



The Lankan Resurgence

Mid-Year Outlook 2022 | Sep 2022 | SRI LANKA

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First Capital
A Janashakthi Group Company

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EXECUTIVE SUMMARY



Time to get cautiously optimistic on Bonds

- 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. However, political stability and ability to enter an IMF support facility are key TRIGGER POINTS that will impact the market sentiment. In light of gradual improvement in economic conditions, yields are expected to moderate depending on the timing of developments that reduce the uncertainty.

AWPR to reverse downwards in 1H2023E

- We expect AWPR to follow the yield of 5Yr bond thus hover in the range of 25.0%-30.0% by Dec-22 and reverse towards 21.0%-23.0% towards Jun-23 and further dip to 16.0%-18.0% by Dec-23.

Exchange Rate is likely to be stable throughout 2022E & 2023E with possible marginal depreciation amidst trade relaxation

- Following IMF Staff level agreement, we expect foreign inflows into the country. However, CBSL is likely to use the opportunity to buy USD to build reserves while trade relaxation may result in the currency marginally weakening over 2H2023E.

ASPI to reach 12,000 by Dec-23E

- On expectation of a strong recovery in earnings and positive growth levels of GDP returning from 4Q2023 and beyond, is likely create a strong bullish sentiment for equities. We expect market to re-rate allowing the index to showcase strong positive returns in 2H2023E with the index likely to reach 12,000.

The background of the slide features a close-up of several gold bars. One bar in the foreground is clearly marked with "NMR MELTER ASSAYER", "G00023", and "100 FINE G 999". Another bar above it has "GLOBAL INTER" visible. A small globe icon is also present in the background. A white horizontal bar with a blue top edge is positioned across the middle of the slide, containing the main title. A dark grey horizontal bar is located below the white bar, containing the section title.

Track Record [Sep 2021 & Jan 2022]

Section 1.0

First Capital Levels of Accuracy

- 81% - 100% accuracy - Accurate
- 61% - 80% accuracy - Mostly Accurate
- 41% - 60% accuracy - Partly Accurate
- 20% - 40% accuracy - Weak Accuracy
- 00% - 20% accuracy - Inaccurate

Previous Recommendations - Bonds

08th Sep 2021 [Mid-Year Outlook 2021 Report]

“Bond Yields to rise sharply by a further 150-200bps within the period 3Q2021 - 2Q2022”

Mostly Accurate

Speed of rise in yields was **even sharper** than our expectations

24th Jan 2022 [Investment Strategy 2022 Report]

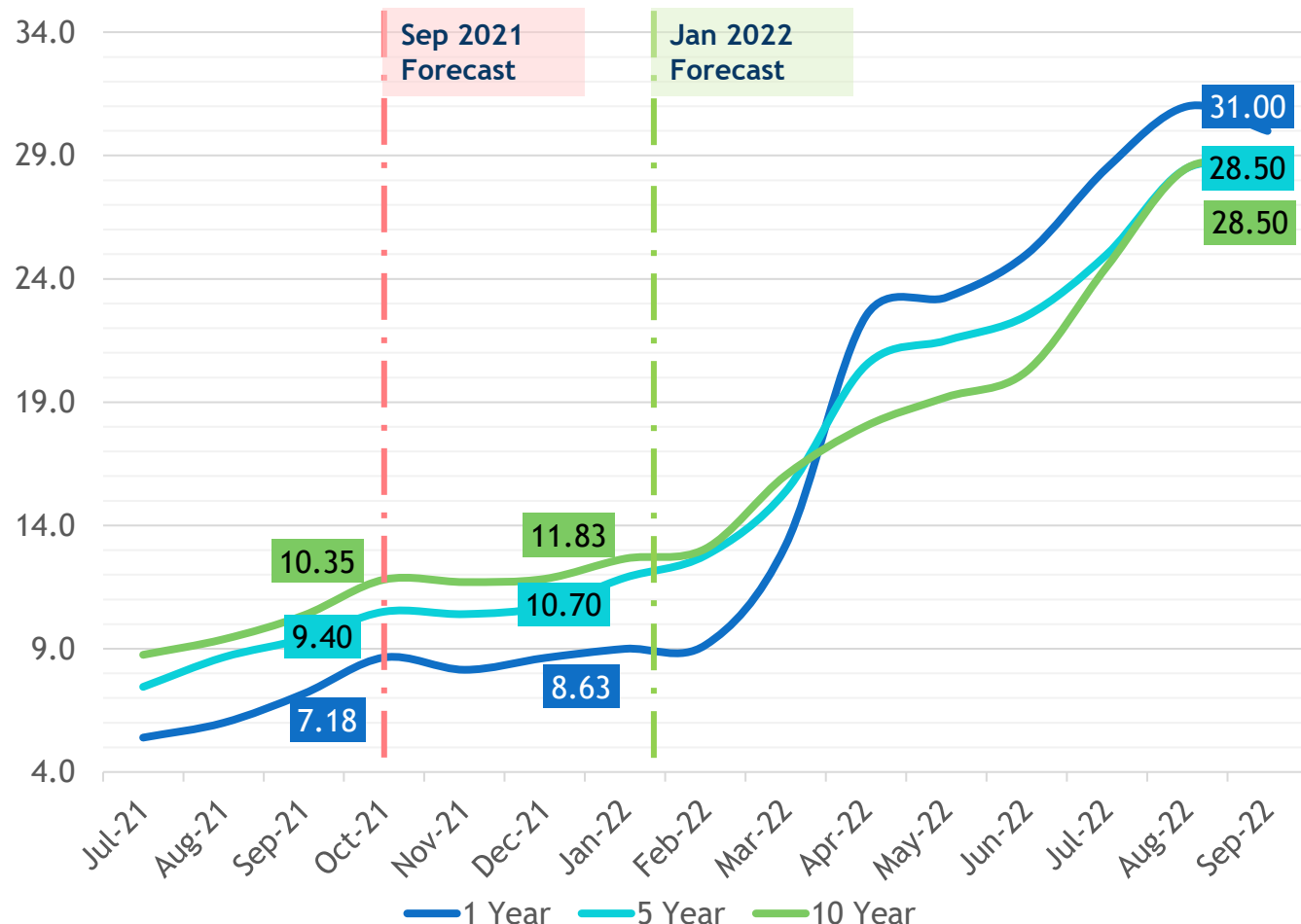
“1H yields to rise by 150bps-200bps and in 2H a further 100bps-150bps; But with no IMF or inflows yields could just skyrocket”

Mostly Accurate

Yields rise **beyond our worse case scenario** amidst political turmoil

Bonds – Sep-21 & Jan-22 Re cap: Mostly Accurate

1H yields to rise by 150bps-200bps and in 2H a further 100bps-150bps; But with no IMF or inflows yields could just skyrocket



Source: CBSL, First Capital Research

YTD 245 bps ↑
YTD 205 bps ↑
YTD 263 bps ↑
4 Months 2021
Sep - Dec

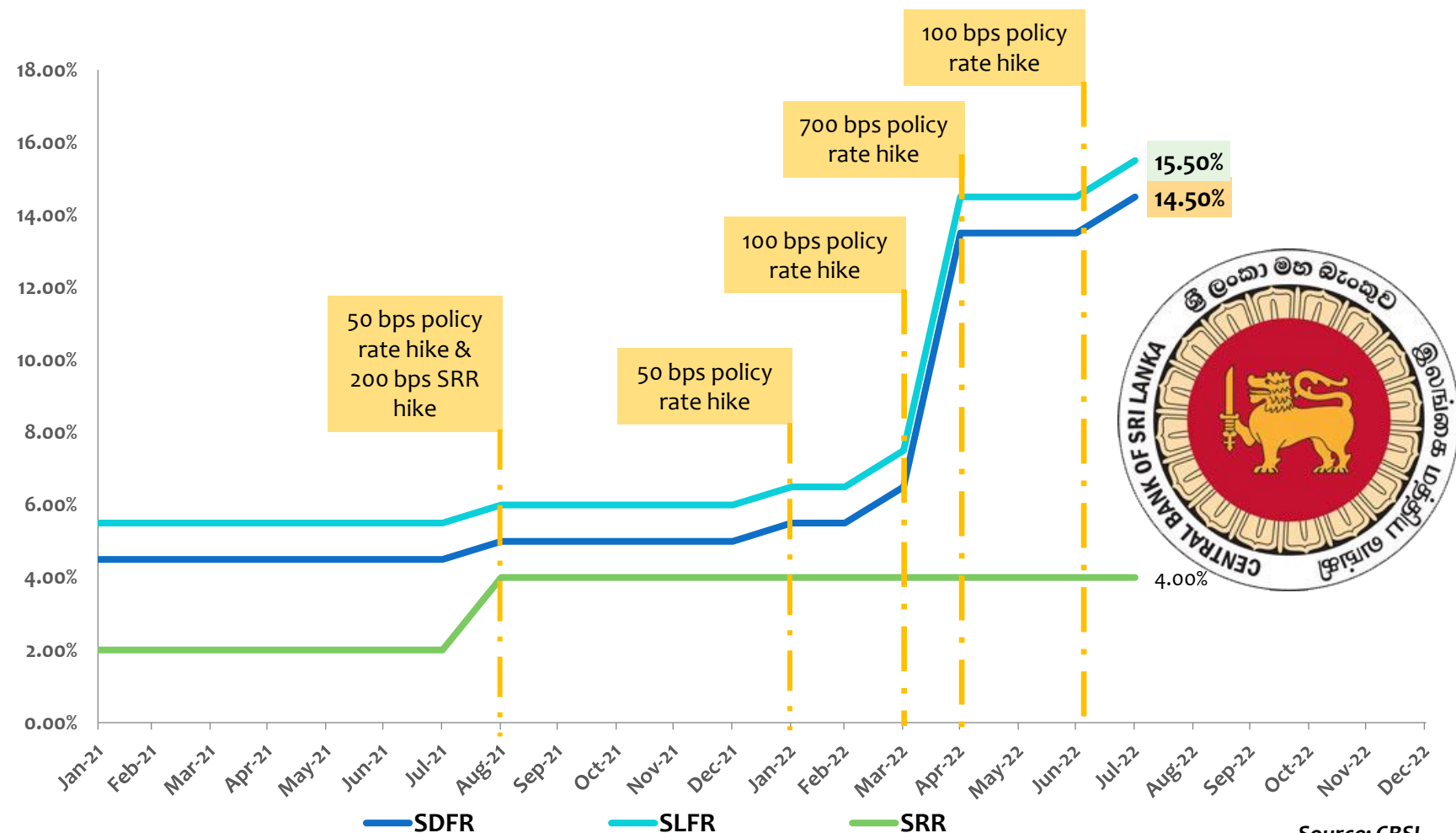
YTD 1185 bps ↑
YTD 1462 bps ↑
YTD 1975 bps ↑
8 Months 2022
Jan - Aug

Policy Rates – Sep-21, Jan-22 & Revised Apr-22 Re cap: Partly Accurate

2 policy rate hikes in 2H2021; 3 rate hikes in 2022

Policy hikes overshoot expectations

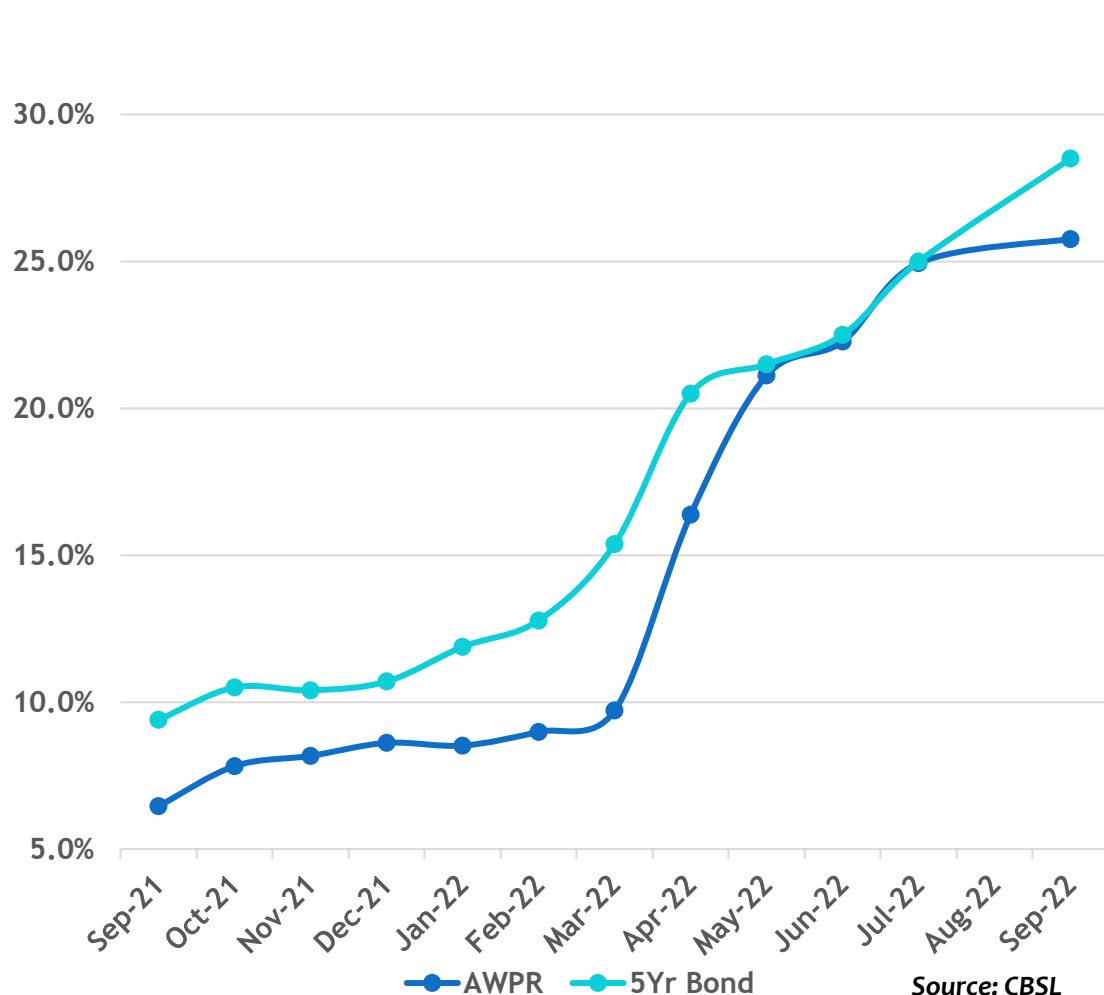
Though we have been most accurate in the number of hikes (5) so far, the expectation (Sep-21, Jan-22 & revised Apr-22) was for around 450bps (100bps in 2021, 350bps 2022), but we have so far witnessed policy rate increase of 1,000bps. However, we renewed our forecast with the change of the Governor ahead of the individual policy meetings which have been proved to be accurate.



Source: CBSL

Bank Rates – Sep-21, Jan-22 & Revised Apr-22 Re cap: Mostly Accurate

AWPR to follow a similar suit with a similar accelerated pace as witnessed in 2H2021



Sep 2021
Expectation

We expect AWPR to rise to a range of 6.0%-6.5% by Dec-2021 and further move towards 7.5%-9.0% by Jun-2022

Mostly Accurate

Target Accurate but 6 months ahead with steep movement in bonds

Jan 2022
Expectation

We expect AWPR to follow a similar suit with a similar accelerated pace as witnessed in 2H2021 to reach 10.0%-11.0% by Jun-22 and 11.0%-12.5% by Dec-22

Mostly Accurate

AWPR moved exactly in line with 5-Yr Bond, but as bond yields overshot expectations AWPR also moved beyond expectations

Apr 2022
Expectation

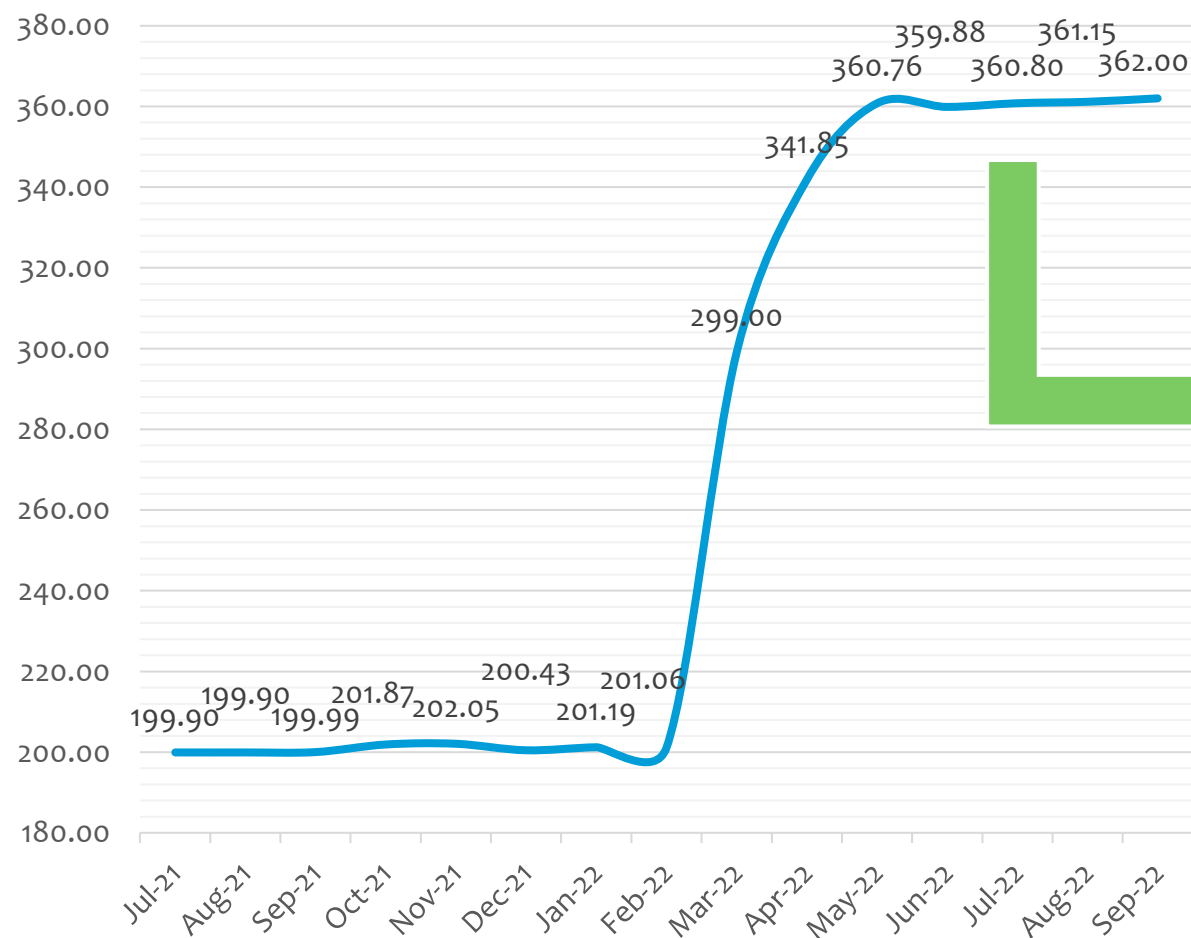
We expect AWPR to follow a similar suit with an accelerated pace and to reach 16.0%-18.0% by Jun-22

Mostly Accurate

AWPR moved exactly in line with 5-Yr Bond, but as bond yields overshot expectations AWPR also moved beyond expectations

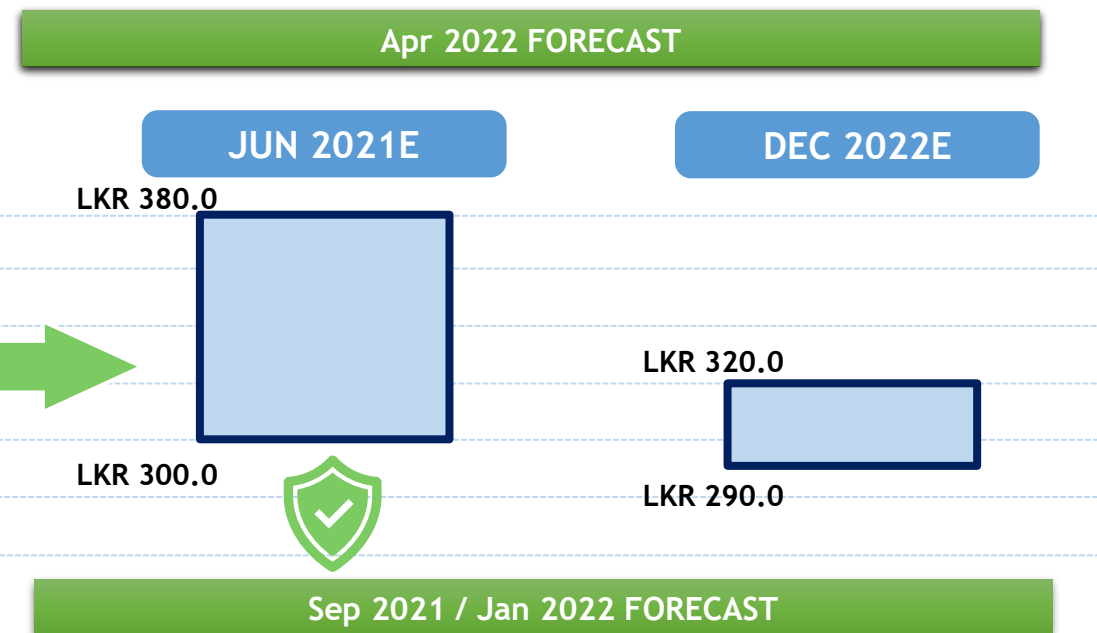
Exchange Rate – Sep-22, Jan-22 & Revised Apr-22 Re cap: Partly Accurate

