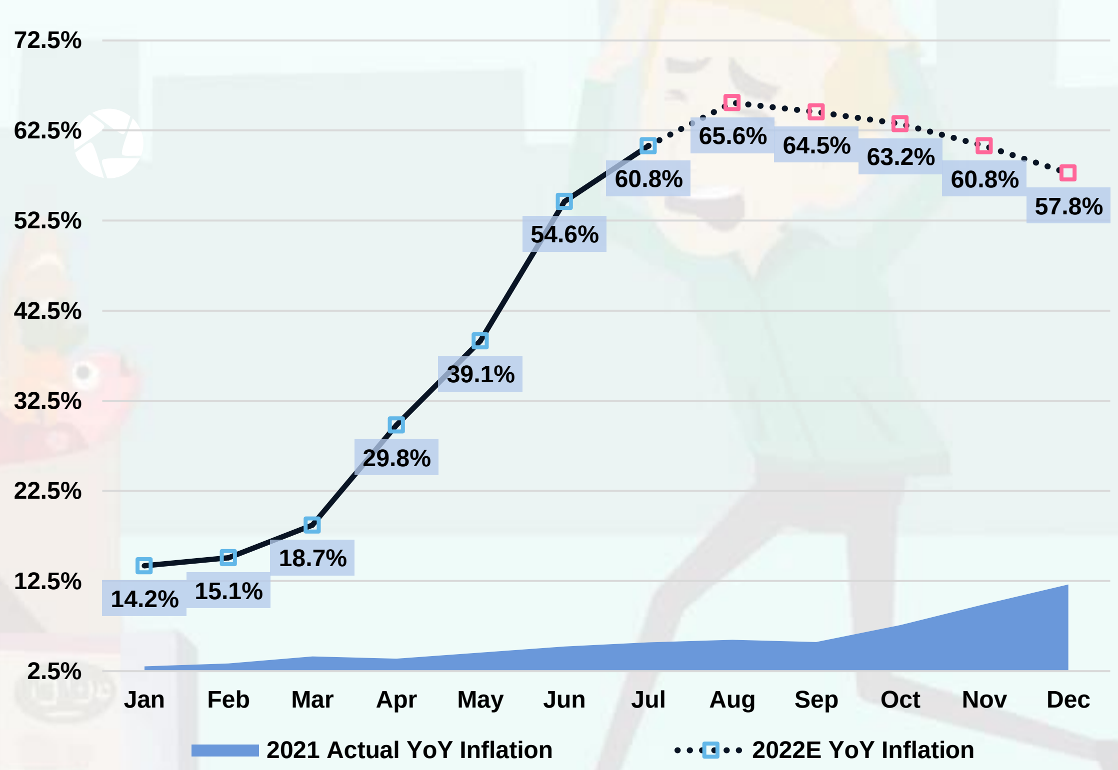
Inflation signals signs of cooling off from its recent peak…

FCR expect inflation to peak in 3Q2022E and moderate during latter part of the year led by stabilization of the currency and global commodity prices in the fear of a recession

First Capital food basket indicates first sign of stabilization signifying a possible moderation of CCPI



