“Clear Direction on Domestic Debt Restructuring drives down yields”

04th Apr 2023

FIRST CAPITAL FIXED INCOME RECOMMENDATION

FIRST CAPITAL RESEARCH

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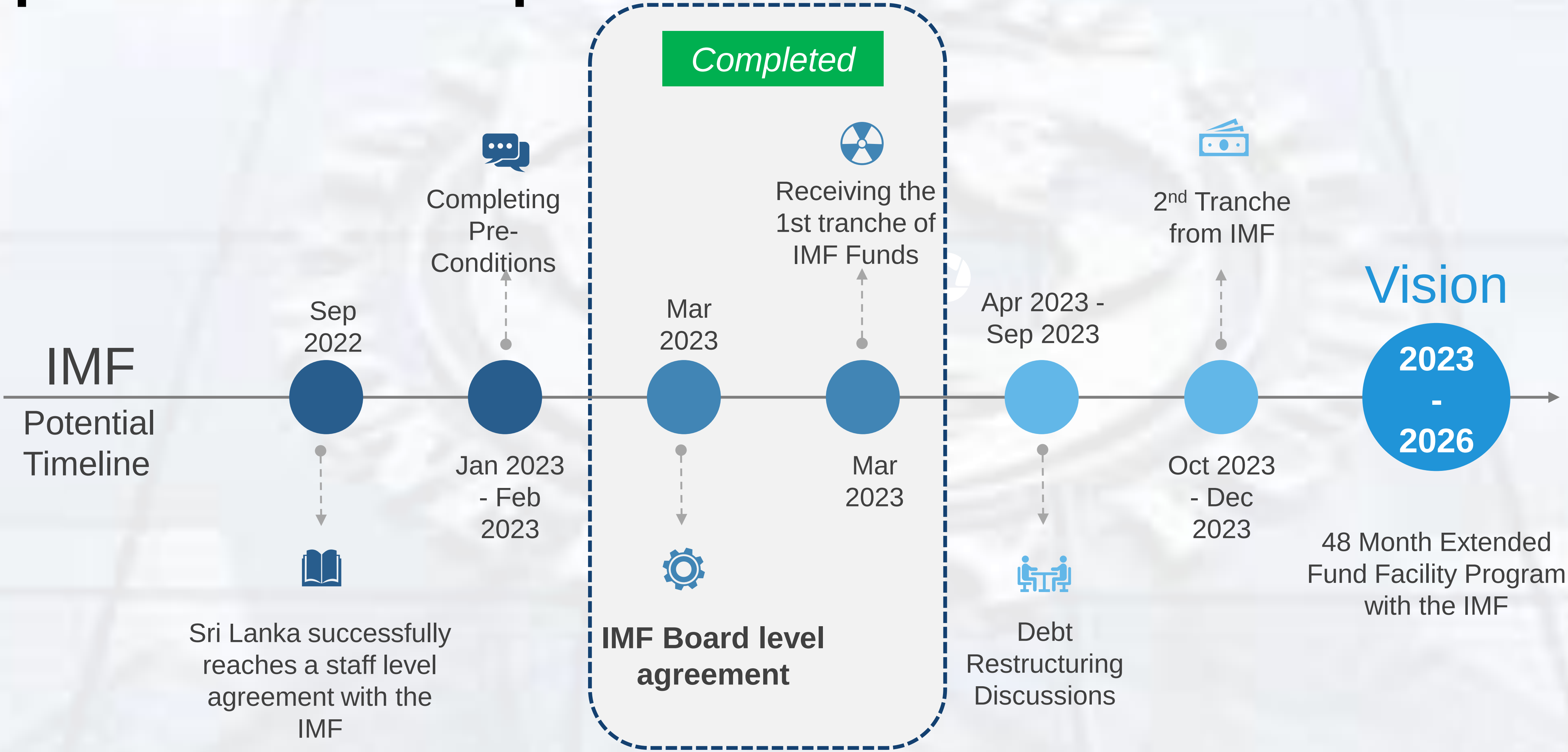
Sri Lanka signs IMF deal in Mar-23, in-line with First Capital Research expectations



Source: First Capital Research

1.0 Summary of Creditor Meeting

“Authorities revealed that T-Bills held by the govt. would be considered for the debt restructuring process and T-Bond re-structure would be voluntary”

Sri Lanka has pledged to implement further extensive reforms to secure long term recovery…