Currency may experience heavy depreciation if floated



Source: CBSL

Previous Recommendations



Sep 2021: Exchange rate target for Dec-2021 downgraded to LKR 218.0-224.0

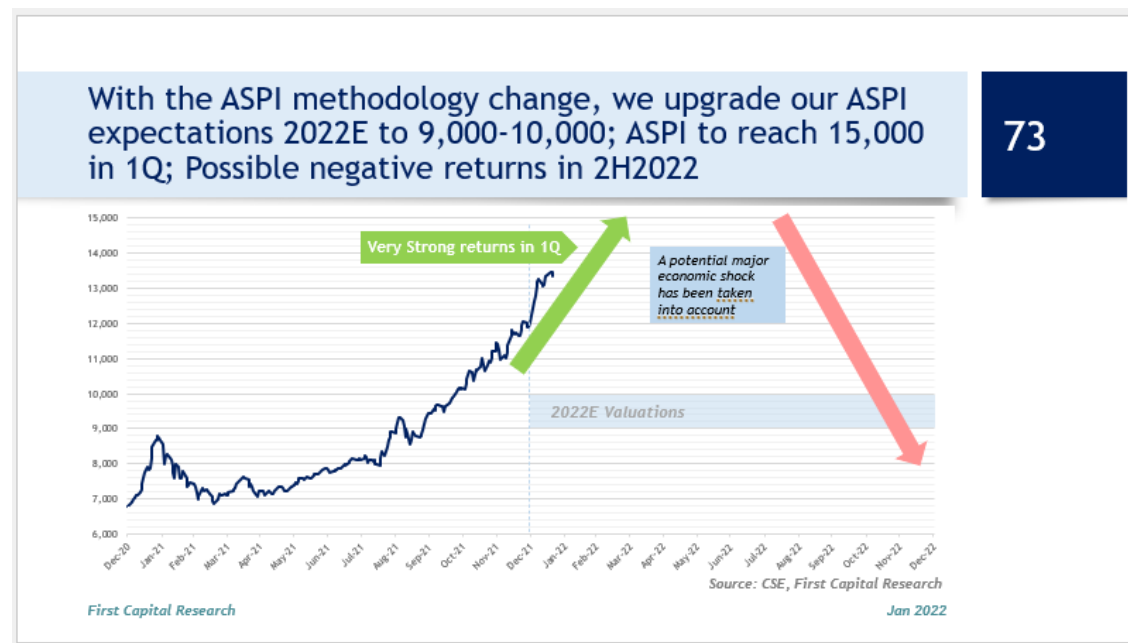
Jan 2022: We further downgrade our Jun-22 target from LKR 225.0-240.0 to LKR 230-245.0 while targeting LKR 240.0-270.0 for the Dec-22

Sep 2021 - Mar 2022 CBSL controlled between LKR 197.0 - LKR 203.0

Equity – Sep-22, Jan-22 & Revised Jun-22 Re cap: Accurate

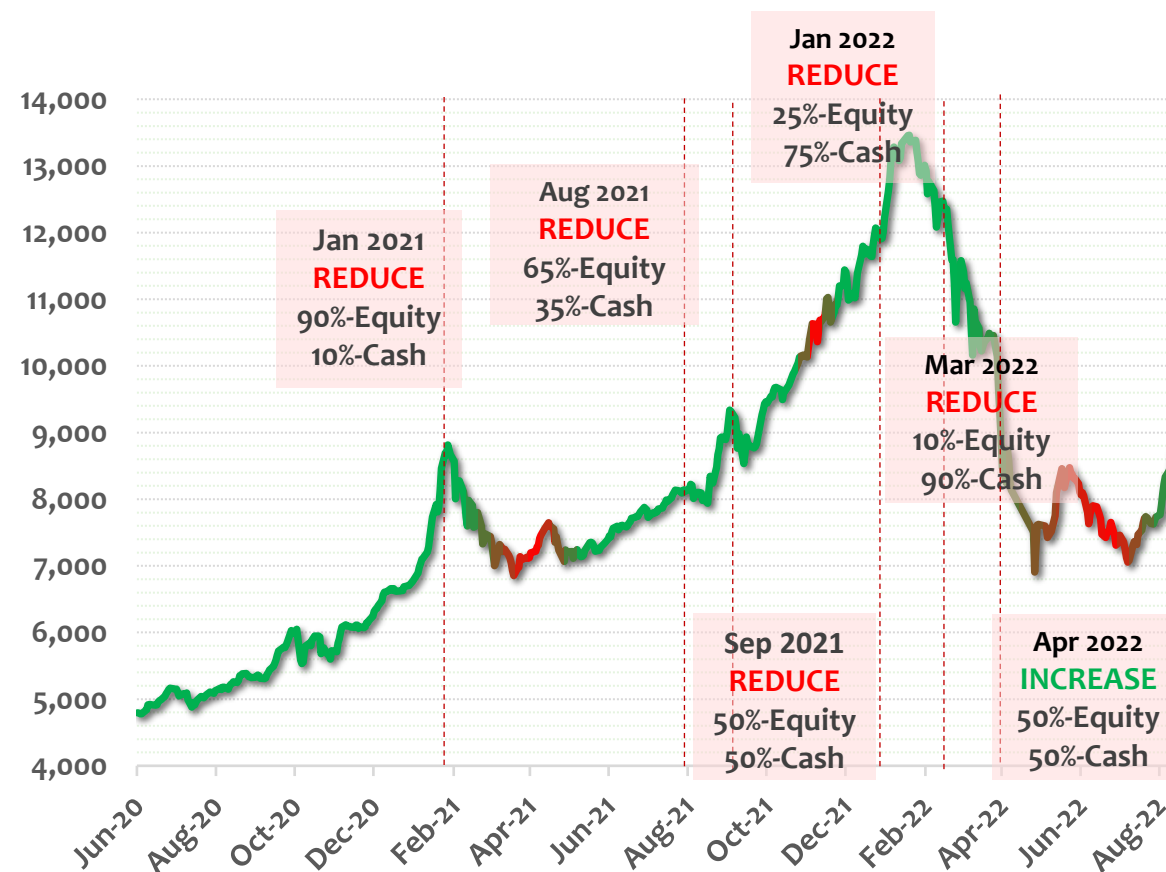
Reduce Equity Allocation by 75% (Jan-22), 90% (Mar-22) & increase to 50% in Apr-22; Possible negative returns in 2H2022

Jan 2022 Expectations



ASPI reverses to the red around 13,500; Negative returns were recorded 6 months ahead of expectations

Equity allocation accurately decreased to reach 10% by Mar-22, again increased in Apr-22



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Key Elements of consideration

for Mid-Year Outlook 2022

Section 2.0

Hope & Opportunity

Sri Lanka's economy has hit an all-time low with the major struggle for essentials such as fuel, electricity and food.

Following the protests, the country went through a change of Government and discussions with the IMF becomes the key turning point for Sri Lanka.

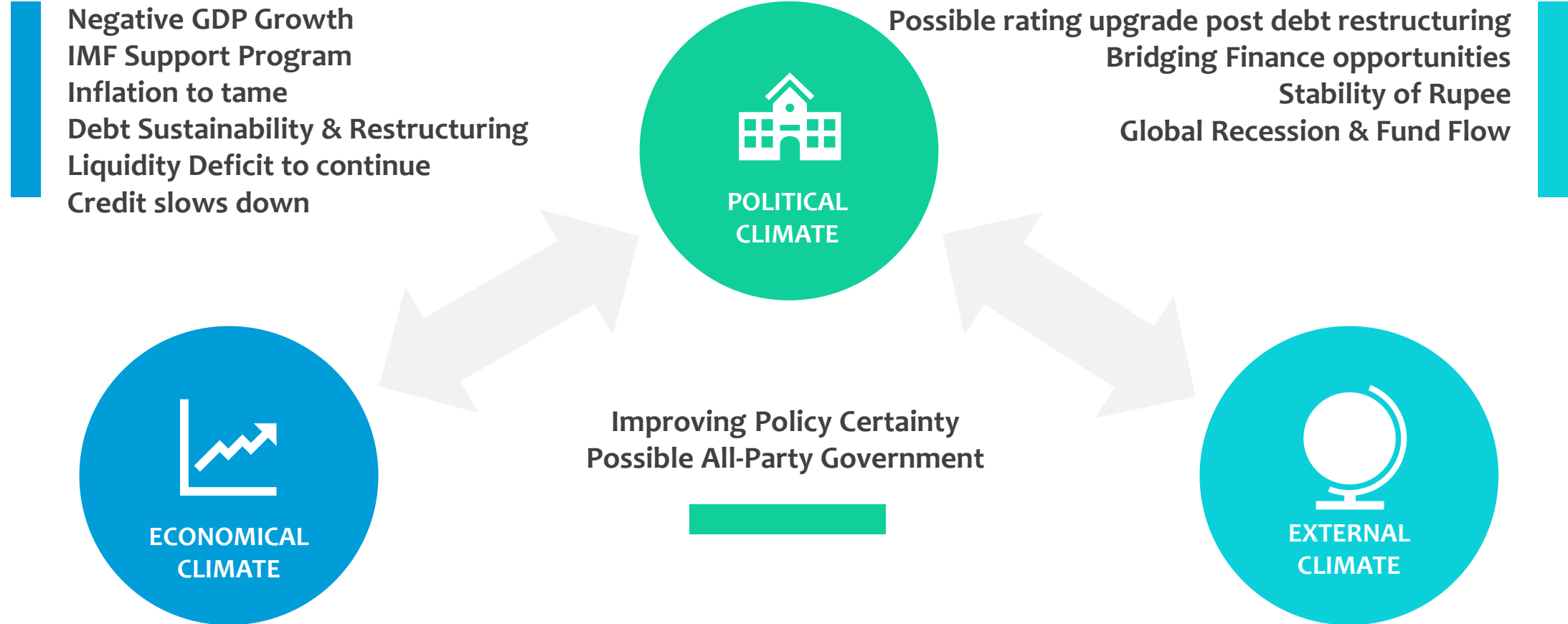
First Capital believes that the country is at a tipping point where the situation is expected to gradually improve over the next 6-12 months giving rise to a massive opportunity for investors.

With lives normalizing and possible IMF staff level agreement is likely to be a start of a brand-new recovery for the country, thereby we expect a **RESURGENCE IN THE ECONOMY** providing hope and opportunity!!!



The Lankan Resurgence

Key Elements





Elections may dilute political stability

Downgraded to **Medium-High Risk** (from Medium-Low Risk)

Section 3.0

Months of protests give rise to the appointment of a New President...



...creating Political & Policy Stability a priority

- With President Gotabaya Rajapaksha resigning following massive protests in Jul 2022, Mr. Ranil Wickramasinghe was appointed President by Parliamentary vote.
- The introduction of the QR code based National Fuel pass system managed to reduce fuel queues in the country while the Gas distribution was normalized. Strong rains improved hydro power generation reducing daily power cuts.
- The appointment of a New President and the subsequent improvement in essential services resulted in calming down the protests in the country.
- Temporary political and policy stability has been achieved despite tough living conditions.



No elections for at least 6 months!!! Possible All-Party Government



With the economic conditions and IMF discussions, most political parties are not willing to go for an election. But opposition is of the view that the Government should stay in power for a short period of time until the essential services are stabilized in the country.

It is estimated to take about 6-12 months to achieve the state of stability following which elections should be held according to the opinion of most political parties. Thereby **elections are unlikely over the next 6 months.**

Discussions are currently being held with the President to achieve a consensus plan and form All-Party Government or working framework.

An **All-Party Government may improve the policy stability significantly reducing overall risk.**

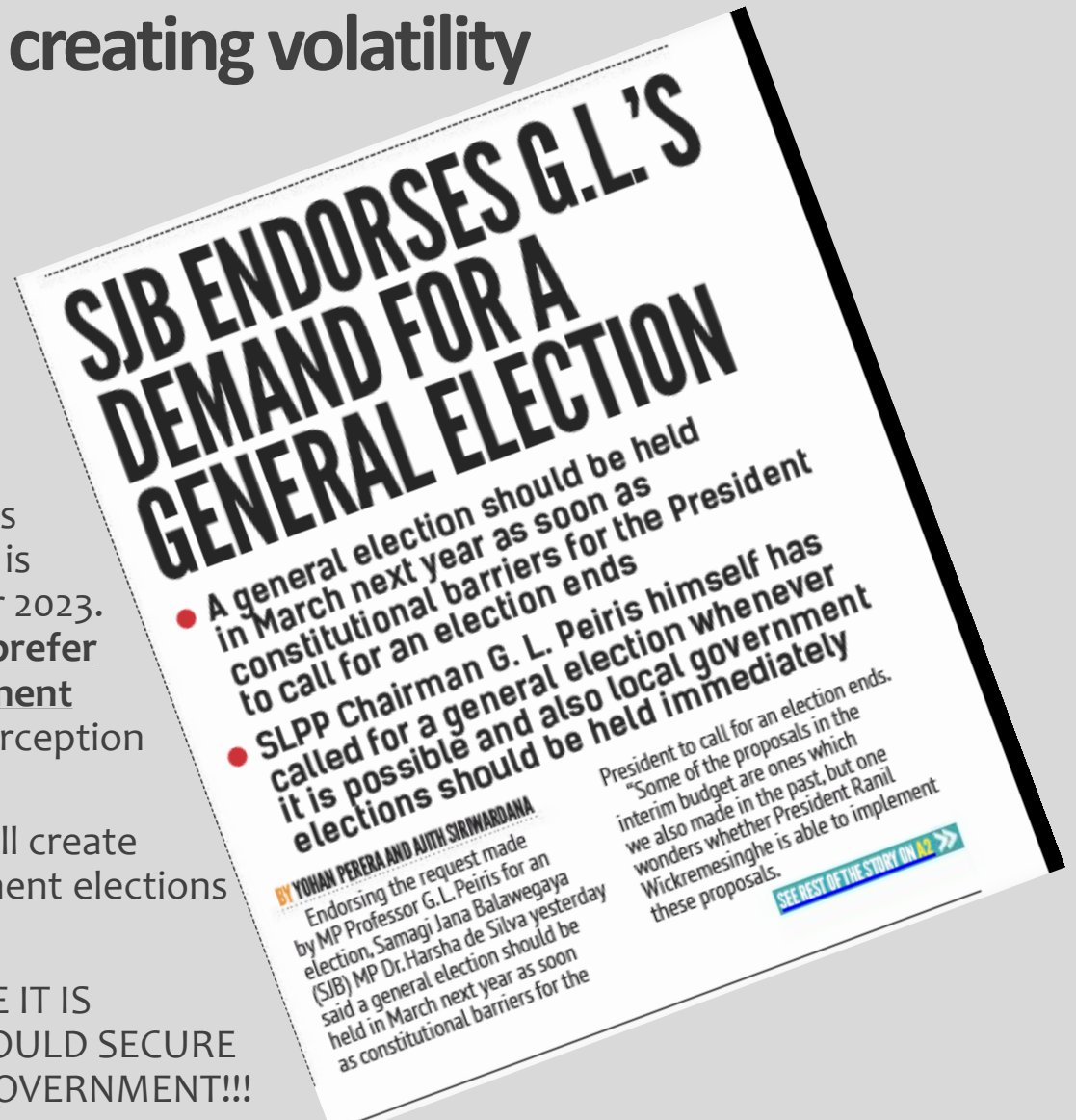
But elections are unavoidable in 1H2023E creating volatility

What Does 2023 hold?

Local Government Elections or General Elections



- First Capital in Jan 2022 (Investments Strategy) accurately predicted that local government elections supposed to be held in Feb 2022 are likely to be postponed by 1 Year.
- Legally the local Government elections cannot be postponed any further and is announced to be held before 20th Mar 2023. **The Government and President may prefer General Elections over Local Government elections** as any election may have perception bearing on the other.
- If General Elections are held first, it will create necessary trend for the local government elections as well.
- HOWEVER, IN THE CURRENT CLIMATE IT IS DOUBTFUL WHETHER ANY PARTY WOULD SECURE SUFFICIENT MAJORITY TO FORM A GOVERNMENT!!!



Political Outlook: Downgraded to *Medium-High Risk*



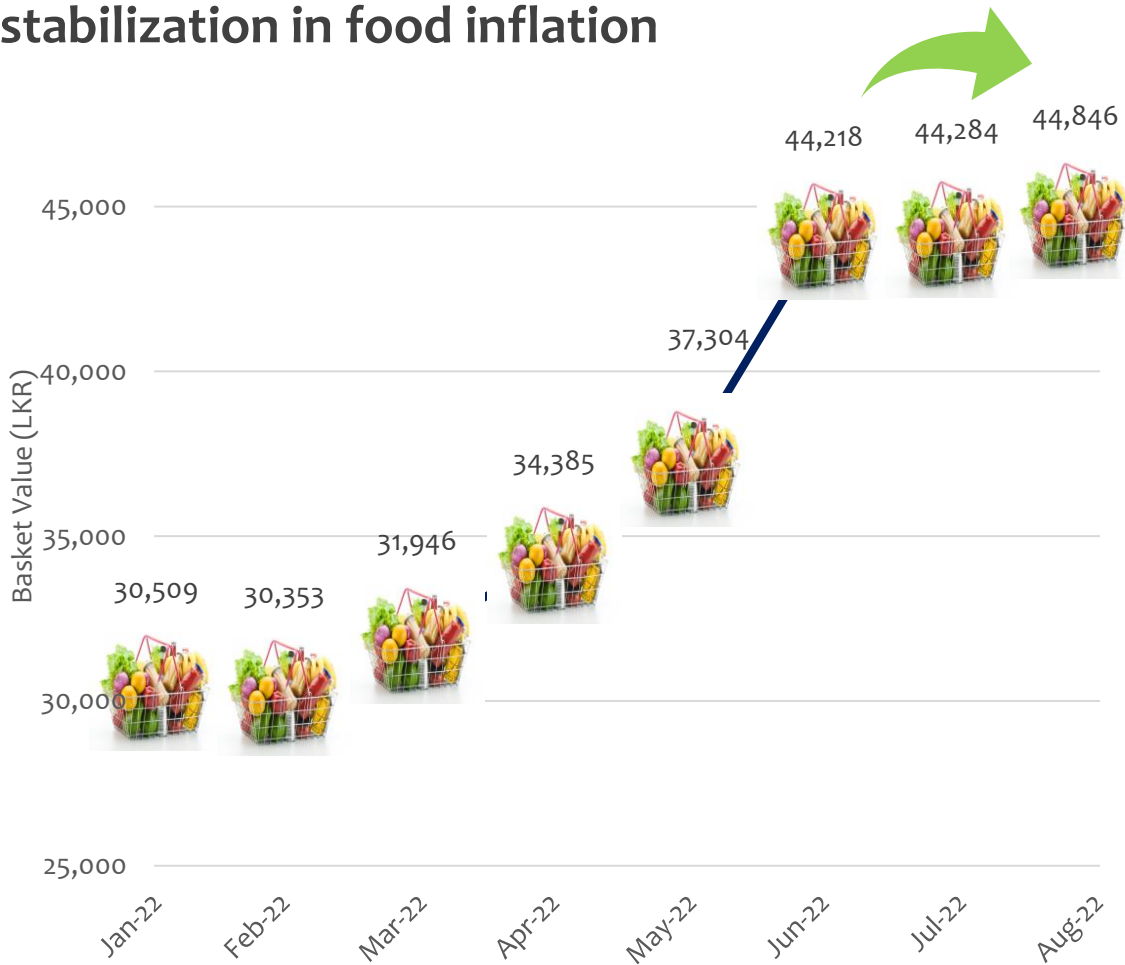
Economy on slow recovery mode

Upgraded to **Medium-High** (from High Risk)

Section 4.0

Food Inflation cools down; But non-food gets an electric shock...