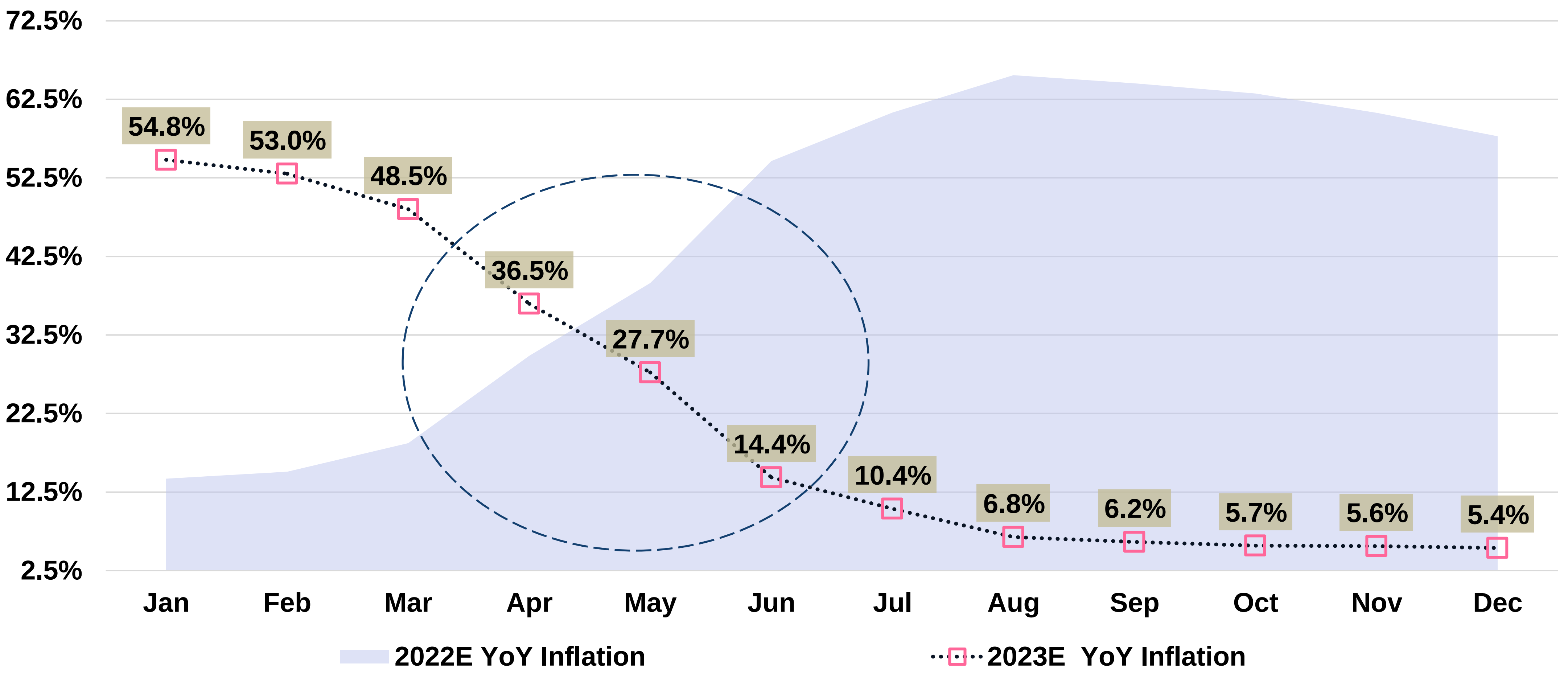
FCR Inflation forecast



Source: Dept. Census and Statistics

…while Inflation for FY23E is likely to record a substantial dip…

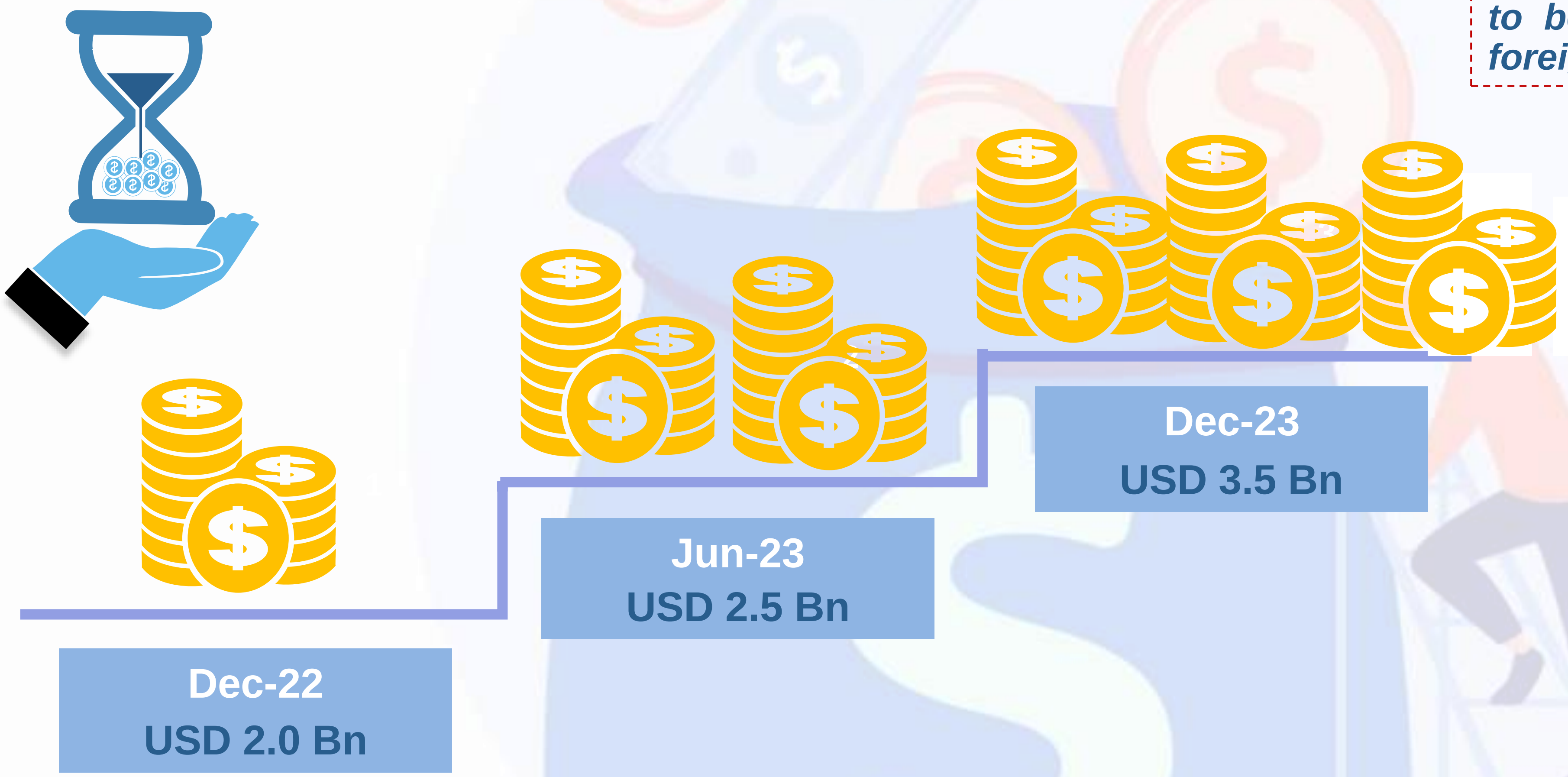
FCR expects inflation to record a significant dip towards the 2Q of 2023E resulting from the higher base effect and stable economic policies



Source: Dept. Census and Statistics

Reserves are expected to recover amidst improvement in current account, suspension of debt payment and…

Foreign reserves are expected to reach USD 2.0Bn by Dec-22 while worker remittances and tourism earnings are expected to be major growth drivers of foreign inflows for 2023E



…potential financial assistance from IMF

IMF staff level agreement
Sep-22

IMF Board level agreement
Dec-22

Receiving the 1st tranche of IMF Funds
Jan-23

Ensuring substantial Debt sustainability
Feb-23

Receiving the 2nd tranche
May-23

FC research expects Sri Lanka to reach a potential staff level agreement by Sep-22 and Board level agreement by Dec-22. However, receiving IMF funds is fundamentally dependent on Sri Lanka's ability to ensure debt sustainability.

However, debt negotiations could be complicated by debt owed to China…

IMF says Sri Lanka needs to talk with China about debt restructuring

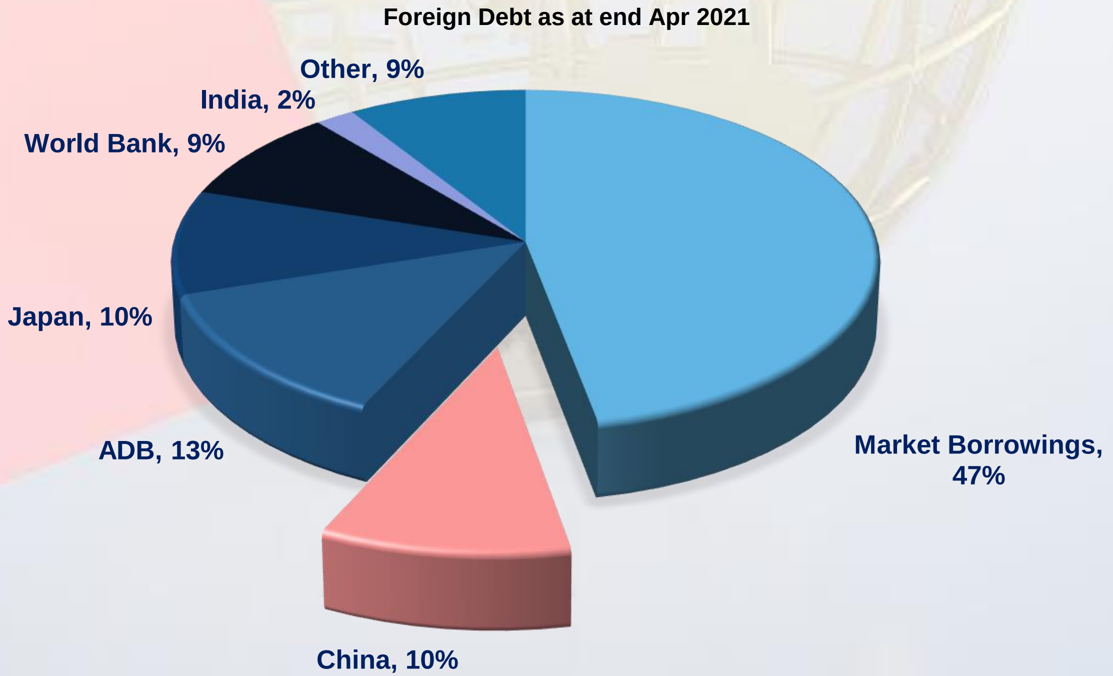
China remains key sticking point in debt restructuring: Fitch