First Capital Food Basket indicated signs of stabilization in food inflation



Source: Dept. Census and Statistics

Electricity prices increased steeply impacting non-food segment (effective from 10th Aug)



Domestic Purpose

	Proposed average tariff (LKR/kWh)	Proposed % Increase - CEB	Average monthly bill CEB proposed (LKR)	Approved average tariff (LKR/kWh)	Approved % Increase	Average monthly bill approved (LKR)
0-30	52.30	835%	508	20.36	264%	198
31-60	35.55	673%	1,488	14.30	211%	599
61-90	35.44	276%	2,439	21.23	125%	1,461
91-120	34.93	126%	3,546	29.31	89%	2,976
121-180	35.52	81%	5,048	35.22	79%	5,005

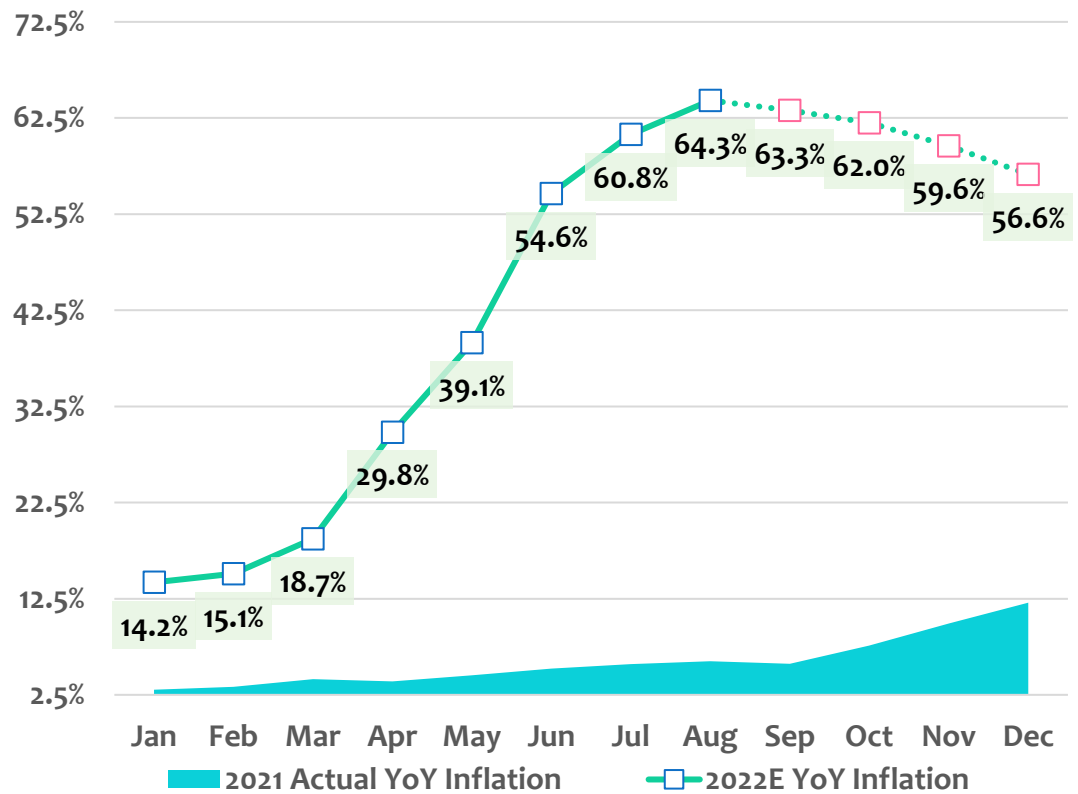
Source: PUCSL

Daily7 GraphicsDesk

However, First Capital expects Inflation to cool off beyond Aug-22

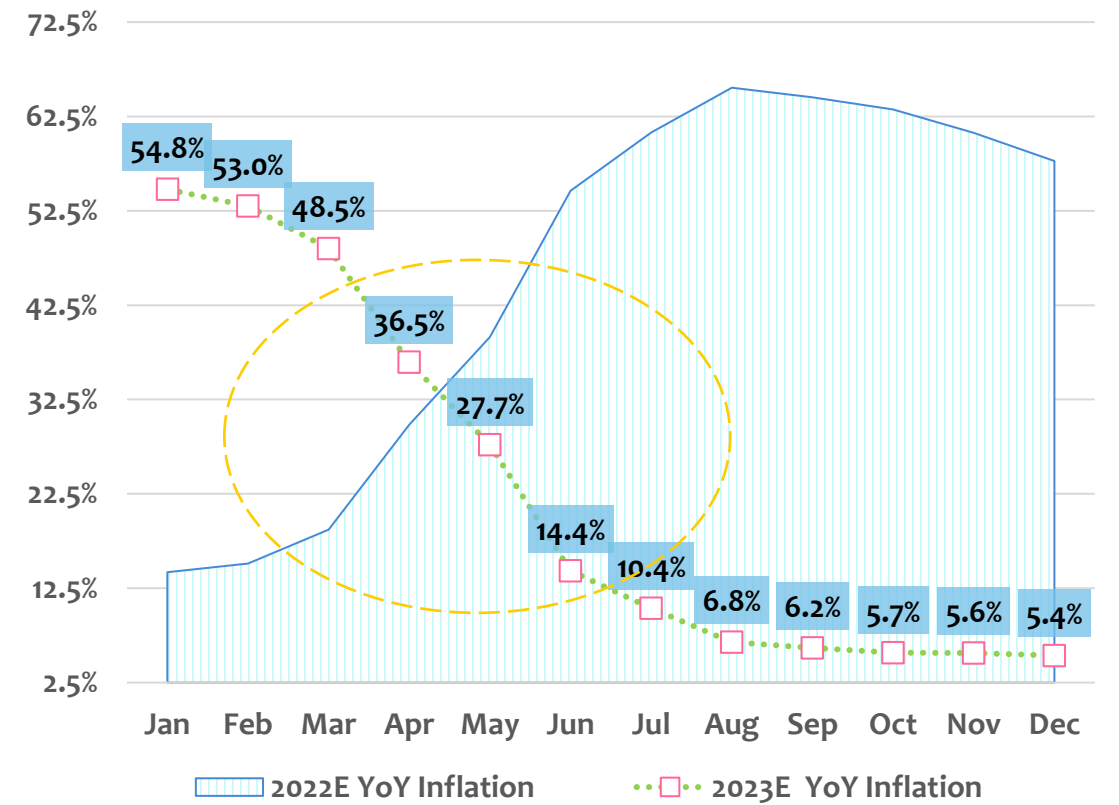
Steep dip in inflation is expected in 2Q2023 amidst the higher base effect on inflation

FCR Inflation forecast only dips marginally during the rest of 2022



Source: Dept. Census and Statistics

FCR 2023 forecast illustrates a sharp dip in inflation towards 2Q2023



Source: Dept. Census and Statistics

“Hyper Inflation and
plunge in private sector
consumption gives rise to
negative GDP growth”



First Capital expects worse than anticipated real GDP growth levels for the current 2 Years

First Capital was the first research units (in Jan 2022) to forecast negative GDP growth for 2022 and continues to be pessimistic

2021

+3.3%

Recovery in GDP post Covid-19, in line with our expectations of 3.2% (Jan 2021 Investment Strategy 2021)

2022E

$$(-9.0\%) - (-12.0\%)$$

Downgrade from Jan 2022 expectations range of +0.5% - (-1.6%)

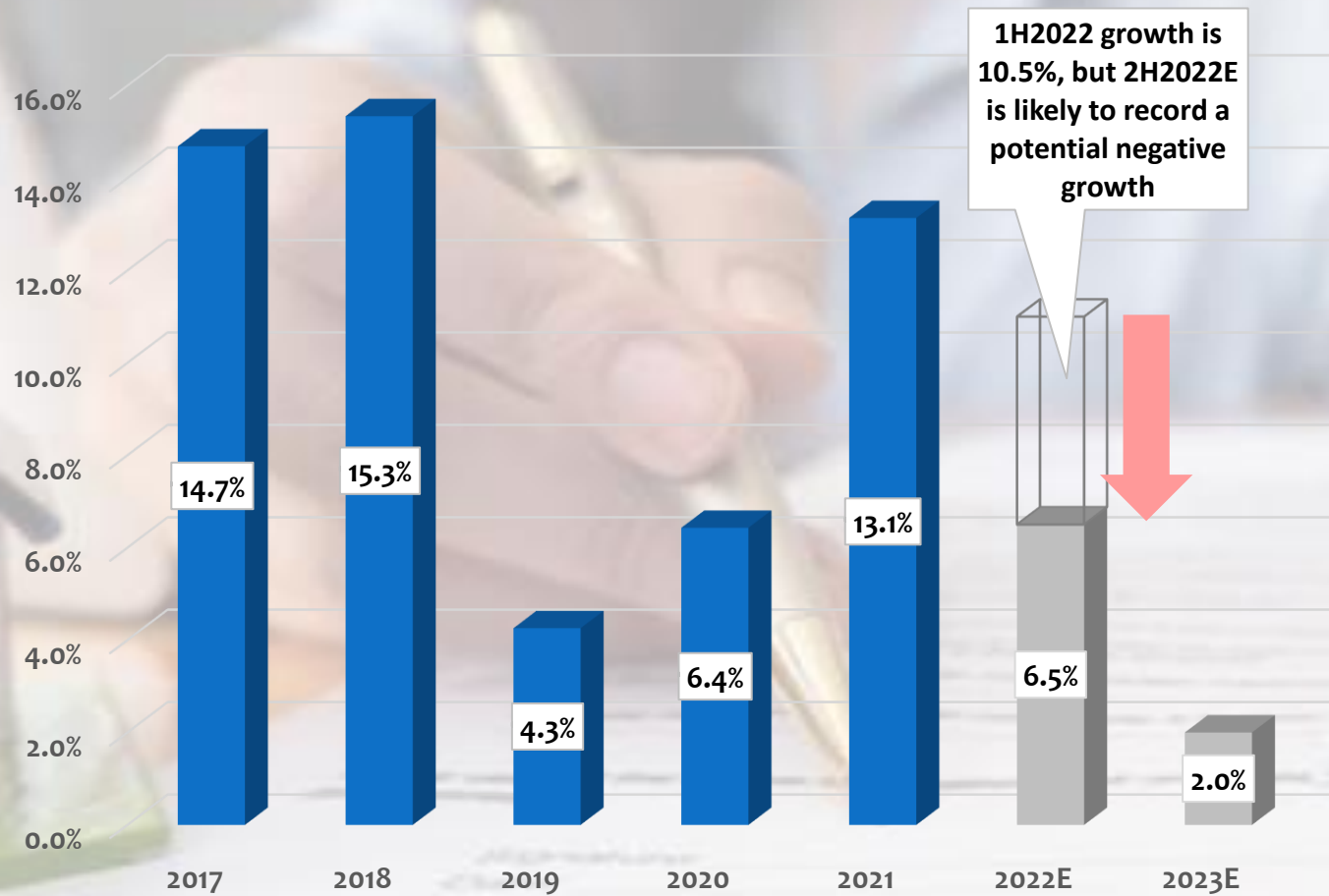
2023E

$$(-4.0\%) - (-6.0\%)$$

Downgrade from Jan 2022 expectations range of
+2.0% - (+2.5%)

Economic contraction may lead to a credit contraction in 2H2022E

Despite the inflationary effects stemming from the LKR depreciation



Source: CBSL, First Capital Research Estimates



Private sector credit for the 1H2022 registered a growth of 10.5% (LKR 732.5Bn) stemming from the inflationary impact of the currency depreciation. However, real credit growth is expected to be negative during 2H2022E netting off the higher credit growth as a result of sky rocketed AWPR and tightened credit conditions adopted by banks.



However, Govt's lack of revenue may result in continued money printing...

Govt. revenue as a % of GDP is expected to be low as a result of shrunk revenue

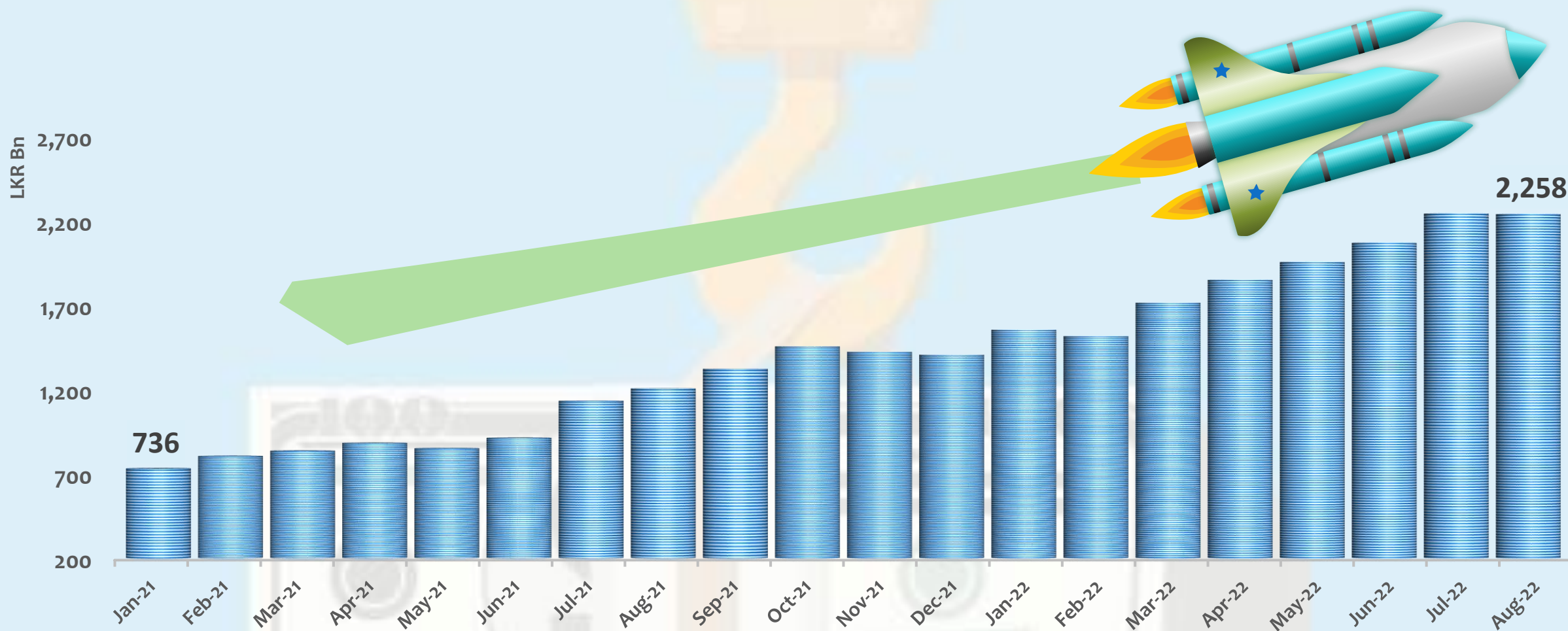
Government revenue in LKR and as a % of GDP



Source: CBSL, First Capital Research Estimates

...expanding CBSL Holdings as they find it difficult to borrow from auctions

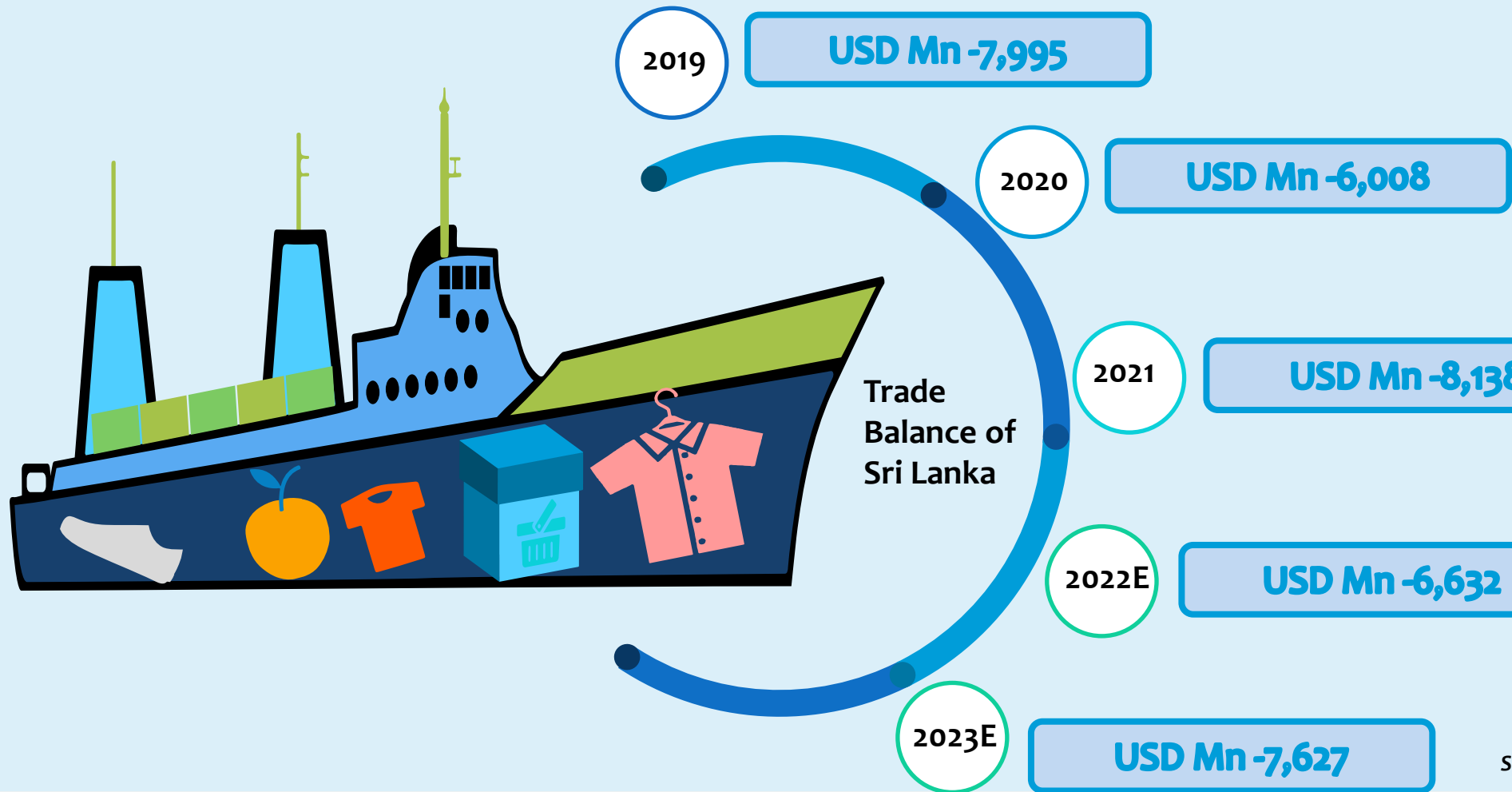
CBSL Holdings surged to LKR 2.3Tn recording the highest value in its history



Source: CBSL

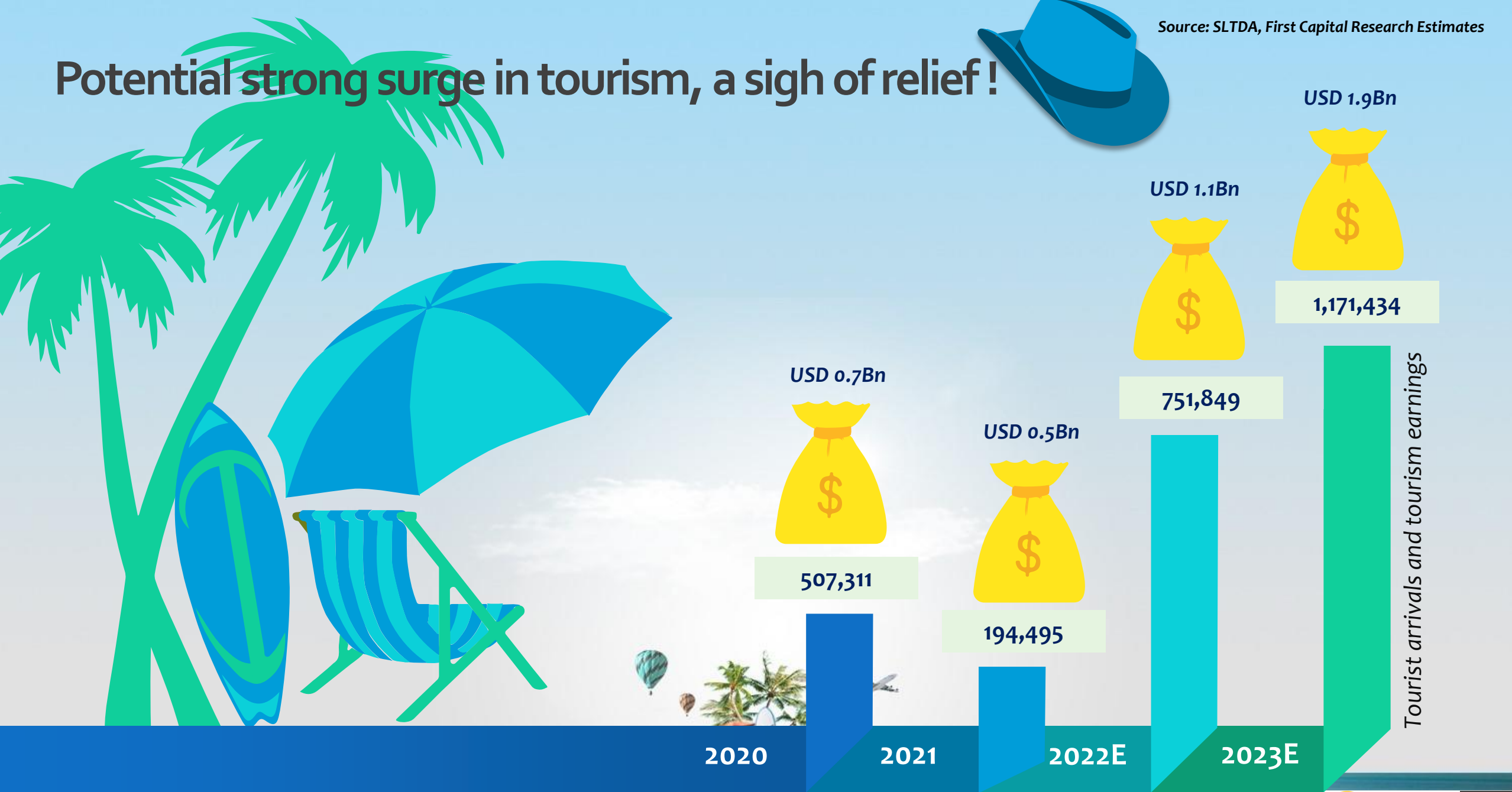
Trade Balance improves with Jun-22 turning positive on import restrictions & fuel quota system

Nevertheless, trade may turn negative with possible relaxation of import restrictions by mid-2023



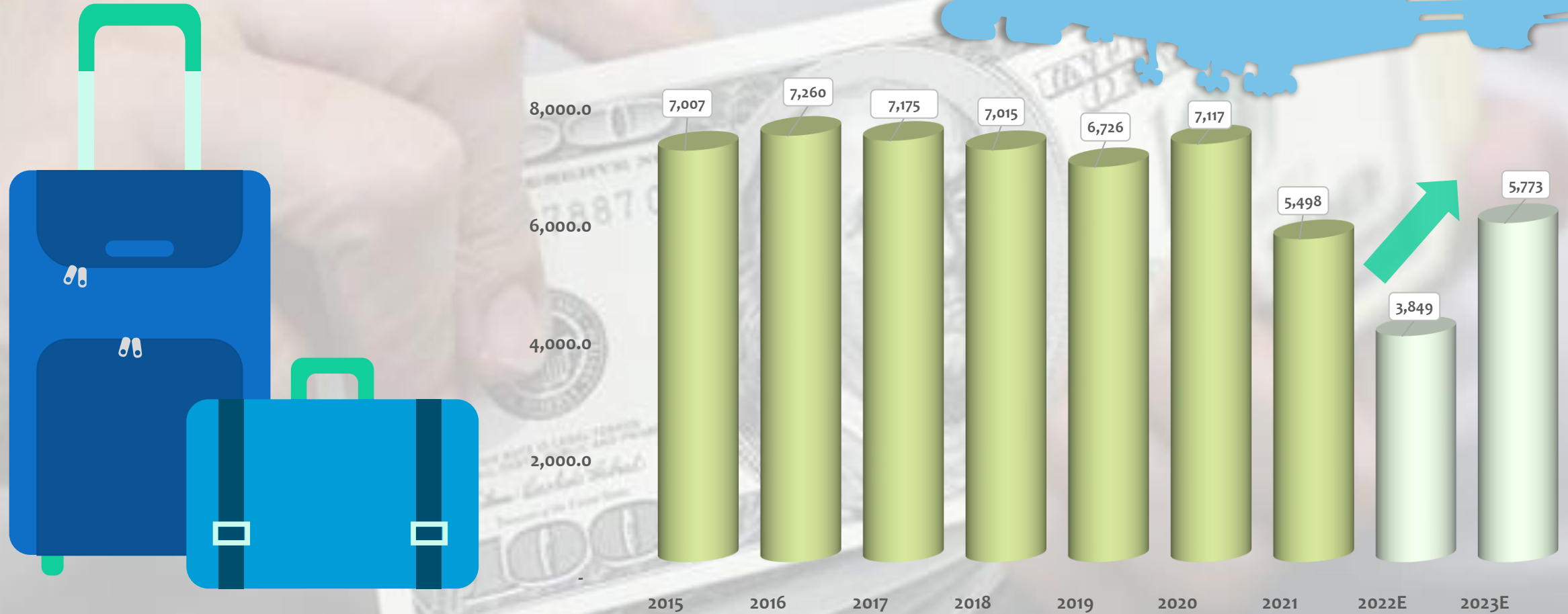
Source: CBSL, First Capital Research Estimates

Potential strong surge in tourism, a sigh of relief!



But recovery in worker remittances may maintain a slow uptrend

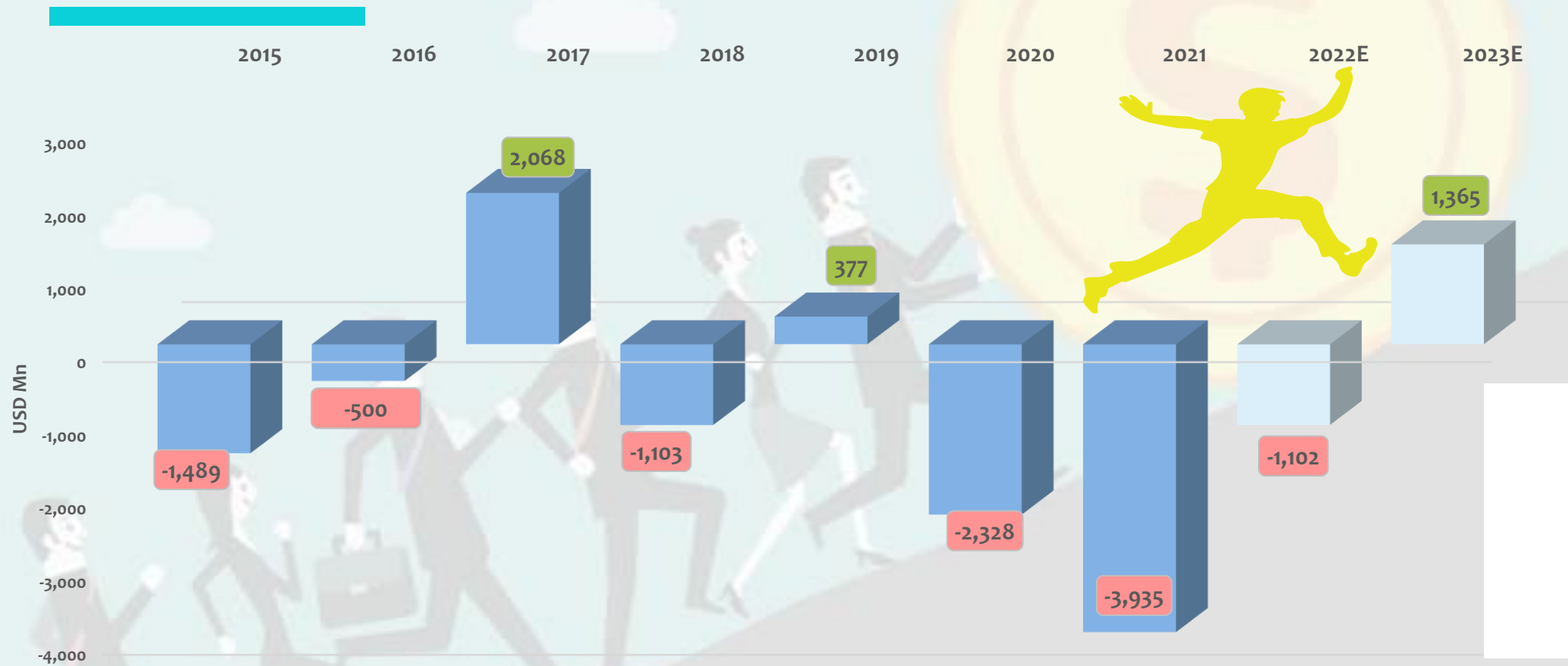
Worker remittances are expected to recover gradually from a 10Yr-low in 2022E amidst the resumed political stability and currency float



Source: CBSL, First Capital Research Estimates

Crisis strengthens the Balance of Payments position

BOP is expected to improve from 2022E onwards while estimating to register a surplus of USD 1.4Bn in 2023E supported by the strict import controls

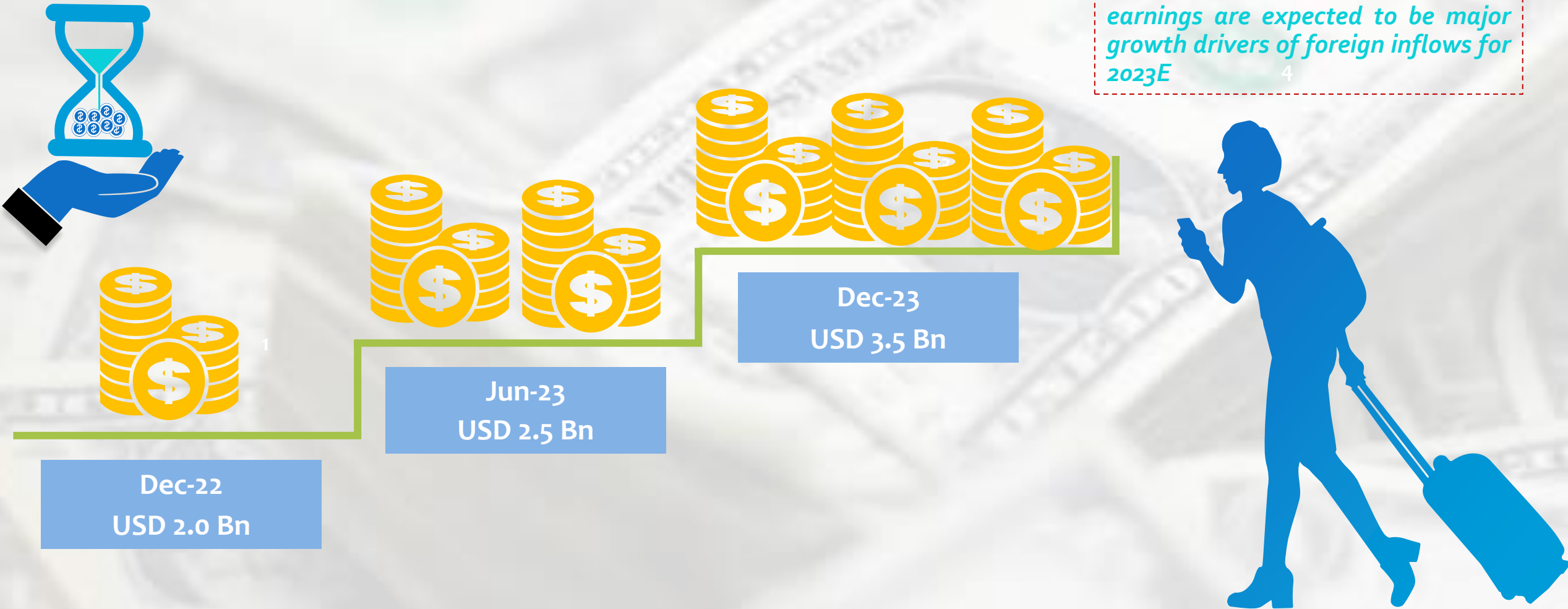


Source: CBSL, First Capital Research Estimates

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

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

4



Source: First Capital Research Estimates

...and potential financial assistance from IMF

IMF staff level
agreement

Sep-22



Receiving the 1st
tranche of IMF Funds

Jan-23



Receiving the 2nd
tranche

May-23



IMF Board level
agreement
Jan-23



Ensuring substantial
Debt sustainability
Feb-23



Sri Lanka reached a potential staff level agreement in Sep-22 and First Capital Research expects a Board level approval by Jan-23. However, receiving IMF funds is fundamentally dependent on Sri Lanka's ability to ensure debt sustainability.

Source: First Capital Research Estimates

IMF announces Staff Level Agreement with SL Government...



SL authorities and the IMF team reached staff-level agreement to support economic adjustment and reform policies with a new 48-month EFF with a requested access of about SDR 2.2Bn equivalent to USD 2.9Bn

...but sets out preconditions...

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

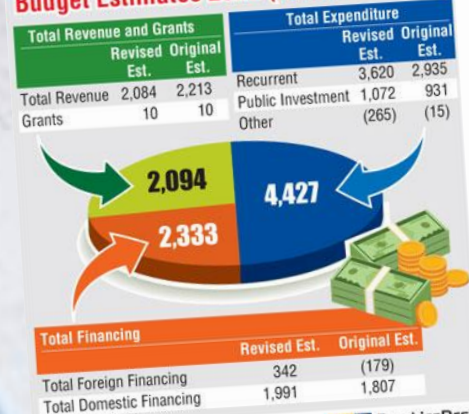


Reforms could entail further higher taxes and expenditure rationalization, and that could even invite further public agitation

...of which, Govt manages to push through some of the critical reforms

Market pricing Electricity, Fuel and taxation reforms through interim budget have been completed

Budget Estimates 2022 (Revised)



Source: Department of Fiscal Policy

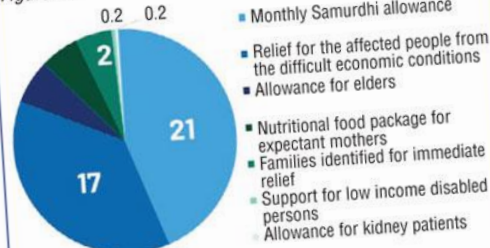
GraphicsDesk

THE INTERIM BUDGET 2022

Social Safety Net programme

The Interim budget allocates LKR 47 bn for a Social Safety Net programme

Figures in LKR bn



Source: publicfinance.lk

No fuel price revision in Sri Lanka for August: energy ministry

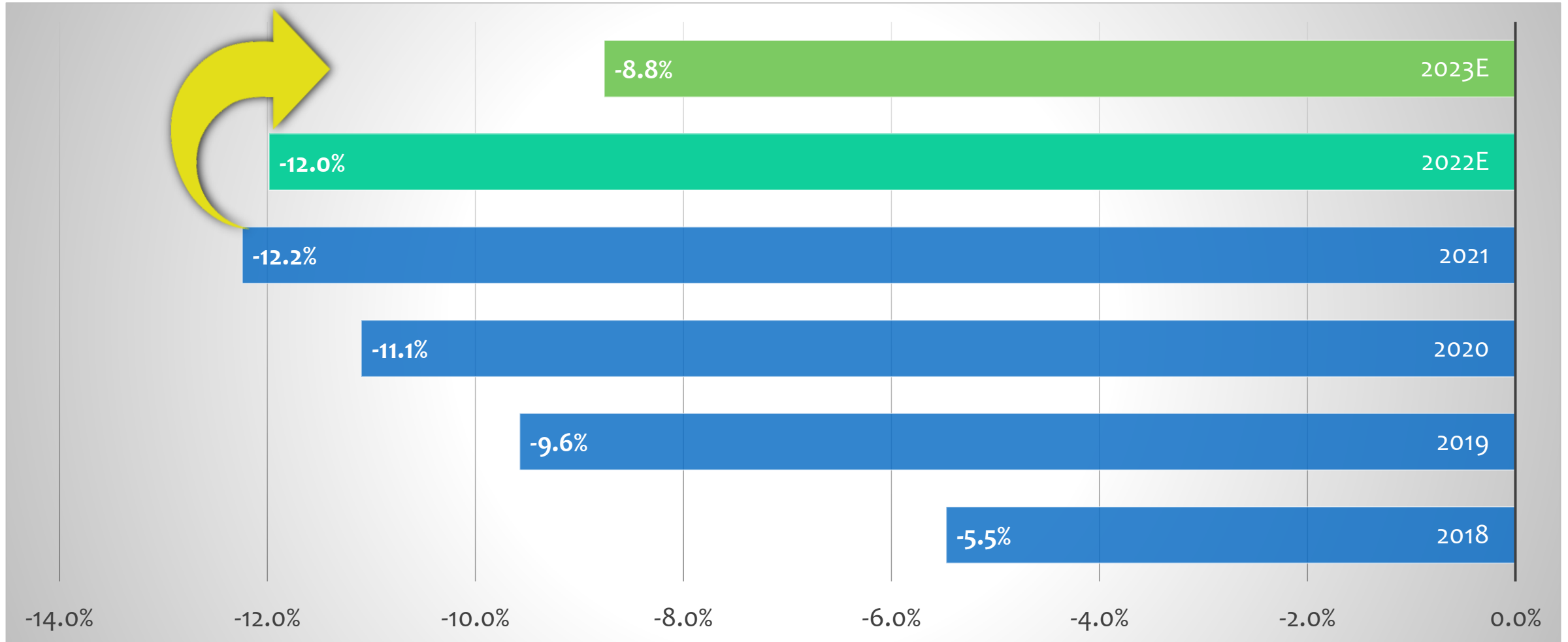


Domestic Purpose

	Proposed average tariff (LKR/kWh)	Proposed % Increase - CEB	Average monthly bill CEB proposed (LKR)	Approved average tariff (LKR/kWh)	Approved % Increase	Average monthly bill approved (LKR)
0-30	52.30	835%	508	20.36	264%	198
31-60	35.55	673%	1,488	14.30	211%	599
61-90	35.44	276%	2,439	21.23	125%	1,461
91-120	34.93	126%	3,546	29.31	89%	2,976
121-180	35.52	81%	5,048	35.22	79%	5,005

...with it, Budget controls step in...

Budget Deficits move back to below double digit from 2023E onwards amidst debt restructuring



Source: Ministry of Finance, First Capital Research Estimates

...Yet, debt sustainability provides the biggest challenge

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

By Jeyarajoo De Silva and Githika Jayasinghe

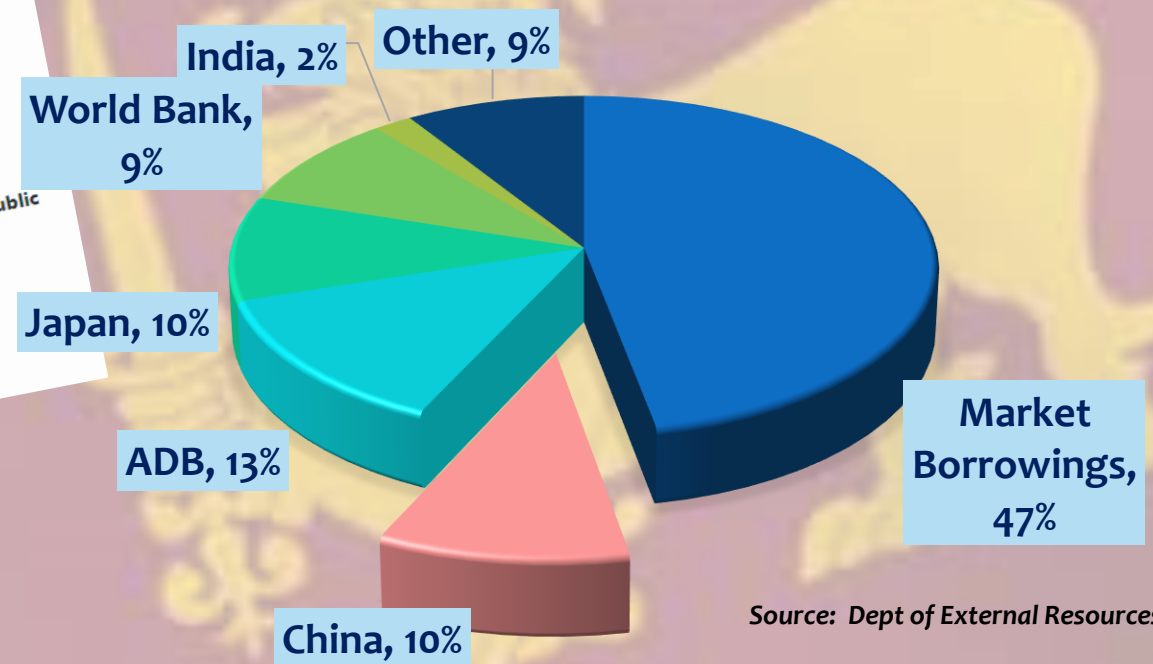
China remains key sticking point in debt restructuring: Fitch

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

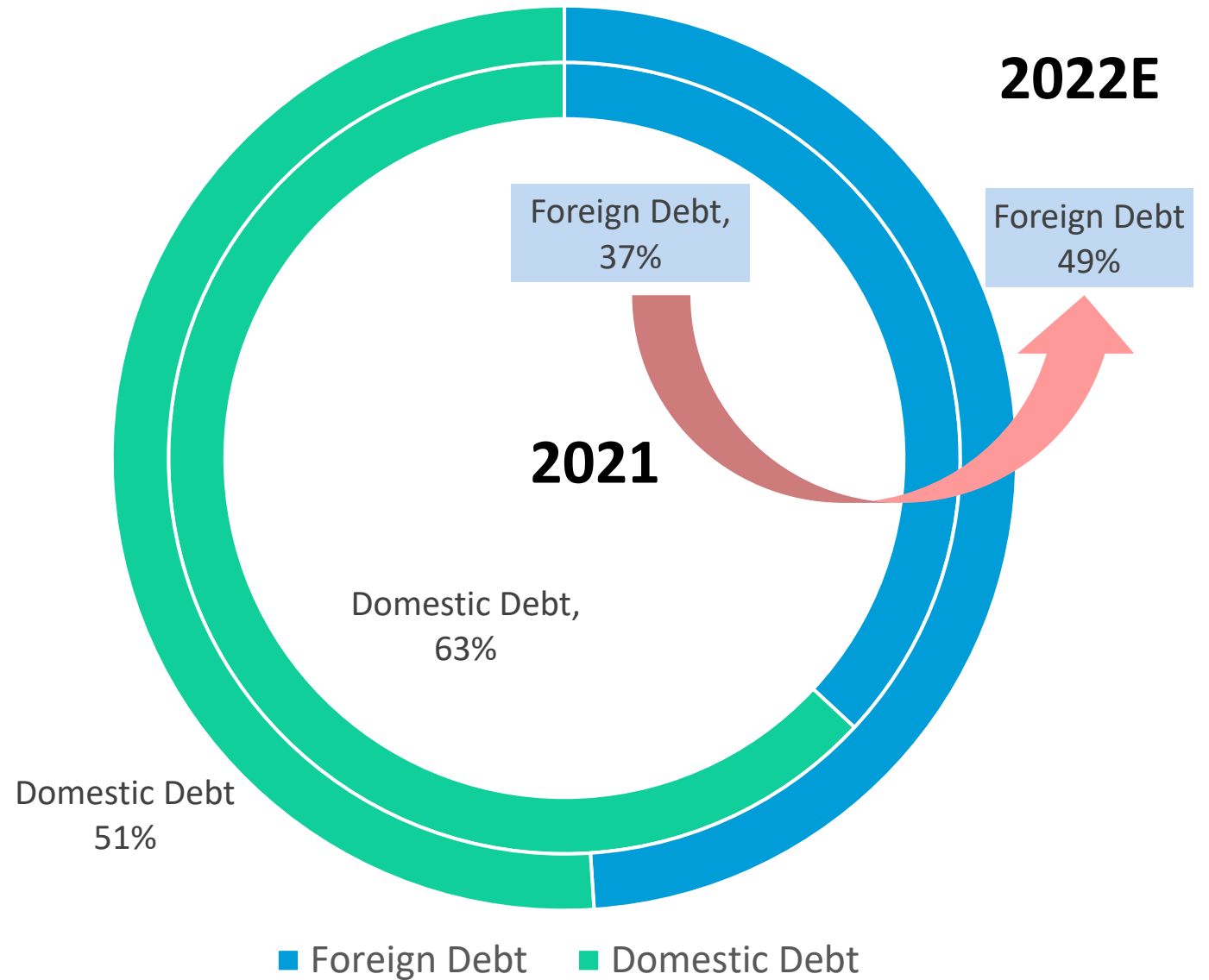
China continuously pops up as one of the key sticking points for Sri Lanka to reach the much needed debt sustainability as Fitch Rating this week too weighed in on the matter saying that the world's second biggest economy could complicate the island nation's debt talks with its creditors.