29 July 2022 12:25 am

- "Debt negotiations could be complicated by debt owed to China" - Sagarika Chandra, Director Sovereigns at Fitch ratings
- Sri Lanka owes China US$ 6.5bn through a combination of development loans and swap line
- China had traditionally preferred to offer debt relief for large loans by way of deferrals
- But Fitch says this approach could increase challenges for SL to successfully negotiate debt restructuring with other creditors
- Also points out IMF reforms could be a tough pill to swallow and they could even invite further public agitation

China continuously pops up as one of the key sticking points for Sri Lanka to reach the much needed debt sustainability as Fitch Rating this week too weighed in on the matter saying that the world's second biggest economy could complicate the island nation's debt talks with its creditors.

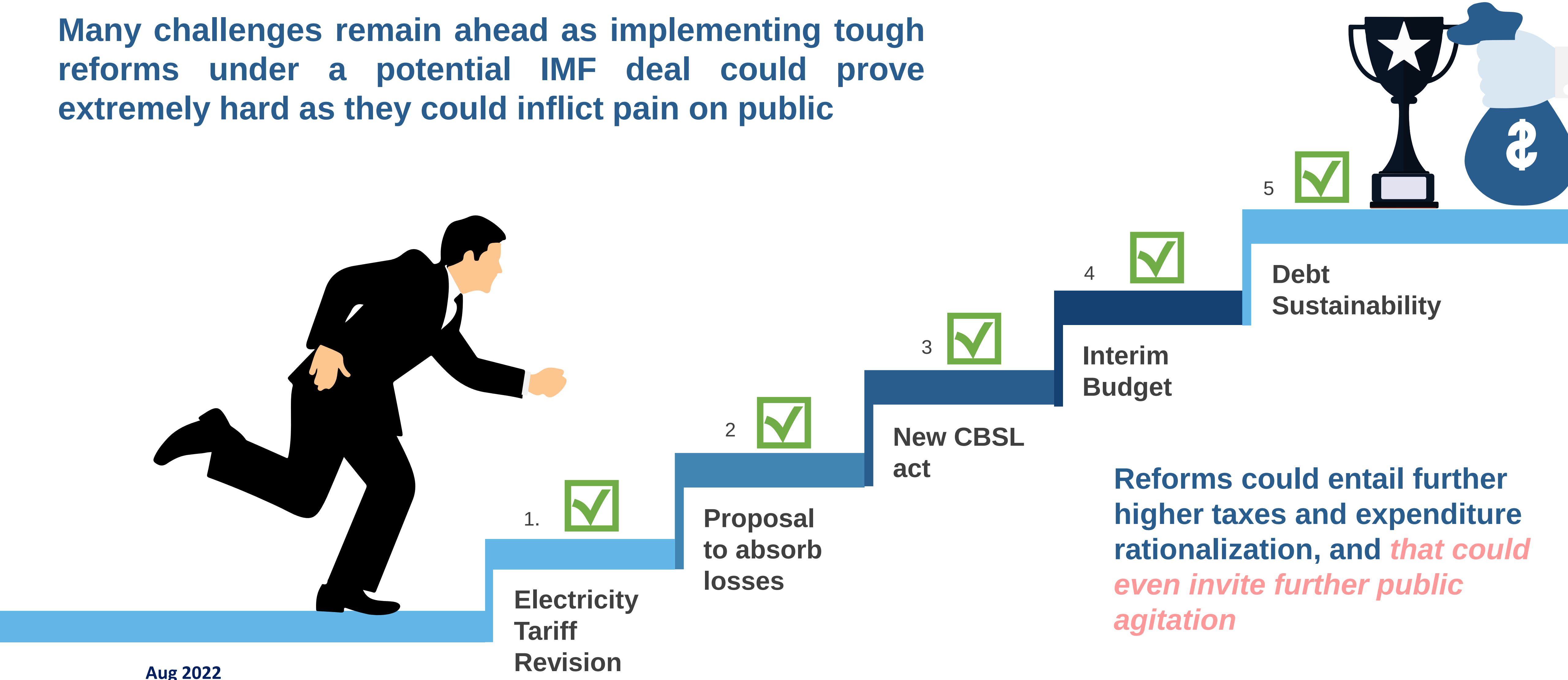
As at Apr-21 SL owed 10% of its foreign debt to China. However, this amount is expected to be higher by 2022 including the USD 1.5Bn equivalent swap line and other loans granted by China subsequent to Apr-21.



Sources: Department of External Resources and Fitch

…while IMF reforms could be a difficult pill to swallow

Many challenges remain ahead as implementing tough reforms under a potential IMF deal could prove extremely hard as they could inflict pain on public

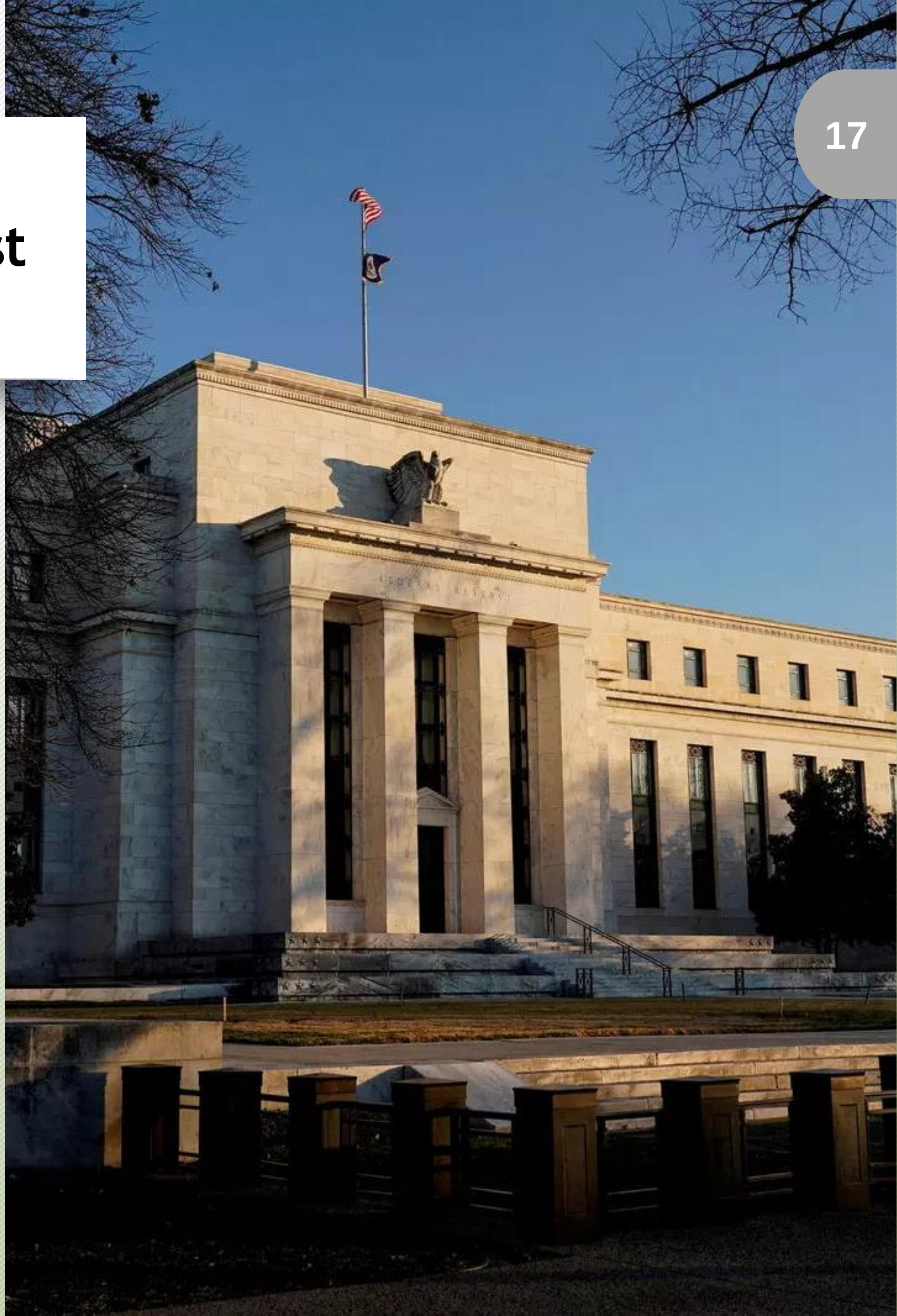


Reforms could entail further higher taxes and expenditure rationalization, and *that could even invite further public agitation*

However, global economic conditions to favour SL

Fed raises policy rates by further 75bps; However, intensity of future hikes may slow down in the midst of unofficial start of recession

- The Fed on 26th Jul-22 raised its policy rate by another 0.75%, bringing the total interest rate hikes since Mar-22 to 225 basis points. Fed Chair Jerome Powell acknowledged the softening economic activity as a result of tighter monetary policy stance.
- However, the US economy has shrunk for the second quarter in a row, a milestone that in many countries would be considered an economic recession signalling that it could slow the pace of its hiking campaign at some point.
- While countries that are dependent on exports to the US remain vulnerable to US recession an import dependent economies such as Sri Lanka is expected to benefit from lower commodity prices and potential inflow of foreign funds.



3.0 Fixed Income Health Score

“Fixed Income health score show signs of improvement in months to come”

FI Economic Health Score – Jul-22

Primary indicators marginally improves while secondary indicators holds steady relative to Jun-22….

Primary Criteria
13+1=14

14
Economic Health Score
Jul-22

As against 13 in Jun-22 & 29 in Jul-21 (1 Year ago)

Secondary Criteria
0+/-0=0

Changes to Health Score – *Primary Criteria*

Foreign Reserves

Foreign reserves recorded at USD 1,815 Mn for Jul-22 recording a decline of USD 39.0Mn relative to Jun-22.

00/15 → 00/15

Liquidity

Liquidity was highly volatile during the month. However, recorded an improvement by LKR 62.4Bn towards the end.

00/15 → 00/15

Inflation

CCPI further increased to 60.8% in Jul-22, exceeding the CBSL's and FC Research's desired range of 4%-6% and 5%-7% respectively.

00/15 → 00/15

Foreign Activity

Foreign Investment in Govt. securities remains below LKR 5.0Bn. However, improved by LKR 491.2Mn during the month.

00/10 → 00/10

Credit

Private sector credit recorded a decrease of LKR 40.6Bn for the month of Jun-22 and is expected to slow down amidst the higher interest rate environment.

03/10 +1 04/10

CBSL Holdings

CBSL holdings surge pass above LKR 2.2Tn.

10/10 → 10/10

New Score 14/ 75

Previous Score 13/ 75

Changes to Health Score –
Secondary Criteria

Rating Outlook

S&P placed SL at e Default while Moody's placed SL at 'Ca'. Fitch assigned Restricted Default.

00/05 → 00/05

External Environment

Foreign exchange market remains stable although USD/LKR slightly depreciated by 0.26% in Jul-22 and recorded -80.0%YTD as at end Jul-22.

00/05 → 00/05

BOT & BOP

BOT recorded at USD 21.0Mn in Jun with a significant improvement on a YoY basis. However, BOP deficit rose to USD -2.8Bn.

00/05 → 00/05

Political Risk

Popularity of the govt. significantly deteriorated questioning the stability of the Govt.

00/05 → 00/05

Investor Confidence

The BCI maintains at 49 in Jul-22, merely 18 points above the all-time low figure of 31 in Sep-01 during civil war and when parliament was prorogued