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



Source: Dept of External Resources

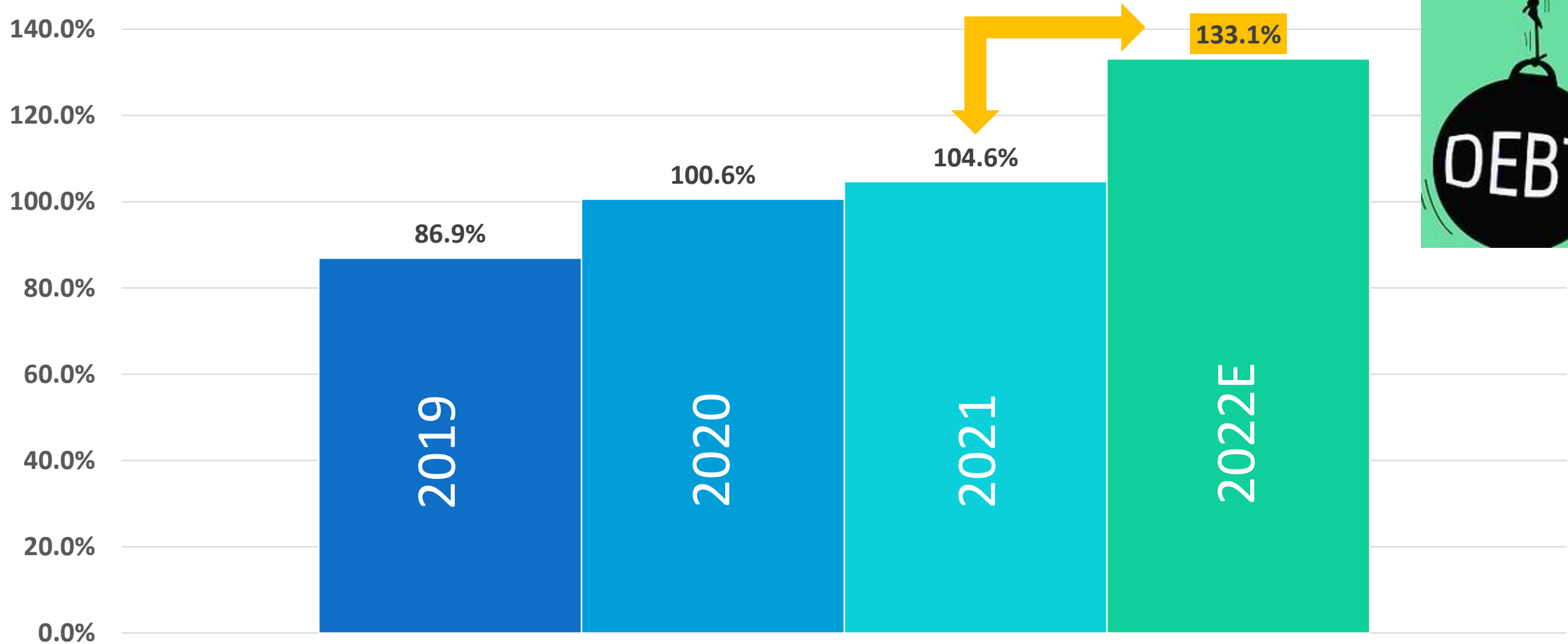
Following the LKR depreciation, Foreign debt surges to 50% of total debt



Source: CBSL, First Capital Research Estimates

...while Debt to GDP is estimated to have surged to 130%+

Hopefully debt restructuring may provide some respite



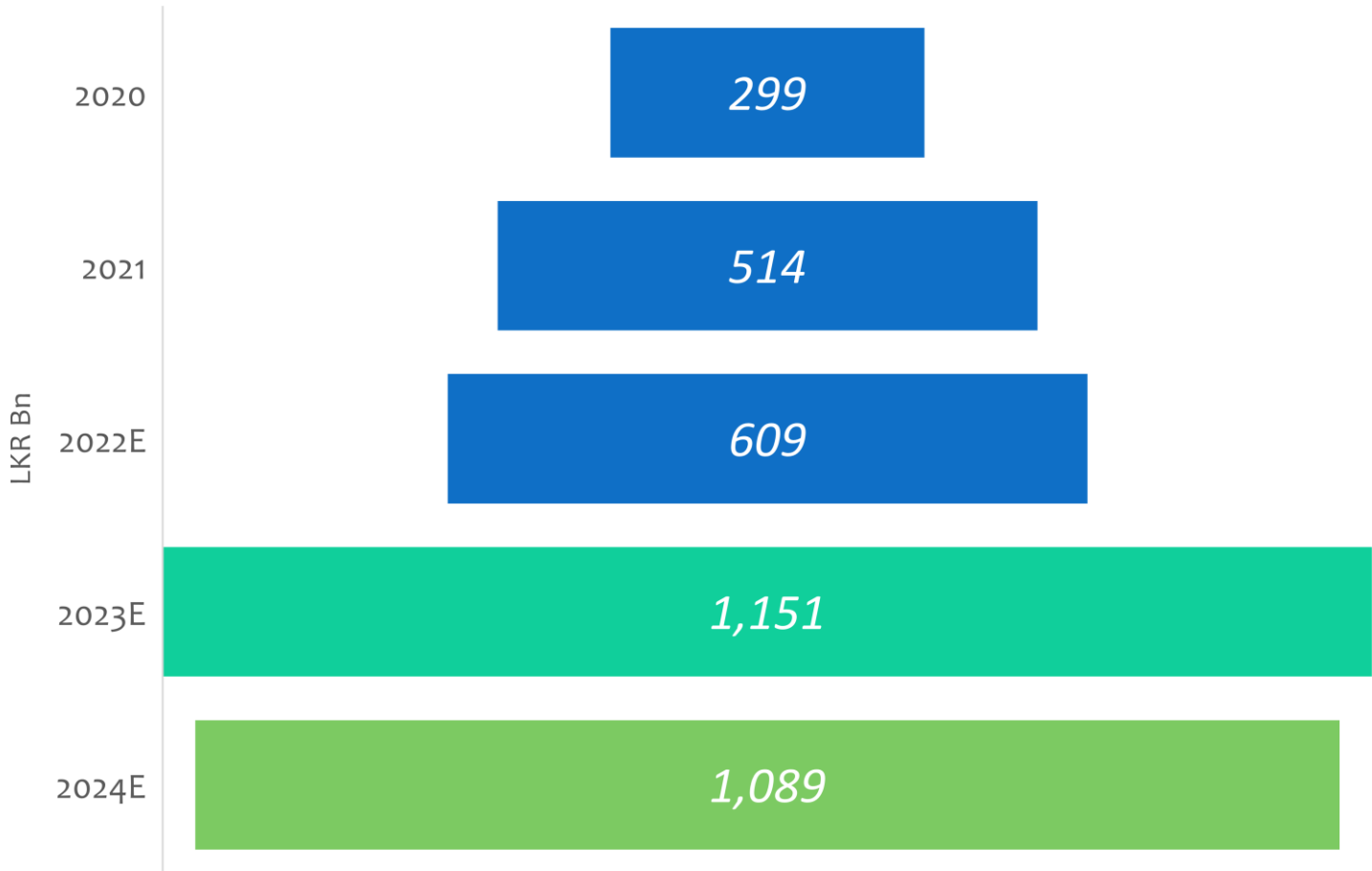
Source: CBSL, First Capital Research Estimates

Foreign debt may not be the only issue

Rupee Debt Maturity Profile illustrates large chunk of debt repayments



Treasury Bond Maturities bloat over the next 2 years



Source: CBSL, First Capital Research Estimates

Debt Restructuring is a lengthy process...

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



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

Source: IMF

...while potential options in Domestic Debt Restructuring are wide

- ✓ 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 the end of 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

However, Possibility of Local Debt Restructuring stands low

Probability – **20%**
(Maintained)

Arguments for Local Debt Restructuring

High level of Gross Financing Needs: Sri Lanka's gross financing needs exceed 25% of GDP which has been a grave concern for IMF. The recommended level stands at 15%. With the substantial gap and the subsequent potential further increase, a local debt restructuring is a reasonable 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 has 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.

Impact Assessment

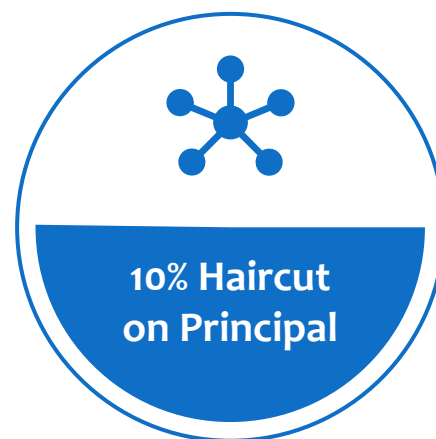
Local Debt Restructuring

Option 1 – Base Case

Option 1 – Base Case for Debt Restructuring – Short Tenors

High impact for short term maturities

Principal



Coupon



Maturity



Hybrid



<2 Year
15 Mar 2024

Coupon – 10.90%

Current Yield –
29.50%

Loss -6.61%
New Yield 22.89%

Loss -1.73%
New Yield 27.77%

Loss -11.19%
New Yield 18.31%

Loss -13.00%
New Yield 16.50%

<3 Year
01 Jun 2025

Coupon – 17.00%

Current Yield –
29.25%

Loss -3.12%
New Yield 26.13%

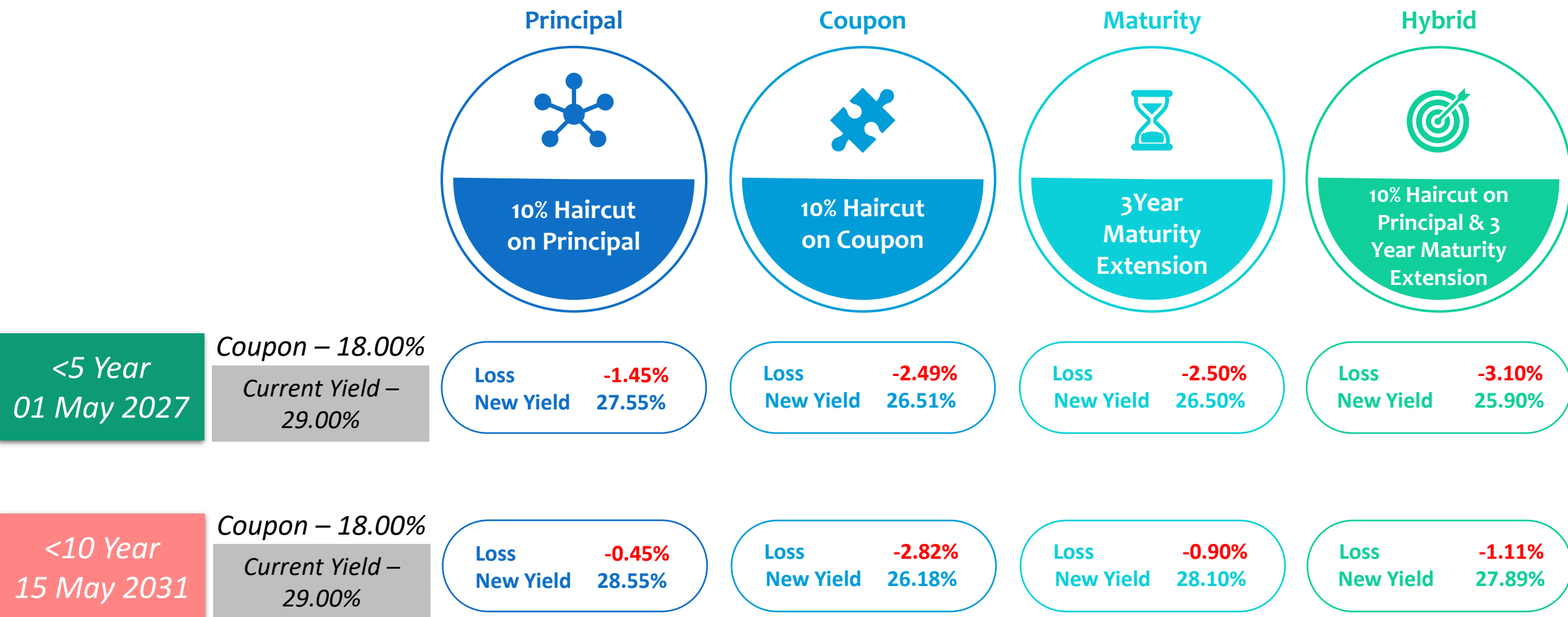
Loss -2.22%
New Yield 27.03%

Loss -4.83%
New Yield 24.42%

Loss -5.90%
New Yield 23.35%

Source: First Capital Research Estimates

Option 1 – Base Case for Debt Restructuring – Mid-Long Tenors



Source: First Capital Research Estimates

Option 2 – Worse Case

Option 2 – Worse Case for Debt Restructuring – Short Tenors

High impact for short term maturities

Hybrid
Principal + Maturity



Loss -15.17%
New Yield 14.33%

Loss -7.17%
New Yield 22.08%

Hybrid
Coupon + Maturity



Loss -18.48%
New Yield 11.02%

Loss -14.39%
New Yield 14.86%

<2 Year
15 Mar 2024

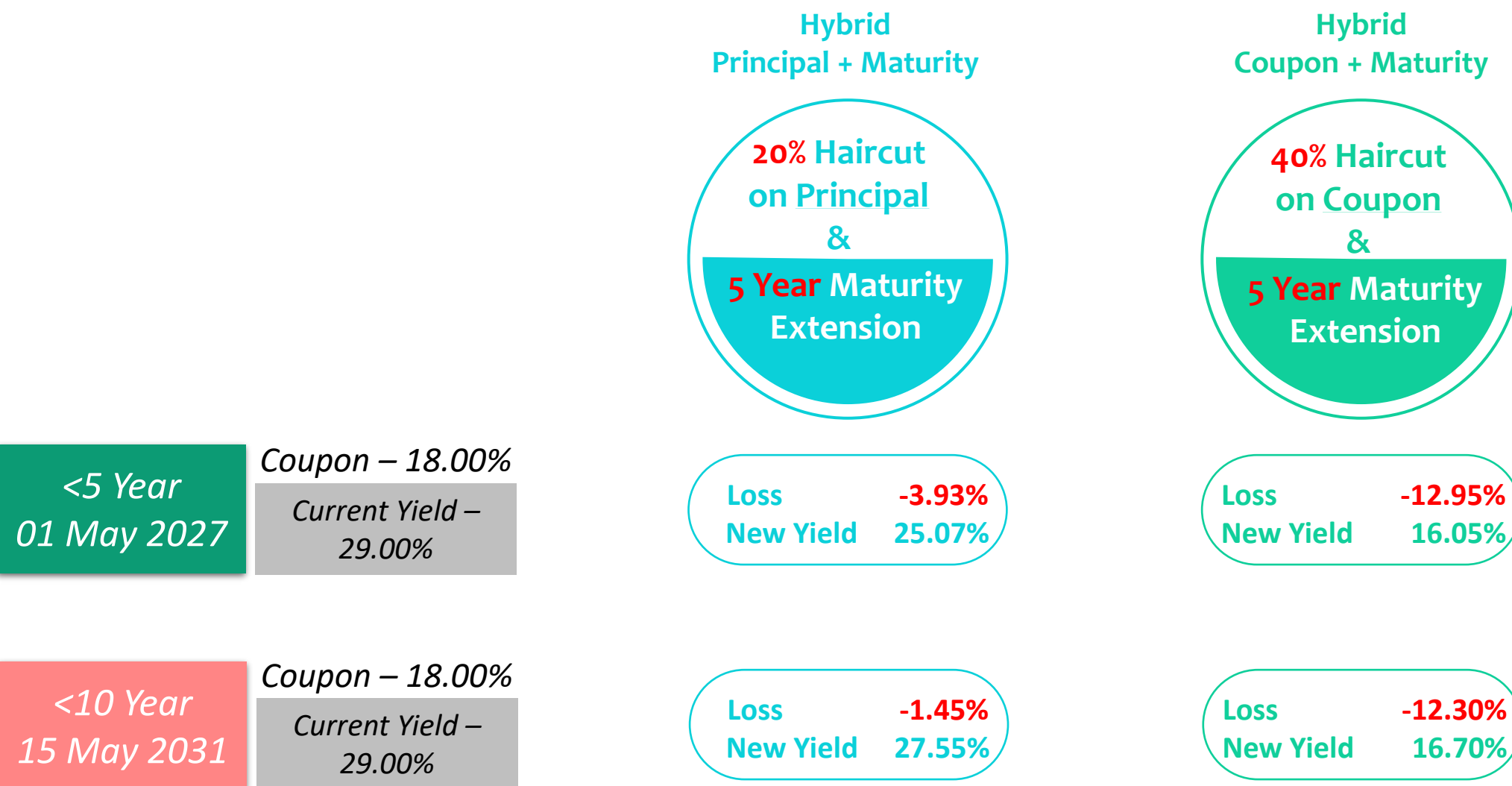
Coupon – 10.90%
Current Yield – 29.50%

<3 Year
01 Jun 2025

Coupon – 17.00%
Current Yield – 29.25%

Source: First Capital Research Estimates

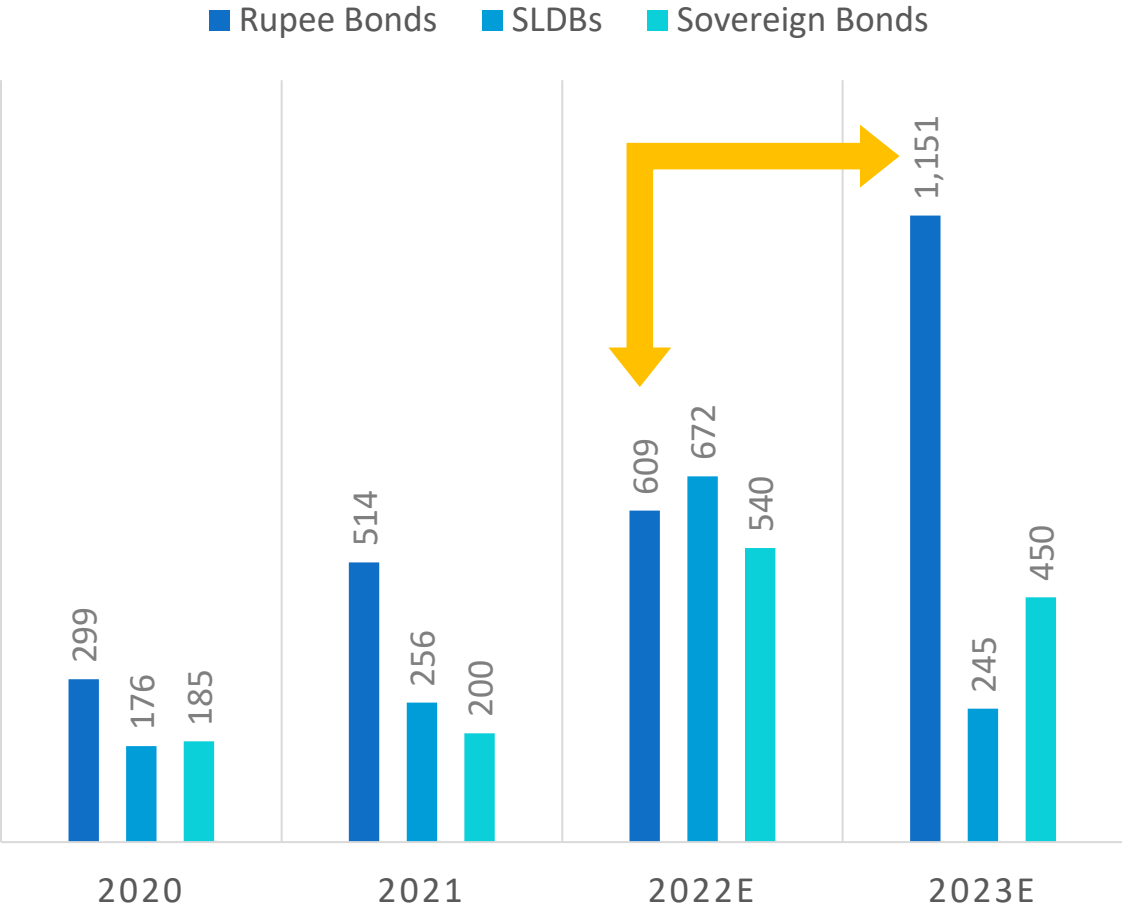
Option 2 – Worse Case for Debt Restructuring – Mid-Long Tenors



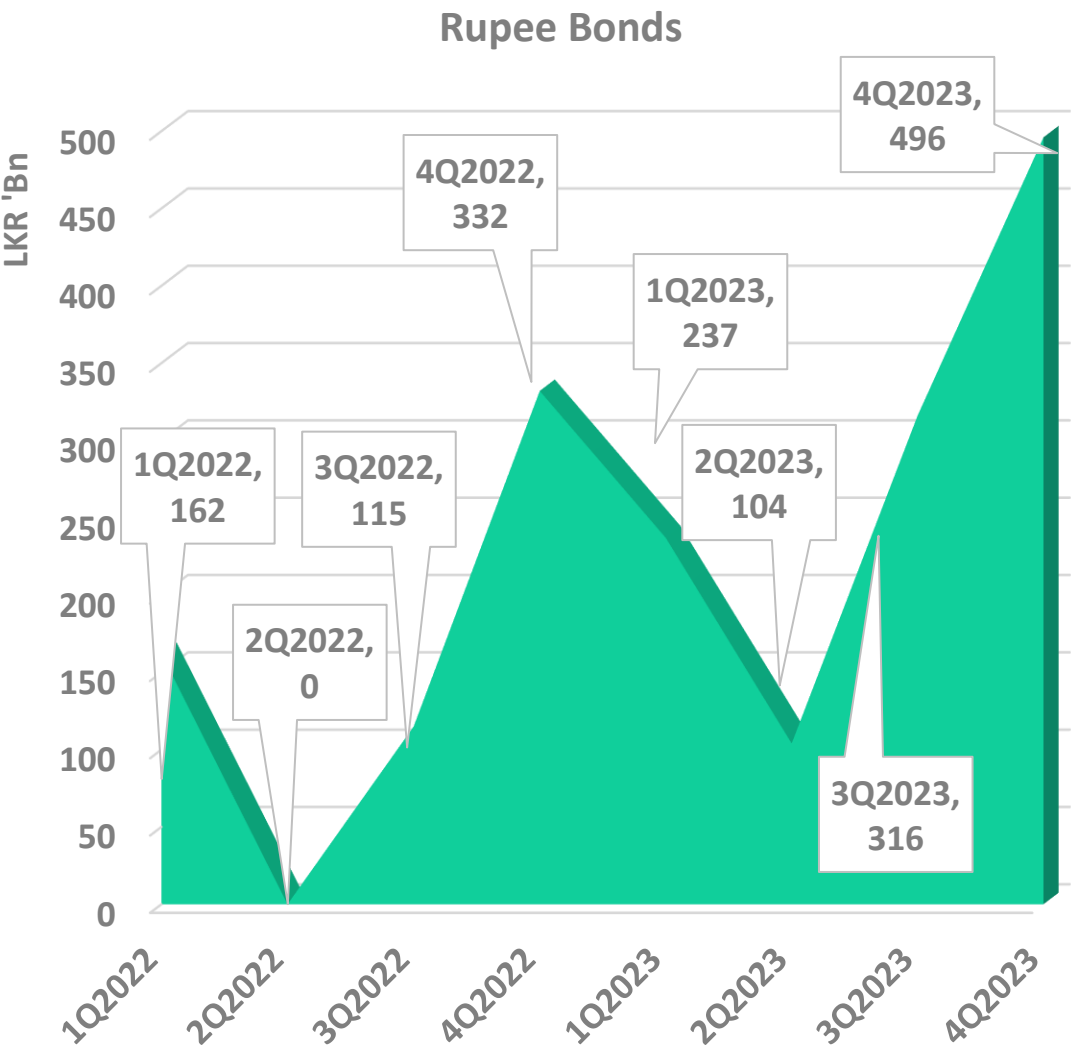
Source: First Capital Research Estimates