00/05 → 00/05

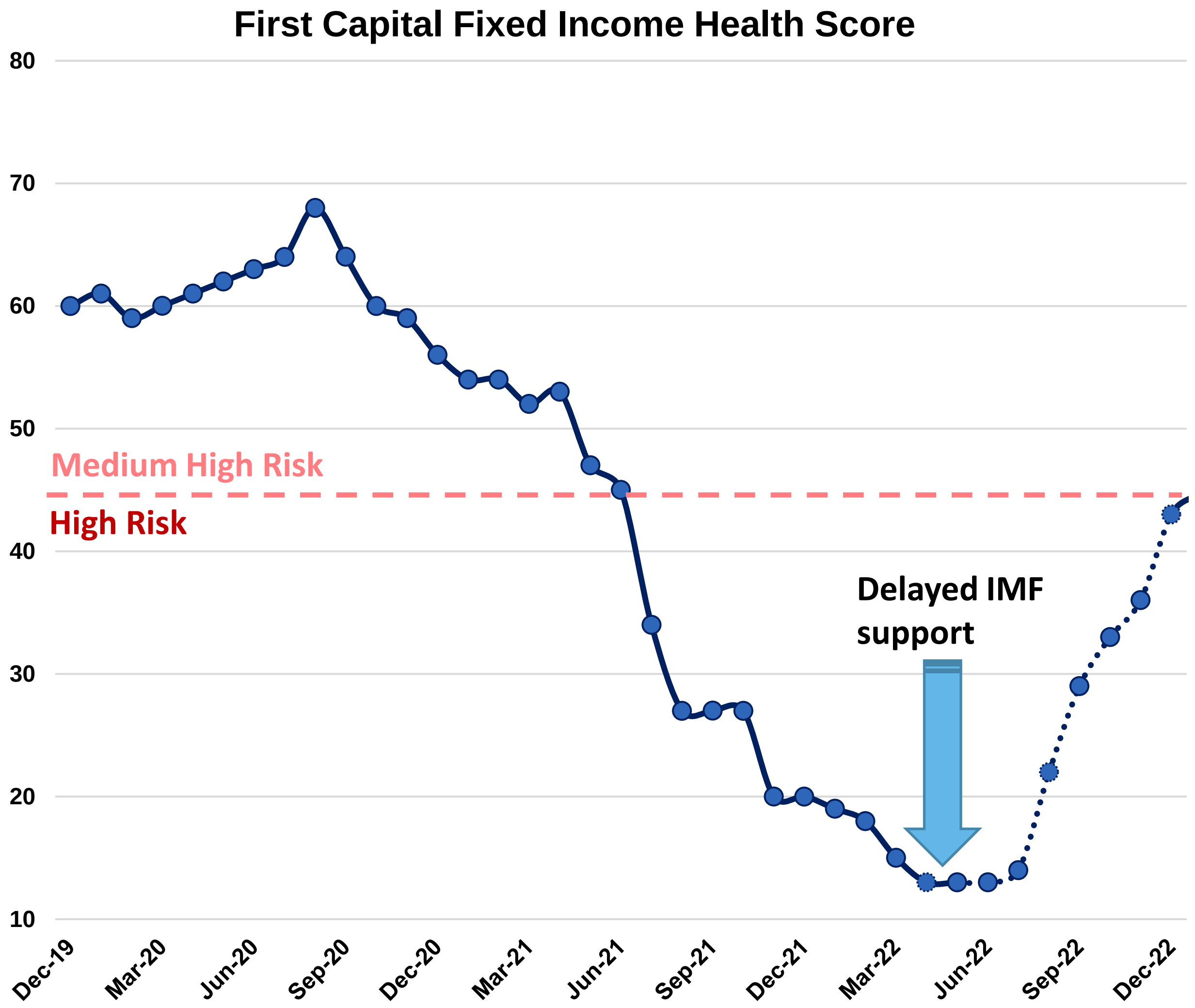
New Score

0/ 25

Previous Score

0/ 25

FI Health score nosedived in Jun-22 and is expected to show signs of improvement from Jul-22 amidst potential development in key economic indicators



4.0 FCR Recommendation

"Time to get cautiously optimistic"

Lessons from the past : Debt Restructuring scenarios

Aug 2022

Debt Restructuring in the past (1998-2020)

Country	Start of default or restructuring process[1]	End of restructuring process[2]	Length of process (in months)	EDR / DDR[3]	Preemptive/ Post-default[4]	FC, LC or Both[5]
Ukraine	Aug-1998	Sep-1998	2	DDR	Preemptive	Both
Russia	Aug-1998	Aug-2000	26	DDR + EDR	Post-default	Both
Pakistan	Jan-1999	Dec-1999	12	EDR	Preemptive	FC
Ecuador	Jan-1999	Aug-2000	20	DDR + EDR	Post-default	Both
Ukraine	Feb-2000	Apr-2000	3	EDR	Preemptive	FC
Côte d'Ivoire	Mar-2000	Apr-2010	124	EDR	Post-default	FC
Argentina	Nov-2001	Jun-2005	45	DDR + EDR	Post-default	Both
Moldova	Jun-2002	Oct-2002	6	EDR	Preemptive	FC
Paraguay	Dec-2002	Nov-2003	12	DDR	Post-default	Both
Uruguay	Mar-2003	May-2003	4	DDR + EDR	Preemptive	FC
Nicaragua	Jul-2003	Jul-2003	1	DDR	Preemptive	LC
Dominica	Jul-2003	Jun-2004	13	EDR	Post-default	Both
Dominican Republic	Apr-2004	May-2005	15	EDR	Preemptive	FC*
Dominican Republic	Aug-2004	Oct-2005	16	EDR	Post-default	FC
Cameroon	Sep-2004	Apr-2005	8	DDR	Post-default	LC
Grenada	Oct-2004	Nov-2005	15	DDR + EDR	Preemptive	Both
Iraq	Jul-2005	Jul-2006	13	EDR	Post-default	FC
Belize	Aug-2006	Feb-2007	8	EDR	Preemptive	FC
Nicaragua	Jun-2008	Jul-2008	2	DDR	Preemptive	LC
Seychelles	Jul-2008	Feb-2010	21	EDR	Post-default	FC
Ecuador	Nov-2008	Jun-2009	8	EDR	Post-default	FC
Jamaica	Jan-2010	Feb-2010	2	DDR	Preemptive	Both
Côte d'Ivoire	Jan-2011	Nov-2012	23	EDR	Post-default	Both
St. Kitts and Nevis	Jun-2011	Apr-2012	11	DDR + EDR	Preemptive	Both
Greece	Jul-2011	Mar-2012	10	DDR + EDR	Preemptive	Both
Belize	Aug-2012	Mar-2013	7	EDR	Preemptive	FC
Jamaica	Feb-2013	Mar-2013	2	DDR	Preemptive	Both
Grenada	Mar-2013	Nov-2015	34	DDR + EDR	Post-default	Both
Cyprus	Jun-2013	Jul-2013	2	DDR	Preemptive	LC
Argentina	Jul-2014	Jun-2016	24	DDR + EDR	Post-default	FC
Chad	Sep-2014	Dec-2015	16	EDR	Preemptive	FC
Ukraine	Jan-2015	Apr-2016	16	EDR	Preemptive	FC
Mozambique	Jun-2015	Apr-2016	11	EDR	Preemptive	FC
Belize	Nov-2016	Mar-2017	5	EDR	Preemptive	FC
Mongolia	Feb-2017	Mar-2017	2	EDR	Preemptive	FC
Chad	Feb-2017	Jun-2018	17	EDR	Preemptive	FC
Barbados	Jun-2018	Dec-2019	20	DDR + EDR	Post-default	Both
Argentina	Dec-2019	Sep-2020	10	DDR + EDR	Post-default	Both
Ecuador	Mar-2020	Aug-2020	6	EDR	Preemptive	FC

Length of debt restructuring could range from 2-24 months generally and sometimes could involve external and domestic debt restructuring

Sources: IMF

Zambia

Dec-20 — In 2020, Zambia became the first African country in the pandemic era to default. The restructuring of its external debt, which amounted to more than USD 17.0Bn is seen by many analysts as a test case.

Dec-21 — Zambia reached a staff-level agreement with the IMF on a USD 1.4 billion three-year extended credit facility in Dec-21, conditional upon its ability to reduce debt to levels the Fund deems sustainable.

Jul-22 — On Jul-22 , Zambia's bilateral creditor committee co-chaired by China and France released a statement committing to negotiating with the Zambian government under the terms of the Group of 20 (G-20) Common Framework.

Jul-22 — Zambia's creditors including China pledged to negotiate a restructuring of the country's debts, a move IMF managing director Kristalina Georgieva welcomed as "clearing the way" for a USD 1.4Bn Fund programme.

Aug-22 — Zambia expects to reach the 2022 IMF board level agreement by end Aug-22.

Zambia's debt restructuring has taken nearly 1 year and China's commitment to restructure Zambia's debt is a good sign for SL

Barbados

2008

Barbados has struggled to break free from a vicious cycle of low or negative growth since the 2008-09 global financial crisis.

2018

In 2018 and 2019, Barbados restructured its public debt for the first time in the country's history. The debt restructuring announced in Jun-18, by a government that had assumed office just a week earlier, was very comprehensive, including external debt to commercial creditors and treasury bills. It took many by surprise—prices on the external bond market fell sharply, and it is one of just a handful of cases over the last few decades where treasury bills were included in a debt restructuring (Russia 1998, Ukraine 1998, and Uruguay 2003).

2018

In Oct-18, the country entered a 4Yr Extended Fund Facility (EFF) for SDR 208Mn million (about USD 290.0Mn).

2019

In Dec-19, Barbados completed a successful external public debt restructuring (following its 2018 domestic debt restructuring) to further reduce the stock of public debt, lower interest payments, and lengthen maturities to increase Barbados's repayment capacity.

2021

Supported by the IMF program, international reserves have recovered from about three months of import coverage pre-program to about eight months of import coverage by October 2021, aided by disbursements from the Inter-American Development Bank and the Caribbean Development Bank.

Barbodos initiated restructuring with domestic debt, moved into an EFF with the IMF, following which it took slightly more than 1 year to complete the foreign debt restructuring

Options for debt restructuring for SL is between a rock and a hard place.

- ✓ Debt sustainability is expected to decide which parameter of restructuring are to be used .
- ✓ The debt of Paris Club members has to be negotiated at the Paris Club. Japan is a Paris club member.
- ✓ Debts with China and India, who are not Paris Club partners, have to be negotiated outside the Paris Club.
- ✓ Usually, IMF, WB, and the ADB are unlikely to restructure debt as it is provided at a concessional rate and with a longer maturity period. In restructuring multilateral debt, generally, a new programme would be introduced to recover the previous debt.

Hair Cut on principle

Reducing the debt stock

Reduction on coupon

Adjusting the interest rates to be paid or coupon rates commonly known as coupon adjustment. However, this option seems to be unlikely as 92.5% of bonds have a coupon value of 12.00% or below while average coupon of outstanding bonds as at end Jun-22 is 10.61%.

Increase in the maturity period

Extending the repayment or maturity period

Hybrid of above options

Mix and match of all above

Possibilities for a Local Debt Restructuring

Sri Lanka is currently planning foreign debt restructuring. Whether a domestic debt restructuring is required would be highly dependent on the negotiations and success of the foreign debt restructuring, the sustainable level of debt and assessment of the cost benefit analysis of the local debt restructuring.

20% Probability

Arguments Against Local debt Restructuring

IMF does not favour it: With the banks holding a large proportion of domestic debt, IMF believes that many type of domestic debt restructuring could impact the financial system stability.

Local investments have suffered pain: With the current high level of inflation and significant depreciation of the currency CBSL believes that the local rupee have already suffered pain (sizable deterioration in buying power) similar to a haircut. In such a situation it is unfair to again consider restructuring of local debt.

May lead to recapitalize selected banks: Domestic debt are mostly held by Banks, Finance Companies, Insurance companies and Pension Funds such as EPF. Restructuring of domestic debt may cause a major loss to financial institutions such as Banks which have invested a large portion of their assets in domestic debt and also are struggling amidst the ailing economic conditions. It is likely to cause a significant erosion in capital resulting in a Govt requirement to support to recapitalize some of the financial institutions which may again be a burden to the budget deficit.

Expectation: Considering above mentioned factors we believe that there could only a **<u>20% probability</u>** that the Government / CBSL may consider local debt restructuring.

Possible Impact on the <2Yr T-Bond

Maturity – 15 Mar 2024
Coupon – 10.90%

Current Yield – 27.5%

	10% Hair Cut on Principal	10% Hair Cut on Coupon	3 Year extension on Maturity	10% Hair Cut on Principal & 3Yr Extension on Maturity
Loss in Yield	-6.56%	-1.69%	-9.98%	-11.79%
New Yield	20.94%	25.81%	17.52%	15.71%

Possible Impact on the <3Yr T-Bond

Maturity – 01 Jun 2025
Coupon – 17.00%

Current Yield – 27.75%

	10% Hair Cut on Principal	10% Hair Cut on Coupon	3 Year extension on Maturity	10% Hair Cut on Principal & 3Yr Extension on Maturity
Loss in Yield	-3.11%	-2.17%	-4.25%	-5.33%
New Yield	24.64%	25.58%	23.50%	22.42%

Possible Impact on the <5Yr T-Bond

Maturity – 01 May 2027
Coupon – 18.00%

Current Yield – 26.5%

	10% Hair Cut on Principal	10% Hair Cut on Coupon	3 Year extension on Maturity	10% Hair Cut on Principal & 3Yr Extension on Maturity
Loss in Yield	-1.46%	-2.36%	-1.97%	-2.58%
New Yield	25.04%	24.14%	24.53%	23.92%

Possible Impact on the <10Yr T-Bond

Maturity – 15 Mar 2031
Coupon – 18.00%

Current Yield – 24.5%

	10% Hair Cut on Principal	10% Hair Cut on Coupon	3 Year extension on Maturity	10% Hair Cut on Principal & 3Yr Extension on Maturity
Loss in Yield	-0.49%	-2.44%	-0.60%	-0.84%
New Yield	24.01%	22.06%	23.90%	23.66%

Attractive yields in spite of possible restructuring

Lower debt structuring impact to maturities of 5 Year and above: As illustrated in slides 23, 24, 25 and 26 considering multiple debt restructuring options it is important to note that for maturing above 5 years of possible debt structuring is limited to a maximum of 260bps according the analysed scenarios.