Local Bond repayment pressure continues to be high

2022E-23E BOND REPAYMENTS ARE SIGNIFICANTLY HIGH



Source: CBSL



Source: CBSL

Summary of Overall Economic Outlook

Positives

- Economic Reforms
 - Cost reflective pricing of electricity, water & fuel
 - Measures to increase Tax Revenue
- Recovery in Tourism
- Slowing Private Credit
- IMF Staff Level Agreement
- Inflation may gradually slowdown
- Stable LKR

Negatives

- GDP may decline sharply
- High budget deficit may increase Govt borrowing requirement
- Negative liquidity
- Potential further rise in CBSL Holdings
- High Rupee and Dollar debt maturities
- Difficulty in raising foreign debt
- Delay in Debt restructuring
- Delay in IMF Board Level approval

Economic Outlook: Upgraded to **Medium-High Risk (from **High Risk**)**



External Outlook show signs of improvement

Upgraded to **Medium-High** (from High Risk)

Section 5.0

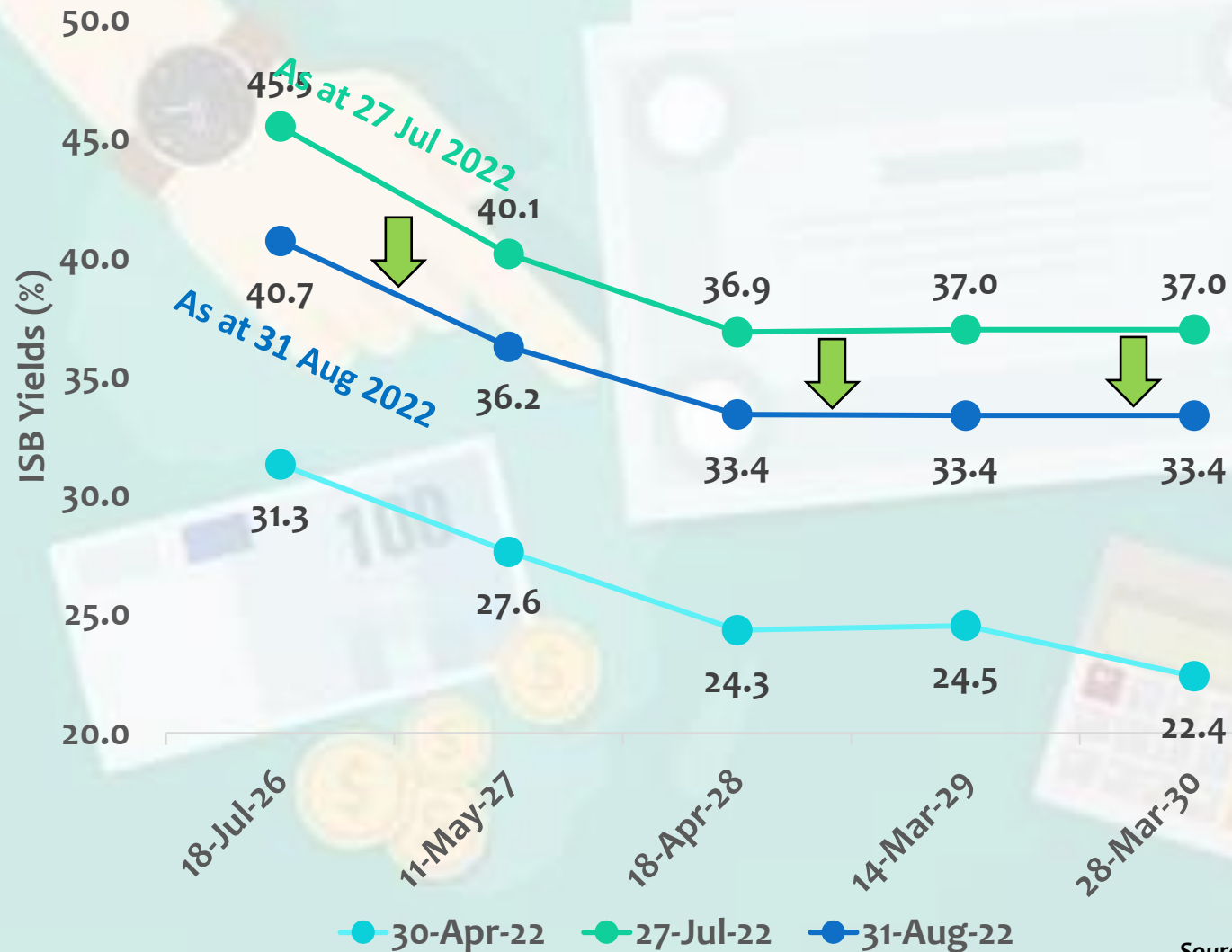
Global recession to favour lower commodity prices & slowdown the rise in rates



Recessionary pressure to favour SL

- 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 signaling 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.

Foreigners turn a positive eye as ISB yields ease...



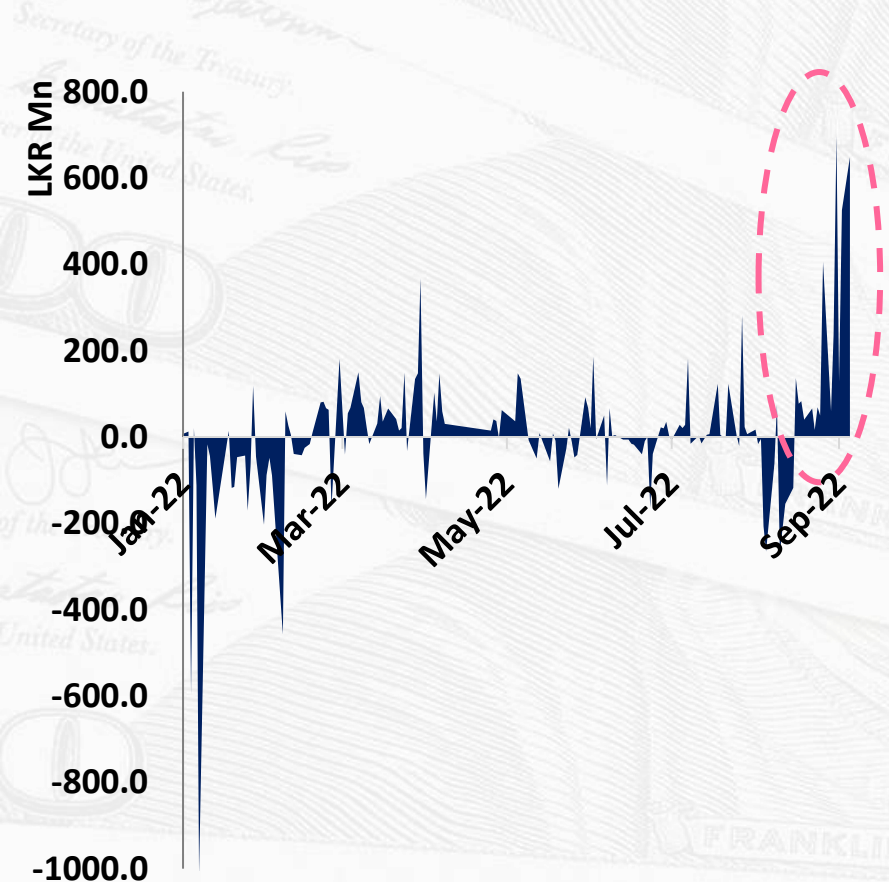
Source: CBSL

Following the political instability ISBs witnessed a surge in yields while trading at historically low prices. With the restoration of political stability ISB yields are expected to ease attracting foreign investors to the govt. securities market

...while foreign inflow into rupee capital markets turn a new leaf

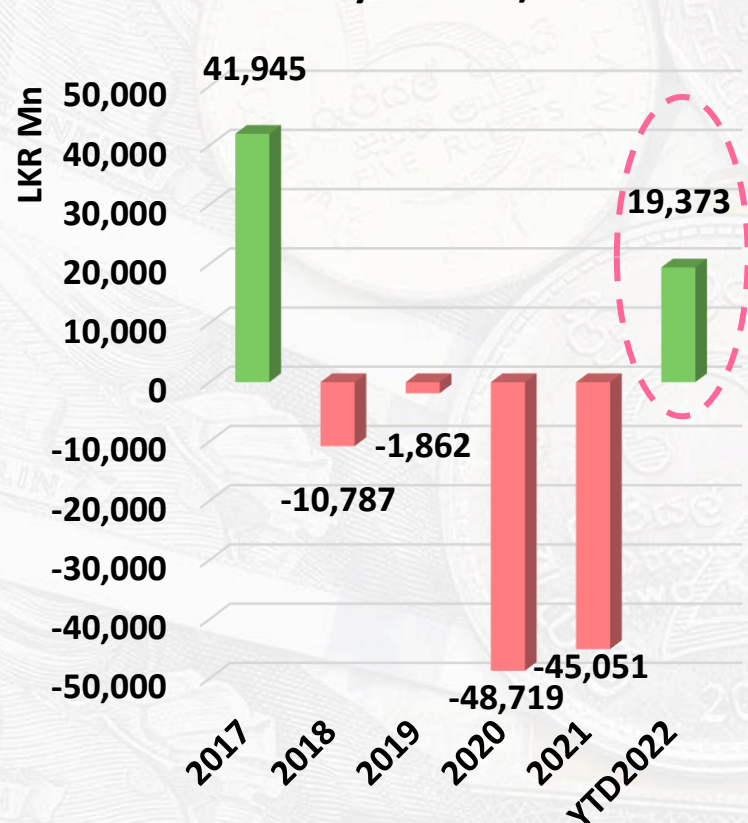
With the reinstatement of the political stability, net inflows to the CSE and holding in govt. securities saw an upward trend

Net foreign inflows to the CSE

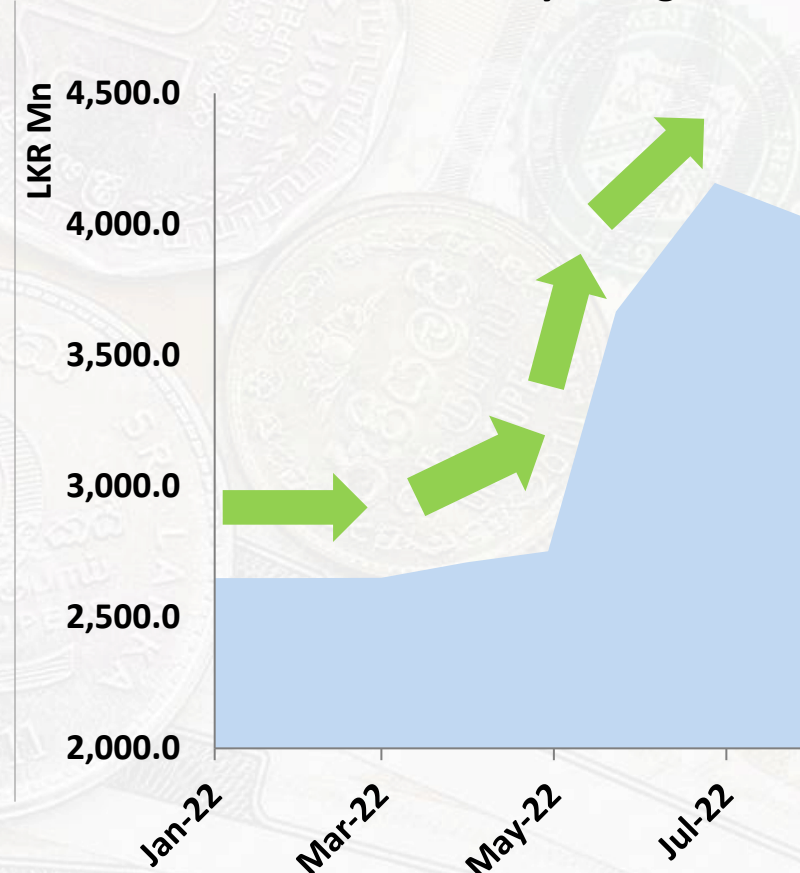


Source: CSE

CSE Net Foreign Flow (including Primary Market)



T-bills and bonds held by foreigners



Source: CBSL

Debt Restructuring may improve credit ratings for SL

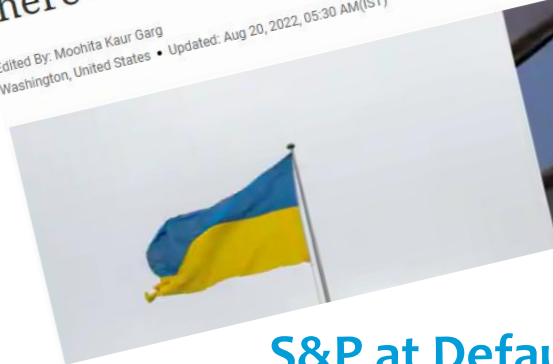
RATING ACTION COMMENTARY

Fitch Upgrades Mozambique to 'CCC+'; Removes From UCO

Fri 26 Aug, 2022 - 5:01 PM ET

S&P, Fitch upgrade Ukraine's credit rating but warn there's still a chance of default

Edited By: Moohita Kaur Garg
Washington, United States • Updated: Aug 20, 2022, 05:30 AM(IST)



S&P at Default
Moody's at 'ca'
Fitch at Restricted default



Fitch Ratings says it may move SL's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) out of 'RD' (Restricted Default) rating upon the government's completion of a commercial debt restructuring



Summary of External Sector

External factors are favouring Sri Lanka at the moment improving the overall outlook



External Outlook: Upgraded to *Medium-High Risk* (from *High Risk*)

Outlook Trend for Sri Lanka

Time Period	Political	Economical	External
Sep 2019	Low Risk	Medium	Medium
Jan 2020	Low Risk	Medium	Medium
Aug 2020	Low Risk	Medium	Medium
Jan 2021	Low Risk	Medium-High Risk	Medium-High Risk
Sep 2021	Medium-Low Risk	High Risk	High Risk
Jan 2022	Medium-Low Risk	High Risk	High Risk
Sep 2022	Medium-High Risk ↓	Medium-High Risk ↑	Medium-High Risk ↑

Risk Levels (Low-High)



 Low Risk

 Medium-Low Risk

 Medium-High Risk

 High Risk

The background of the slide features a close-up of several gold bars. One bar in the foreground is clearly marked with 'NMR MELTER ASSAYER', 'G00023', and '100 FINE G 999'. Another bar behind it has 'GLOBAL INTER' visible. A small globe icon is also present on the right side of the slide, partially overlapping the title area.

Recommendations

Section 6.0



First Capital Research View on Bond Market Jul'22-Jun'23

Section 6.1



Primary Criteria



Foreign Reserves

Continues to remain significantly low
Risk Level: **HIGH**



Liquidity

Significantly Negative
Risk Level: **HIGH**



Inflation

Inflation surges past 60% with
significantly high levels of food
inflation
Risk Level: **HIGH**



Foreign Activity

Low level of Foreign buying has been
witnessed in both equity and debt
capital markets.
Risk Level: **Medium-High**



Credit

Credit growth turned negative with
repayment into the system.
Risk Level: **Low**



CBSL Holdings

Extremely high and continuous
increase amidst the lack of Govt
revenue.
Risk Level: **HIGH**

Secondary Criteria



Rating Outlook

All 3 rating agencies have Sri Lanka at the Default level, but Sri Lanka has managed to secure IMF staff level agreement

Risk Level: **MEDIUM-HIGH**

External Environment

Currency is showing signs of stability with tight monetary policy and import controls.

Risk Level: **MEDIUM-LOW**

BOT & BOP

BOT turns positive and at manageable level while BOP remains negative amidst the lack of ability to raise funds.

Risk Level: **MEDIUM-HIGH**

Political Risk

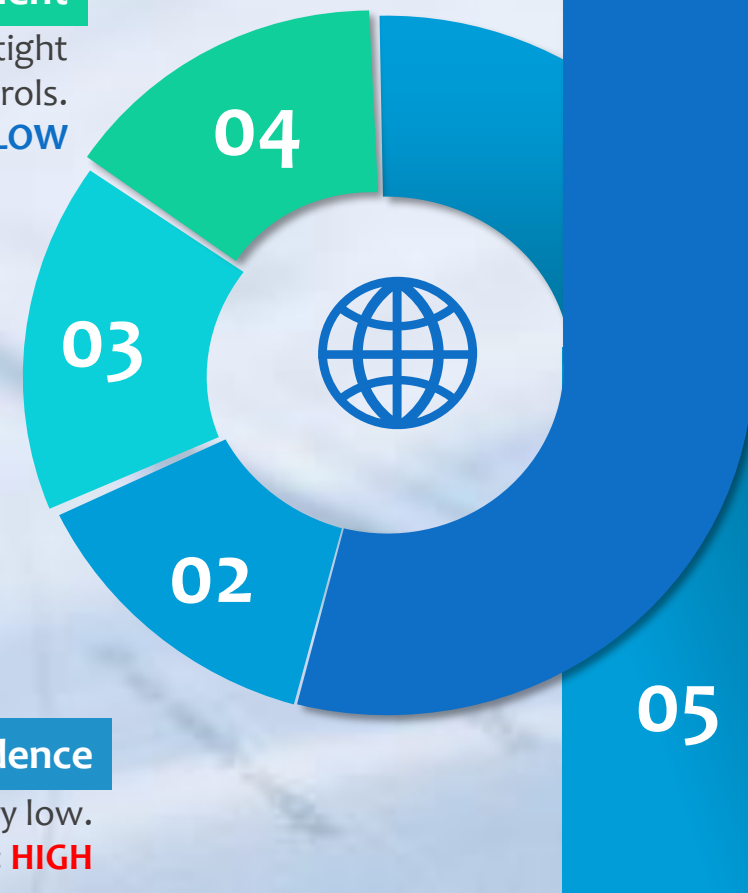
Some level of stability has been achieved, but elections are likely to come in 1Q2023 creating instability.

Risk Level: **MEDIUM-HIGH**

Investor Confidence

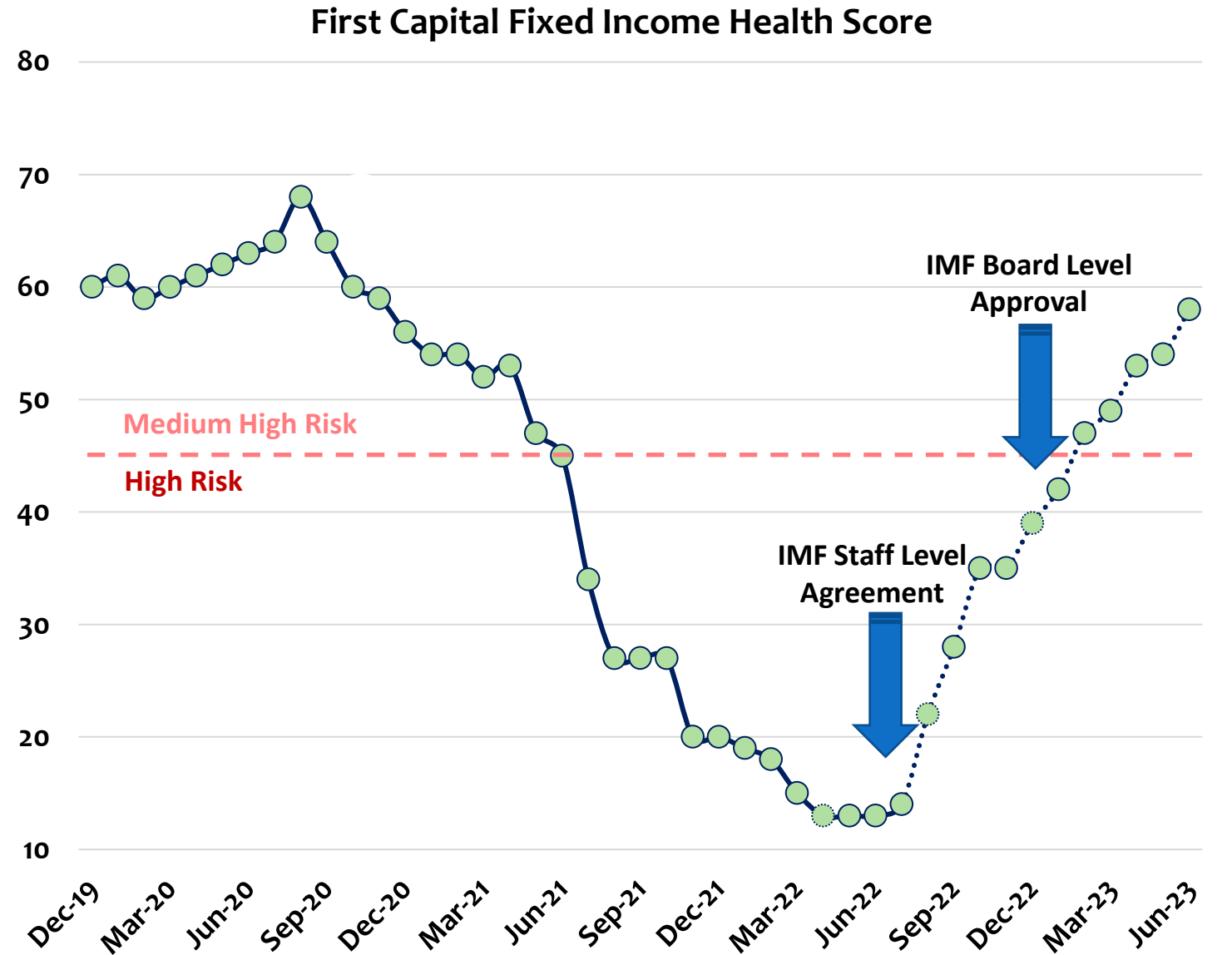
Business confidence is very low.

Risk Level: **HIGH**



FI Health score nosedived in Jun-22 and in line with our expectations is now showing signs of improvements

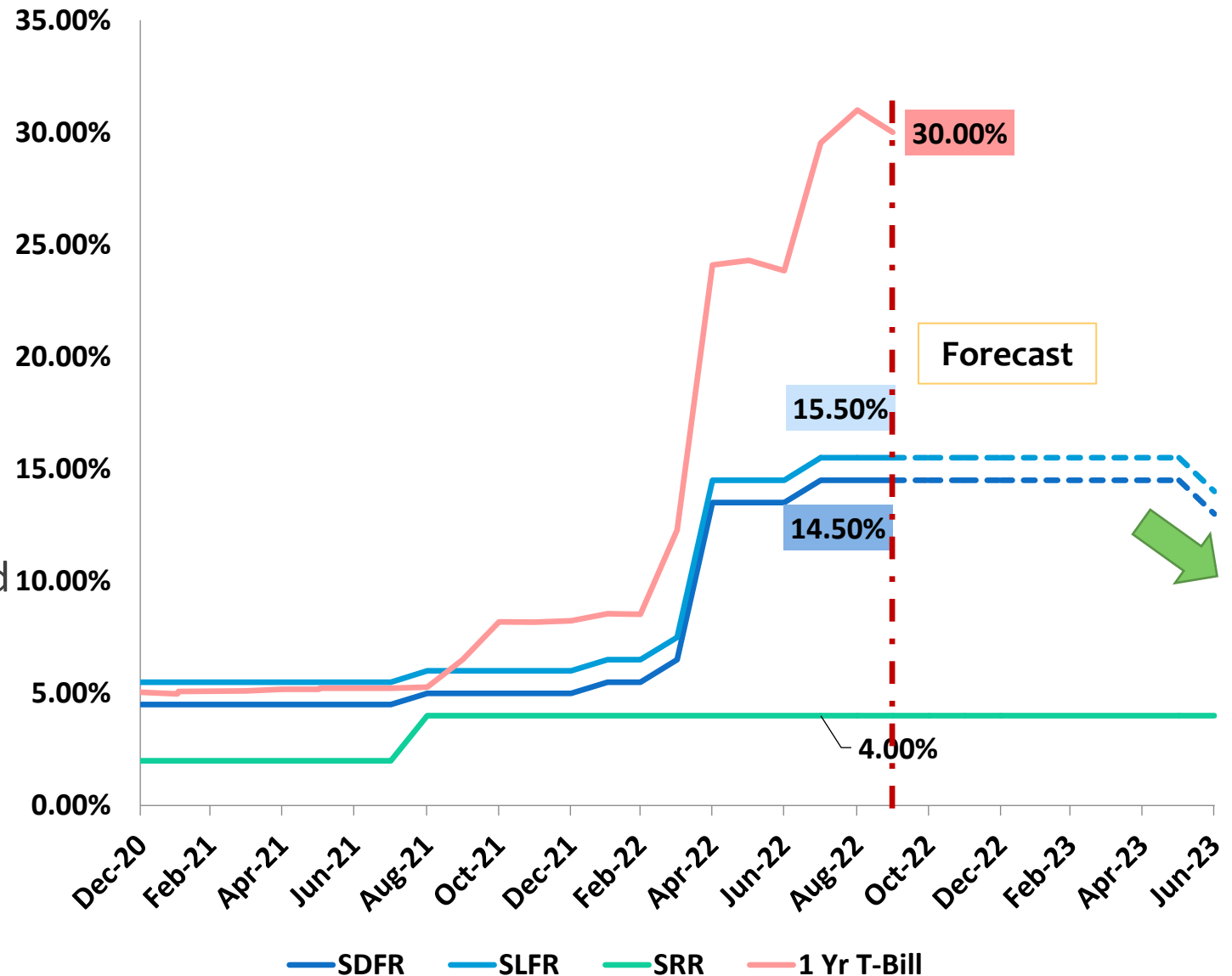
However, exceptional level of recovery is anticipated in 4Q2022 and 1Q2023



Policy rates to remain unchanged and trend downwards

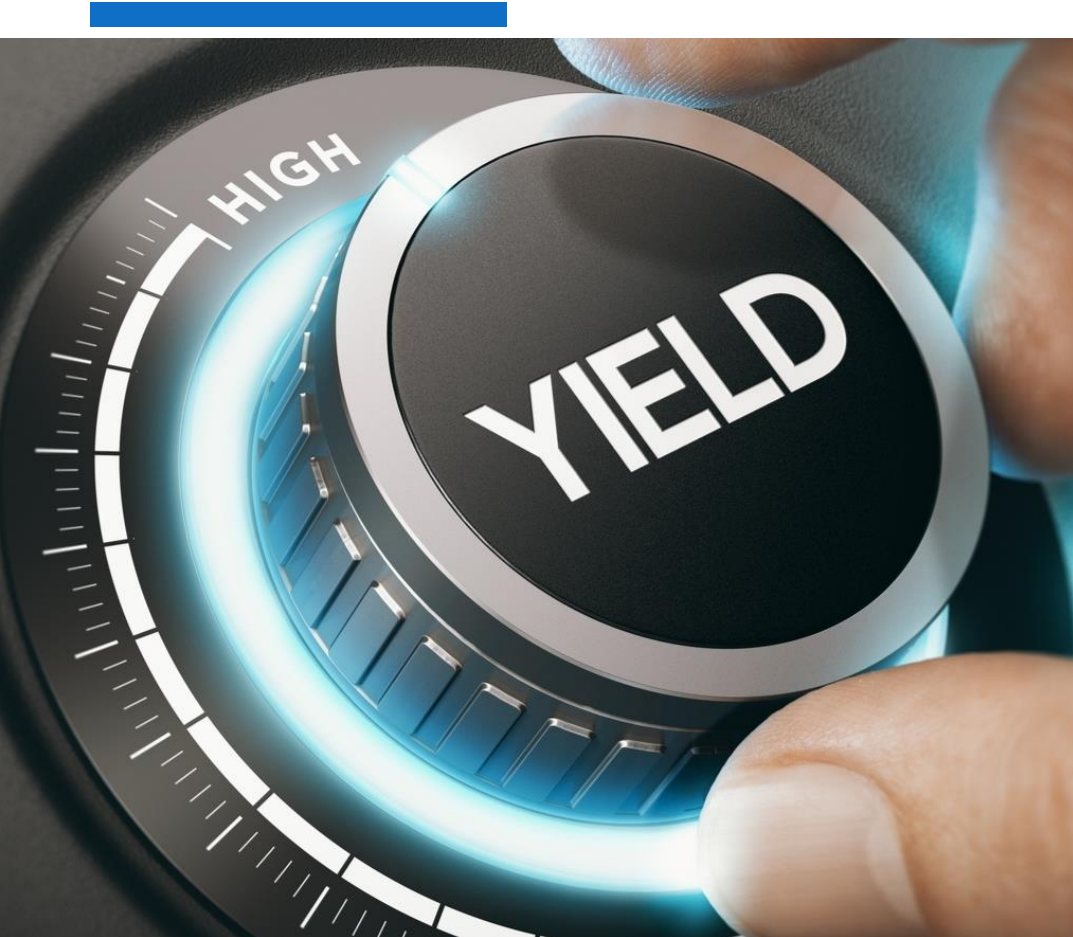
Considering the outlook over the next 06M-01Yr, we expect the complete normalization of the economy with the country being able to enter into an IMF EFF support program. Thereby with the complete stabilization of economic indicators, concentration would be shifted towards fast tracking the revival of the economy giving rise to a possibility of a rate cut towards 4Q2022 to 1Q2023 although at a lower probability of 10%-20%.

Rate cut is likely to be a strong probability towards 2Q2023 where we target 1 rate cut of about 150bps.



Source: CBSL, First Capital Research Estimates

Attractive yields in spite of possible restructuring



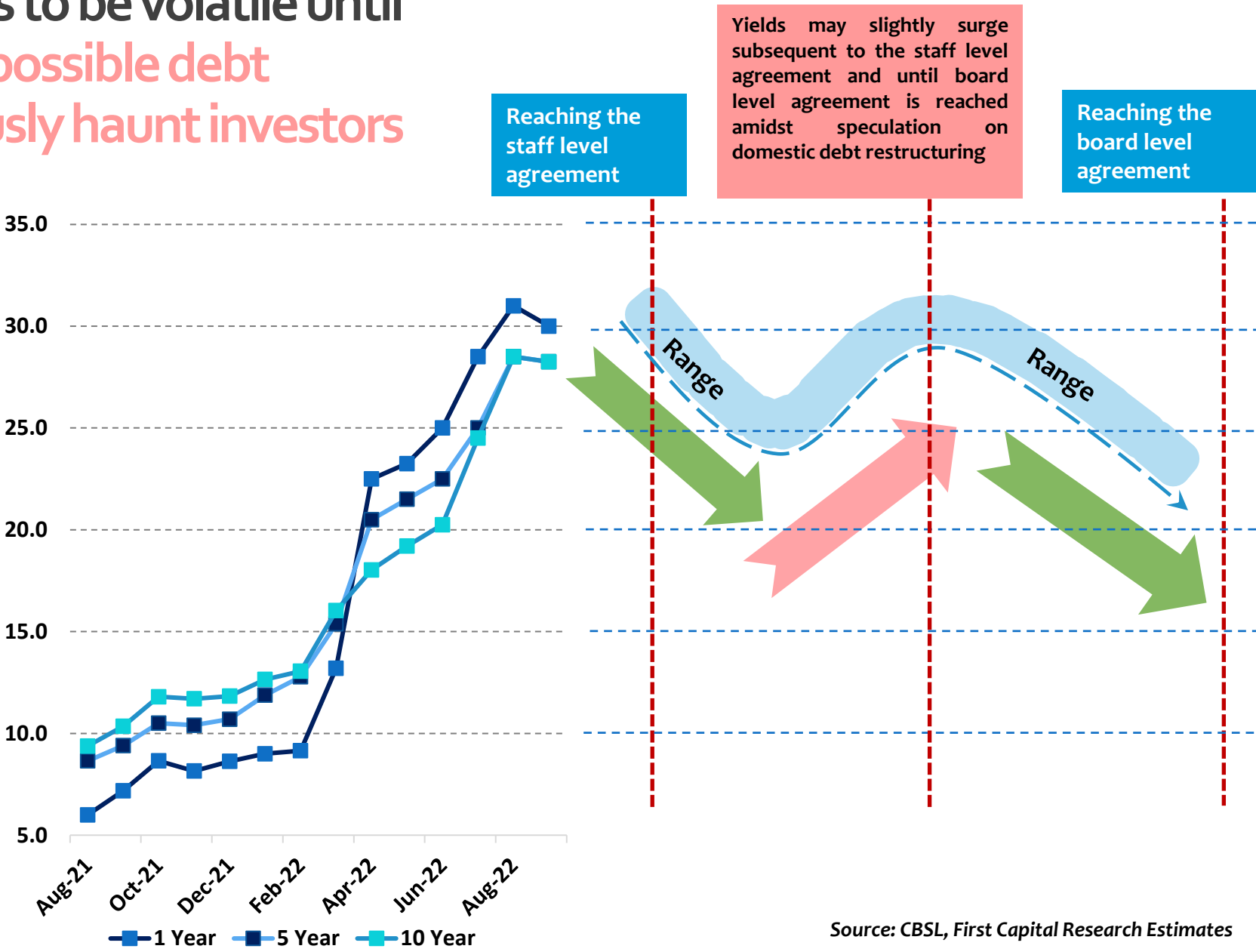
- **Lower debt structuring impact to maturities of 5-Year and above:** As illustrated in slides 47-52 considering multiple debt restructuring options it is important to note that for bonds maturing above 5-years, the impact of possible debt structuring is limited.
- **Attractive returns for long term investors:** Sri Lanka's interest rates rarely move beyond 20%. The last time it was witnessed was in the period of 2008-09 when 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 47 & 50. 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 uprising 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 end Sep-22 on successful progression 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: CBSL, First Capital Research Estimates

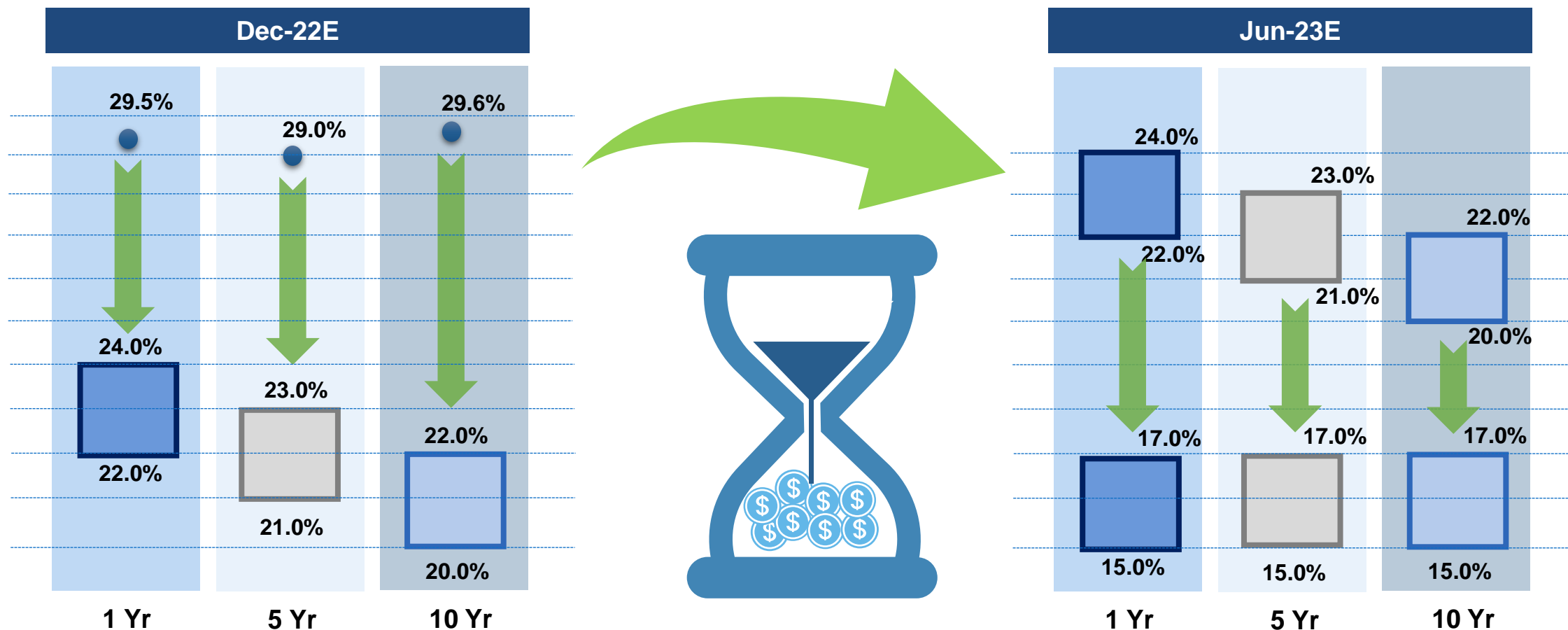
Broader View: Time to get cautiously optimistic on Bonds

Bond yields to moderate by 4Q2022E

- 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.
- However, political stability and ability to enter an IMF support facility are key TRIGGER POINTS that will impact the market sentiment.
- Time for Cautious OPTIMISM!
- Consequently, in light of gradual improvement in economic conditions, yields are expected to moderate depending on the timing of developments that reduce the uncertainty.

Overall worse case view (from Apr 2022) maintained

FCR maintain the view of moderate yields by end 4Q2022E to 2Q2023E amidst political stability (post elections), clarity on debt restructuring and IMF Board Level Approval



Source: first Capital Research Estimates

Selected maturities remain attractive even beyond the worst debt restructuring; But long-term maturities the safer option

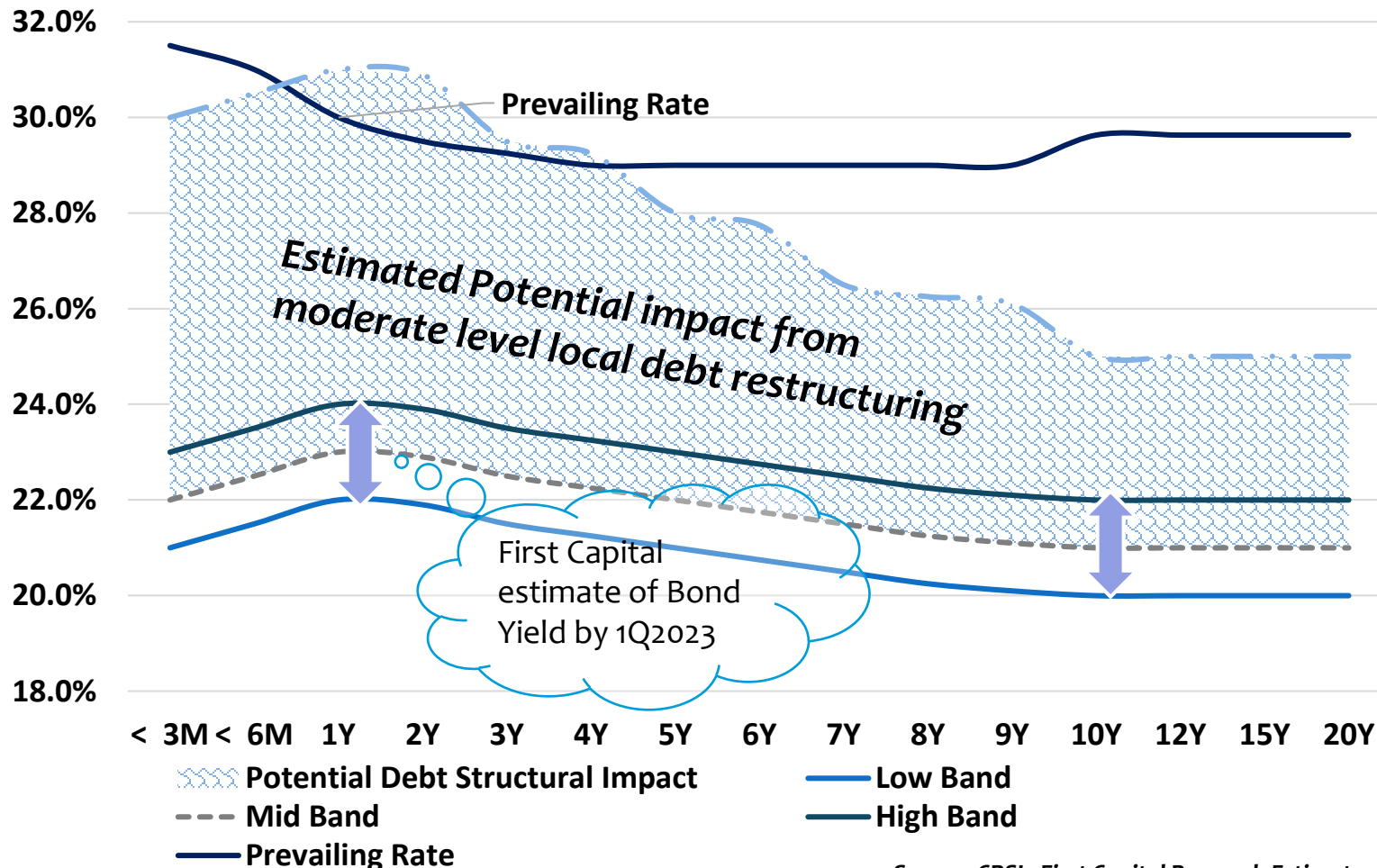


Safer to Buy into Mid-Long tenors

As per Slide 42, 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 **recommend investors to buy Bonds with tenors of 5-Year and above** which could be classified as Mid-Long tenor maturities. However, you may want to avoid the 8Yr due to its lower yield.



Source: CBSL, First Capital Research Estimates

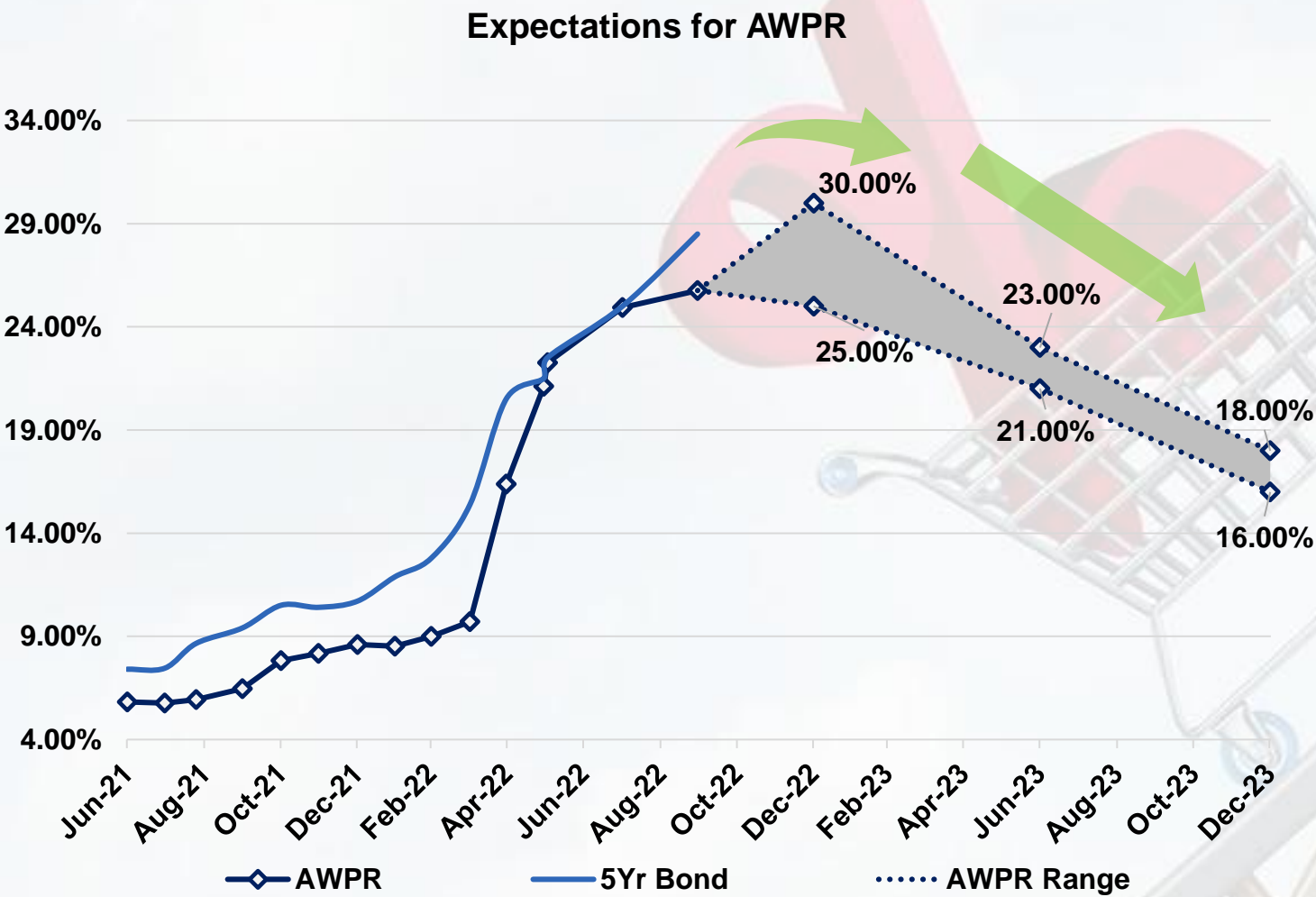


First Capital Research View on Banking Rates Jul'22-Jun'23

Section 6.2



AWPR to reverse in 1H2023E



Source: CBSL, First Capital Research Estimates

Following the sharp rise in policy rates in Bond yields, AWPR was expected to follow a similar suit with an accelerated pace.