Attractive returns for long term investors: Sri Lanka's interest rates rarely move beyond 20%. The last time it was witnessed was in the period of 2008-09 where Sri Lanka went through another Balance of Payments crisis. Despite the local debt restructuring risk it can be noted that after eliminating the potential loss in yields, the current market & auction yields could be identified as one of the most attractive yields in the recent past. We recommend long term investors to BUY into the market to take advantage of the current attractive yields.

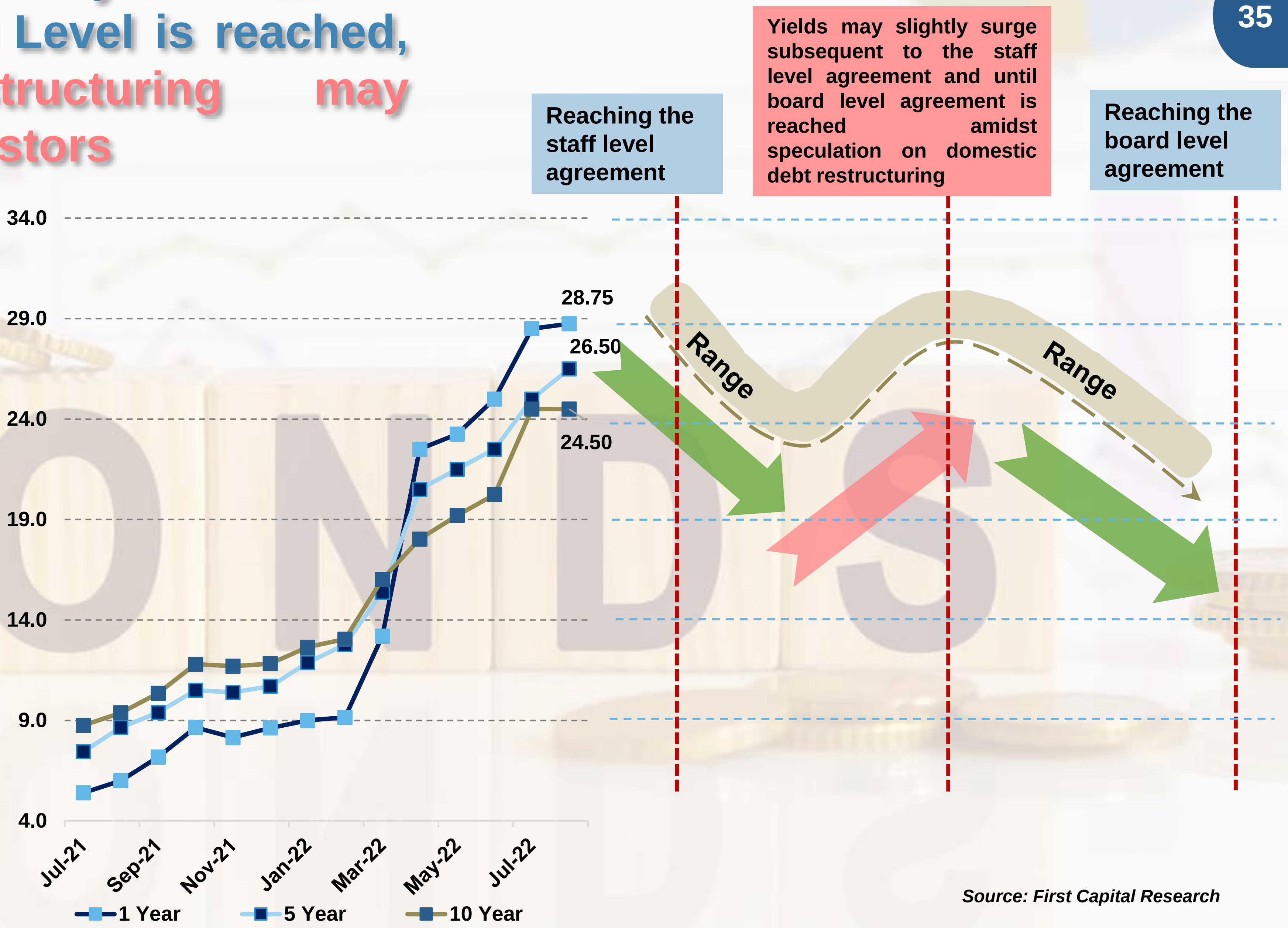
Avoid Shorter Tenor Maturities: The impact of local debt restructuring seems to be severe on shorter maturities as illustrated in Slide 23. The impact could be anything in between 2-12%. We recommend investors avoid shorter tenor maturities up to the belly end of the curve

Short term View: Bond yields to be volatile until IMF Board Level is reached, possible debt restructuring may continuously haunt investors

As a result of persistent instability on the political front and uprise in civil unrest, key economic indicators; Inflation, exchange rate and foreign reserves registered a significant deterioration in 2Q2022 while T- bills and bond yields joined the bandwagon. This was broadly in line with our worse case scenario where we expected yields to further rise in 2Q2022 in the event of a political deadlock accompanied with a policy rate hike.

FCR is of the view that yields are likely to witness a slight dip towards Sep-22 on successful progression that may be made on reaching the staff level agreement. However, subsequently there can be volatility in yields until a board level agreement is reached.

Ensuring debt sustainability is likely to improve the outlook for Sri Lanka resulting in a moderation in bond yields by Dec-22.



Source: First Capital Research

Broader View: Bond yields to moderate by 4Q2022E

However, political stability and ability to secure an IMF agreement are key TRIGGER POINTS that will impact the market sentiment

Bond yields are expected to moderate in 4Q2022E and gradually witness a decline as political instability resolves and as Govt. secures an IMF Board Level agreement.

"

Time to get cautiously optimistic on Bonds

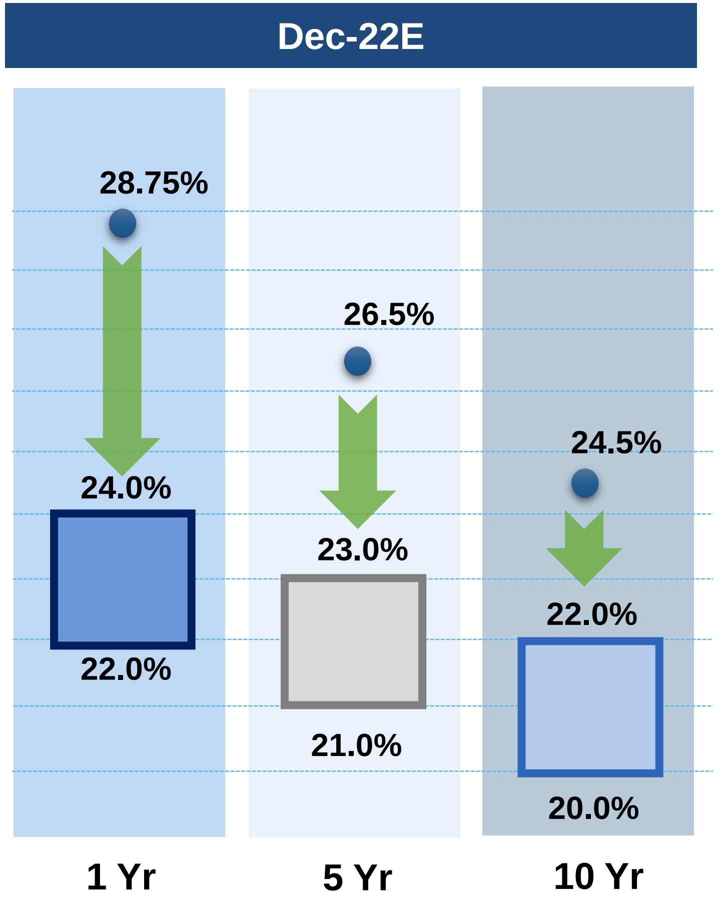
Considering the current scenario, we expect outlook for Sri Lanka to improve by 4Q2022E. Consequently, in light of gradual improvement in economic conditions, yields are expected to moderate depending on the timing of developments that reduce the uncertainty.