We expect AWPR to follow the yield of 5Yr bond thus hover in the range of 25.0%-30.0% by Dec-22 and reverse towards 21.0%-23.0% towards and Jun-23 and further dip to 16.0%-18.0% by Dec-23.

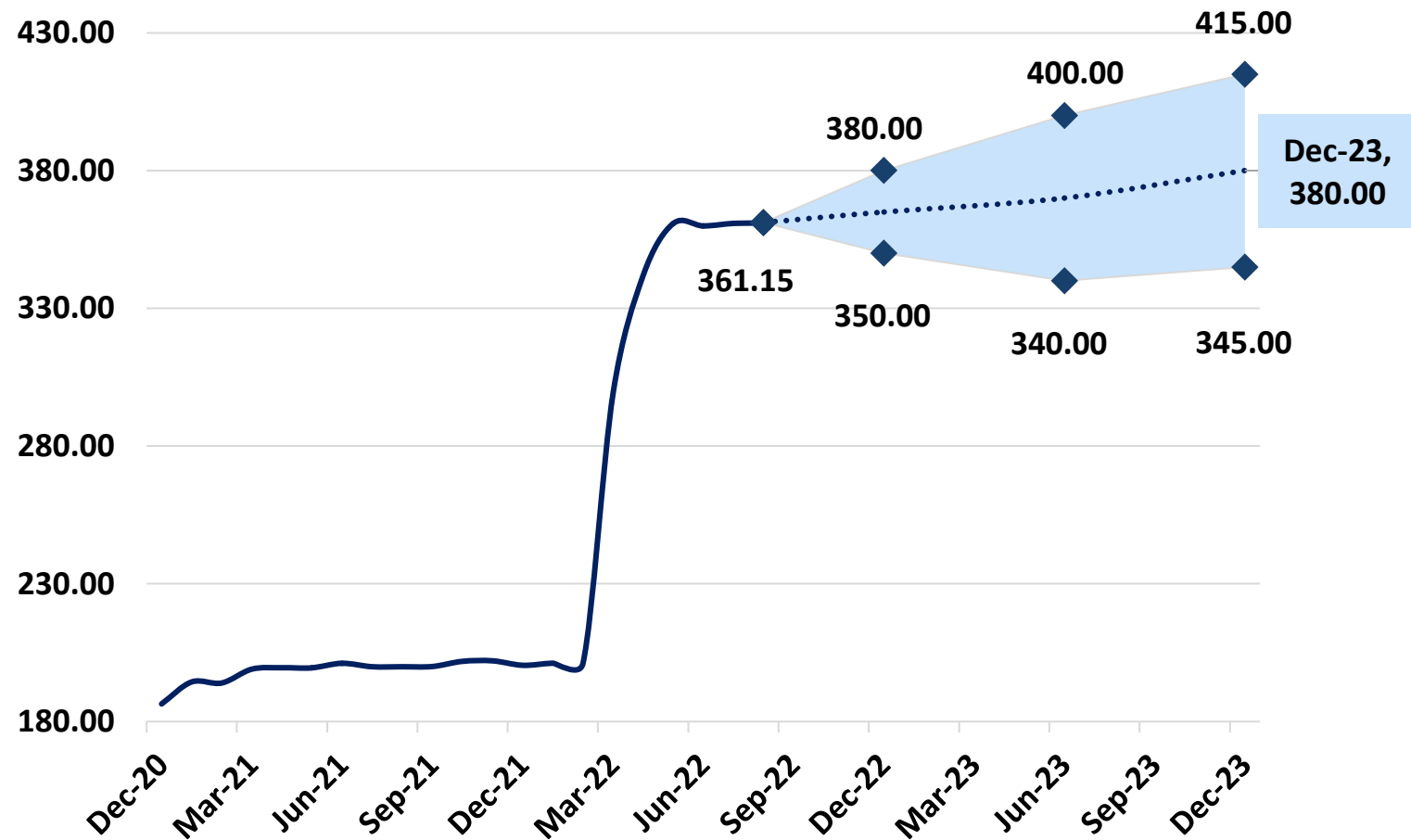


First Capital Research View on Exchange Rates Jul'22-Jun'23

Section 6.3



Exchange Rate is likely to be stable throughout 2022E & 2023E with possible marginal depreciation amidst trade relaxation



Source: CBSL, First Capital Research Estimates

Following IMF Staff level agreement being signed and Board level agreement expected around Dec-22, we expect foreign inflows in terms of investments and potential loans into the country.

However, CBSL is likely to use the opportunity to buy USD in the market in order to build reserves which is a significant priority. Therefore, currency appreciation opportunities are likely to be limited in the market.

During 2023E with the IMF program, we may see trade relaxation, which may result in the currency marginally weakening over the period



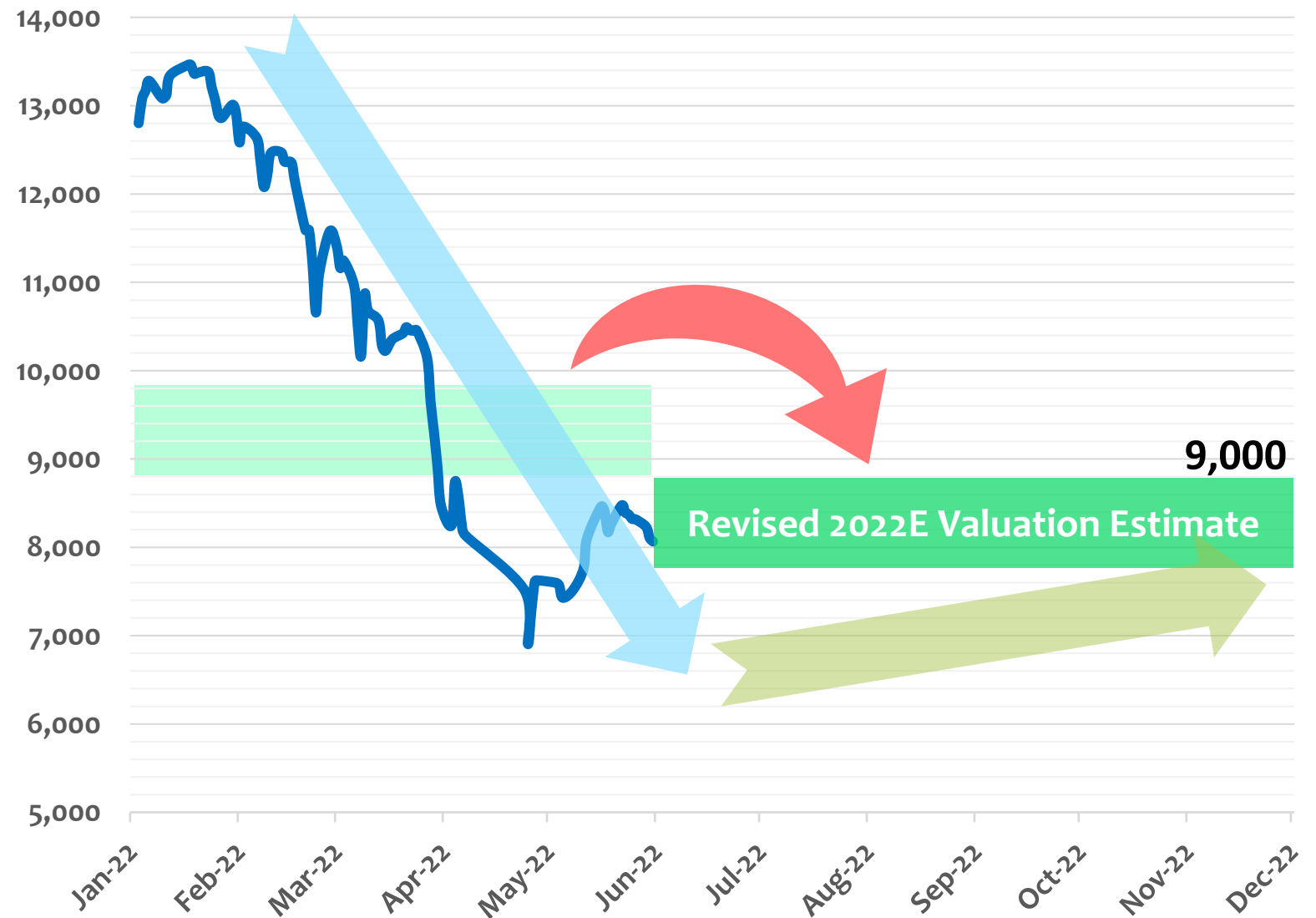
First Capital Research View on Equity Market Jul'22-Jun'23

Section 6.4



Our Equity Strategy of 6th Jun 2022 was proven accurate with the ASPI surging past 9,000 after weeks of stagnation and falling below the 7,000 as indicated

RECAP: Jun 2022 Accurate



Source: CSE, First Capital Research Estimates

Impact of Fiscal Consolidation on Businesses to be negative...



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.

...with Multiple shocks on Earnings...



Ballooning Finance Cost

Surge in AWPR



Uprising Energy Cost

Surge in Electricity, Fuel



Eroding Buying Power

Surge in Inflation & Currency Depreciation



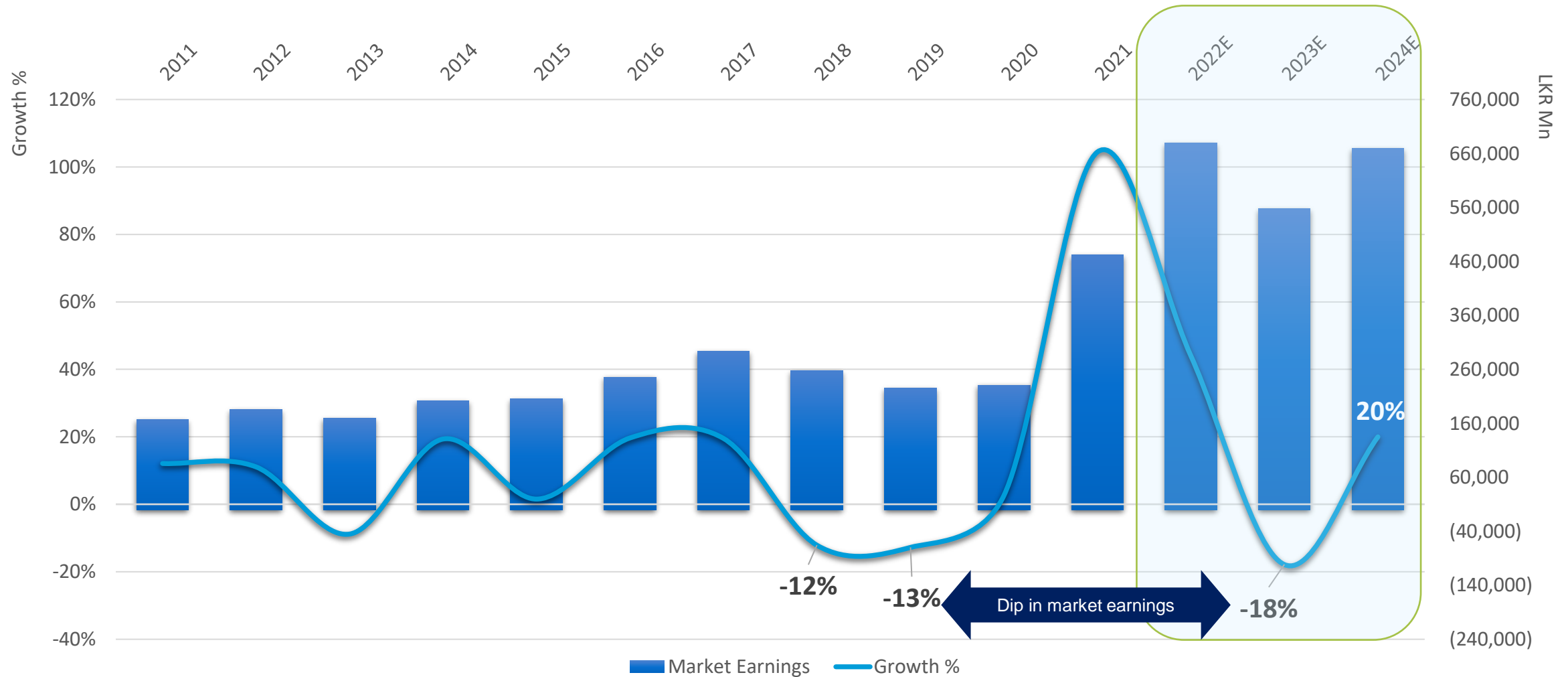
Operational Disruptions

Power outages / Distribution disruptions



Tax Hikes

...resulting in market earnings potentially compressing by -18.0% in 2023E and thereafter growing by 20.0% in 2024E



Source: CSE, First Capital Research Estimates

ASPI to reach 12,000 by Dec-2023E

With strong indications that Sri Lanka may enter an IMF support facility creating a cautiously bullish environment for equities.

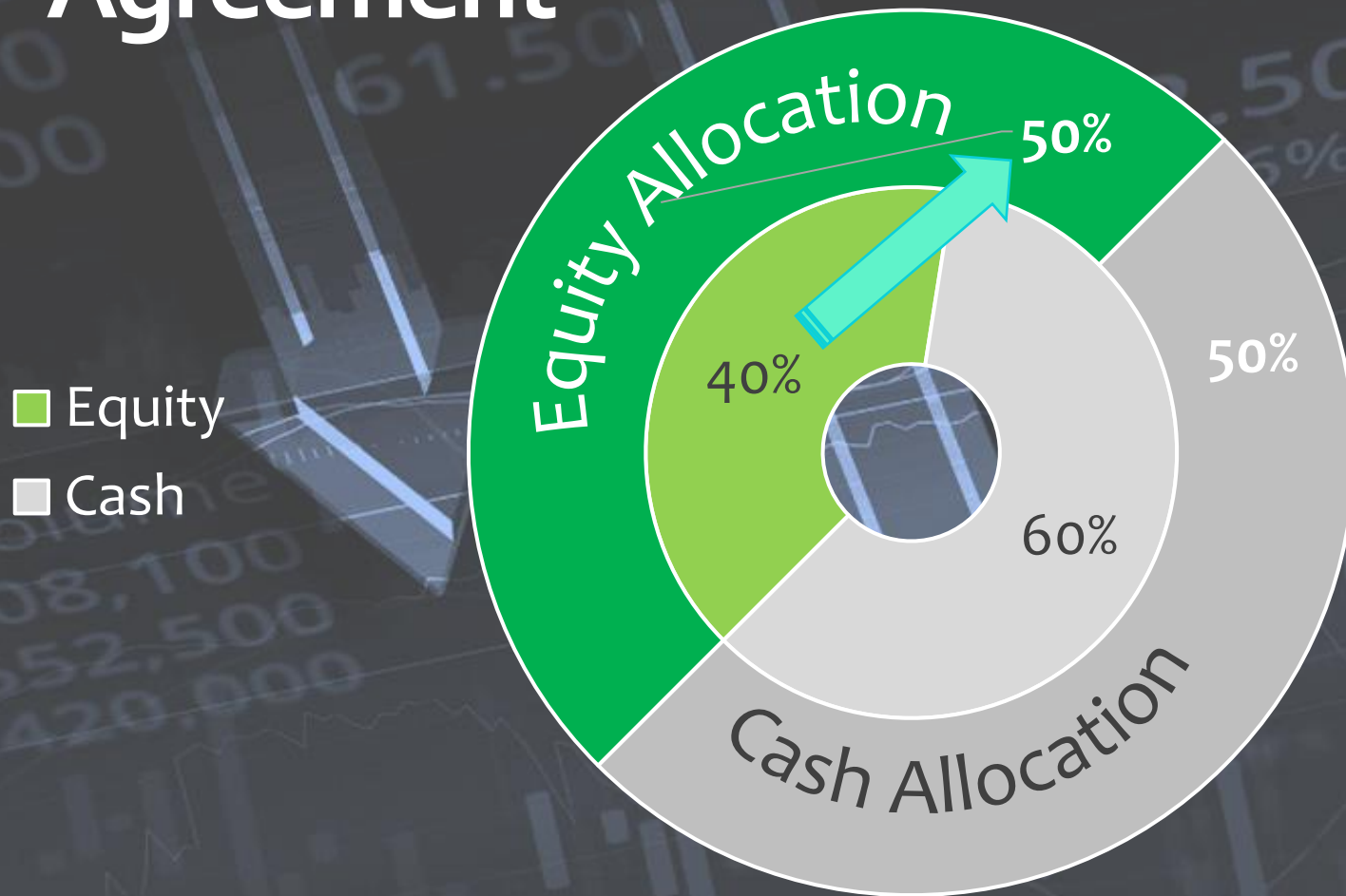
We believe that purchasing power of consumers to return over a 3-year period with the re-rating of wages.

Further post Debt structuring and elections would provide the much-needed clarity in policy implementation which is expected to significantly improve within an IMF program.

On expectation of a strong recovery in earnings and positive growth levels of GDP returning from 4Q2023 and beyond, is likely to create a strong bullish sentiment for equities. We expect market to re-rate allowing the index to showcase strong positive returns in 2H2023E with the index likely to reach 12,000.



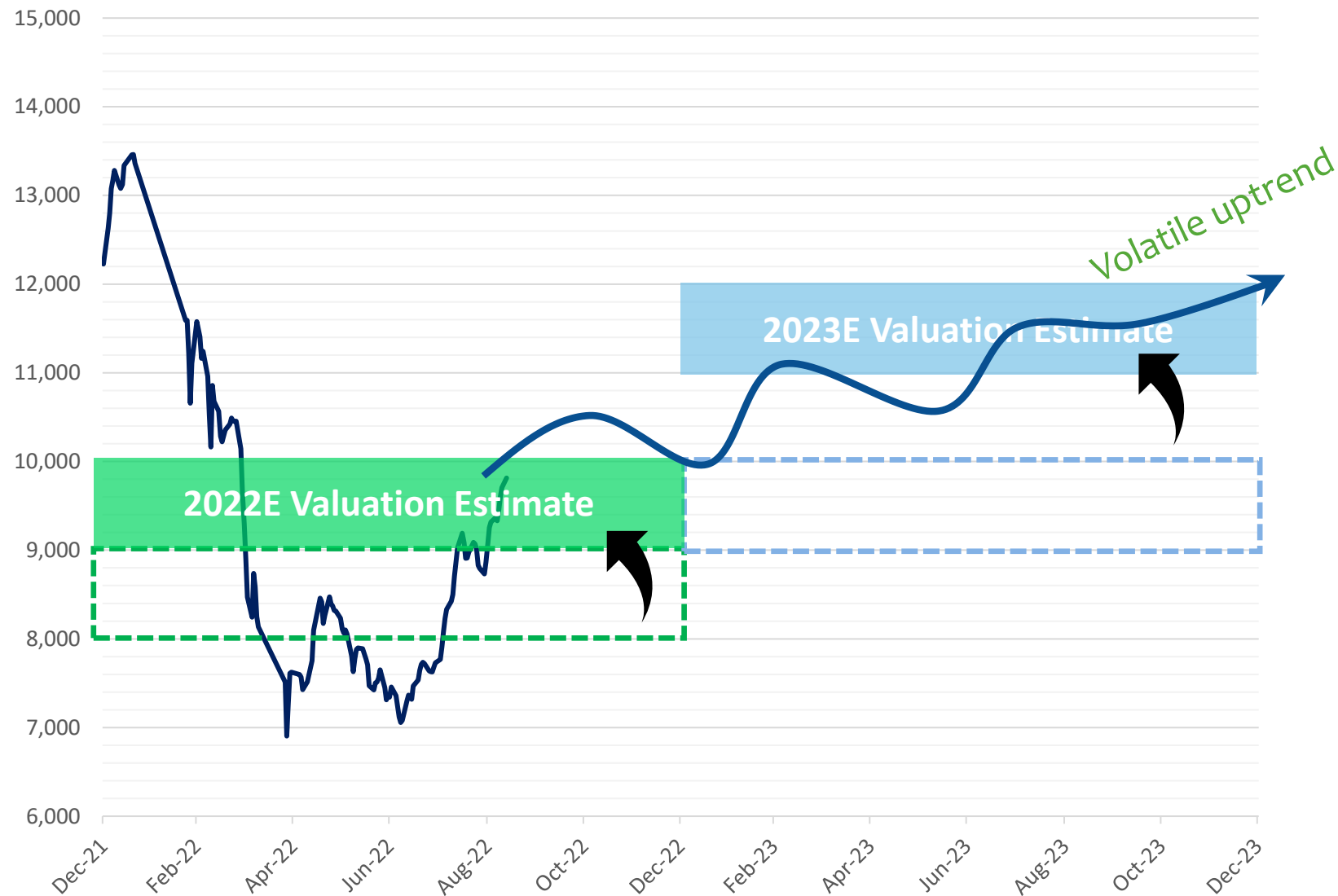
Cautiously Optimistic amidst entering an IMF Staff Level Agreement



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

Our ASPI fair value for 2022E is upgraded to a range of **9,000-10,000** and our range for 2023E significantly increased to **11,000-12,000** on positivity on entering an IMF support program

ASPI to reach **12,000** by Dec-2023 on IMF positivity



Source: CSE, First Capital Research Estimates

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Thank You

“Successful investments is about managing risks”

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