"

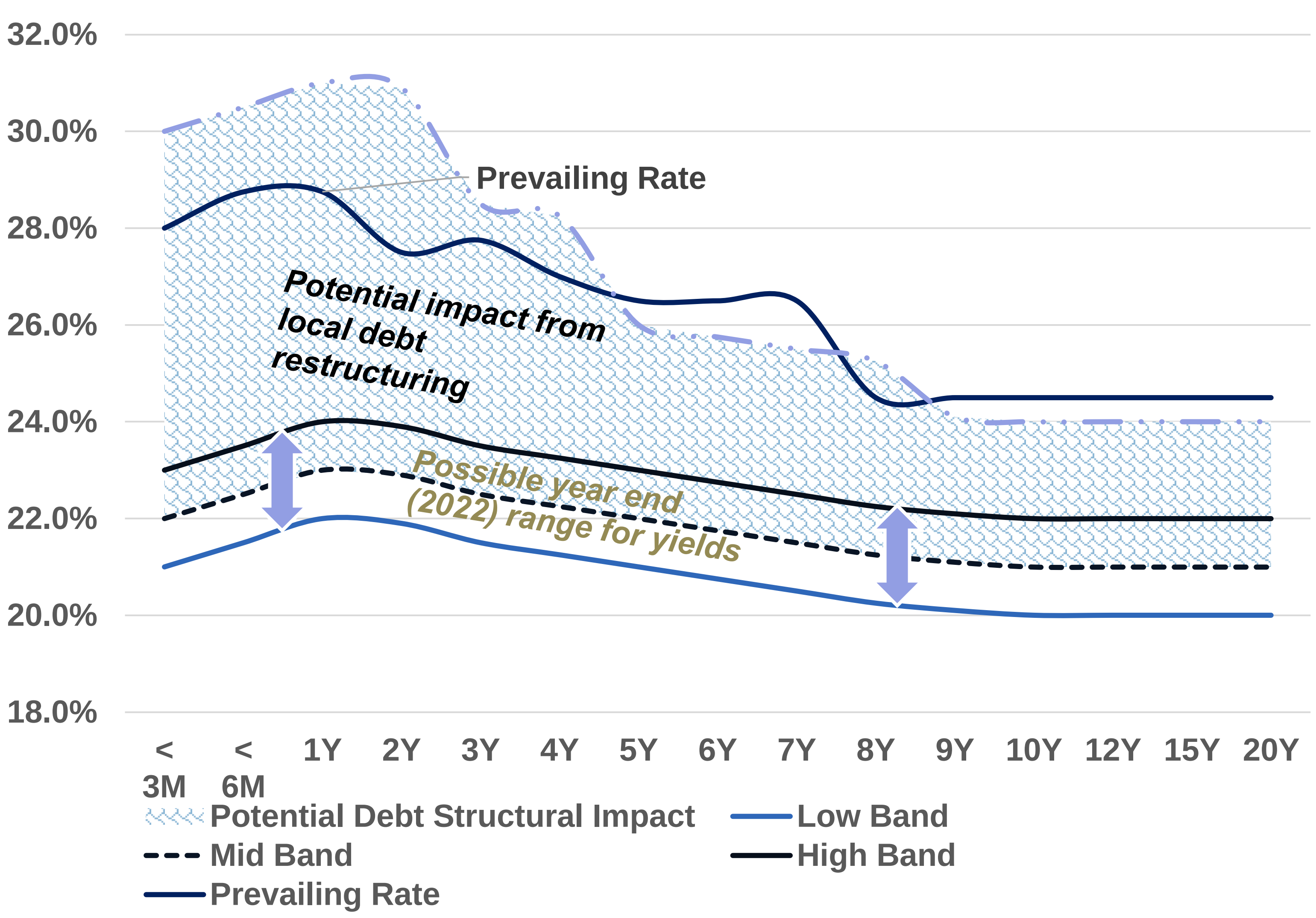
Scenario 02 broadly maintained

Yields are expected to moderate by end 4Q2022E

FCR maintain the view of moderate yields by end 4Q2022E as political instability is resolved under the newly appointed government, clarity on debt restructuring is improved and with govt's ability to secure an IMF agreement.



Selected maturities remain attractive even beyond the worst debt restructuring



Safer to Buy into Mid-Long tenors

As per Slide 37, the potential yield curve bands targeted for Dec-22E are drawn at the bottom of the chart. In the shaded (light blue) area, First Capital Research has estimated the most probable impact, if there is any local debt restructuring.

Accordingly, as long as the yields trade above the shaded area, we believe it is safer to BUY into Bonds.

*Therefore, we would like to **<u>recommend investors to buy Bonds with tenors of 5-Year and above</u>** which could be classified as Mid-Long tenor maturities. However, you may want to avoid the 8Yr due to its lower yield.*

Disclaimer

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Thank You

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Contact Us

First Capital Holdings PLC
No: 02, Deal Place,
Colombo 00300,
Sri Lanka.
E: research@firstcapital.lk

Dimantha Mathew
Head of Research
T: +94 11 2639 853
E:dimantha@firstcapital.lk

Hiruni Perera
Assistant Manager- Research
T: +94 11 2639 864
E: hiruni@firstcapital.lk

Ranjan Ranatunga
Assistant Manager- Research
T: +94 11 2639 863
E: ranjan@firstcapital.lk

Vidushika Perera
Assistant Manager- Research
T: +94 11 2639 865
E: vidushika@firstcapital.lk

Tharusha Ashokgar
Research Analyst
T: +94 11 2639 866
E: tharushaash@firstcapital.lk

Zaeema Jihan
Research Analyst
T: +94 11 2639 868
E: zaheema@firstcapital.lk