2Q2023

- Parliamentary approval of welfare benefit payment scheme (Enhanced Social Safety Nets)
- Cabinet approval of a comprehensive strategy to restructure the balance sheets of key SOEs
- Parliamentary approval of new anti-corruption legislation
- Parliamentary approval of the new Central Banking Act

3Q-4Q 2023

- Revamping the VAT system by removing almost all product specific VAT exemptions
- Submitting the Public Financial Management (PFM) Law to Parliament
- Parliamentary approval for the full revision of the Banking Act

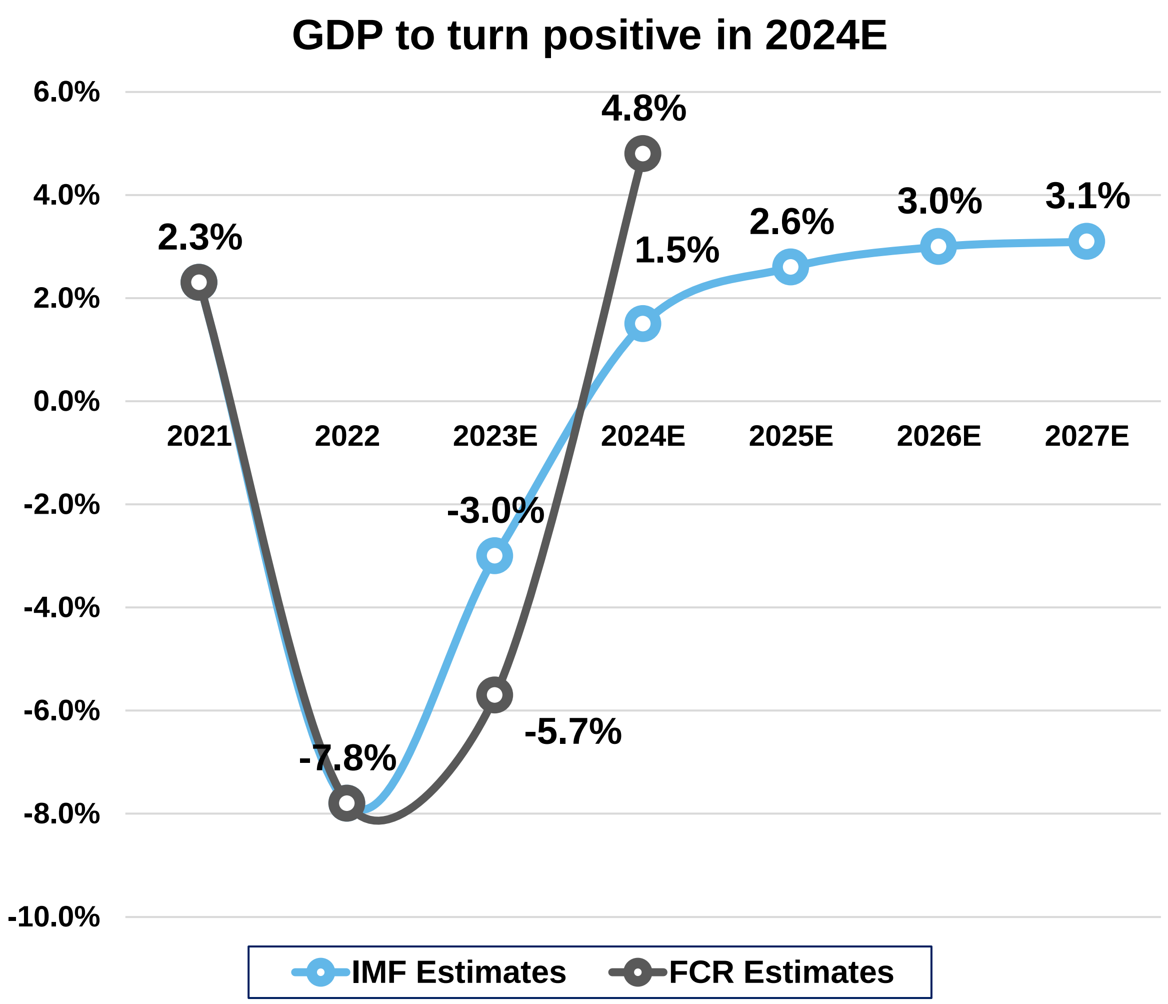
2024

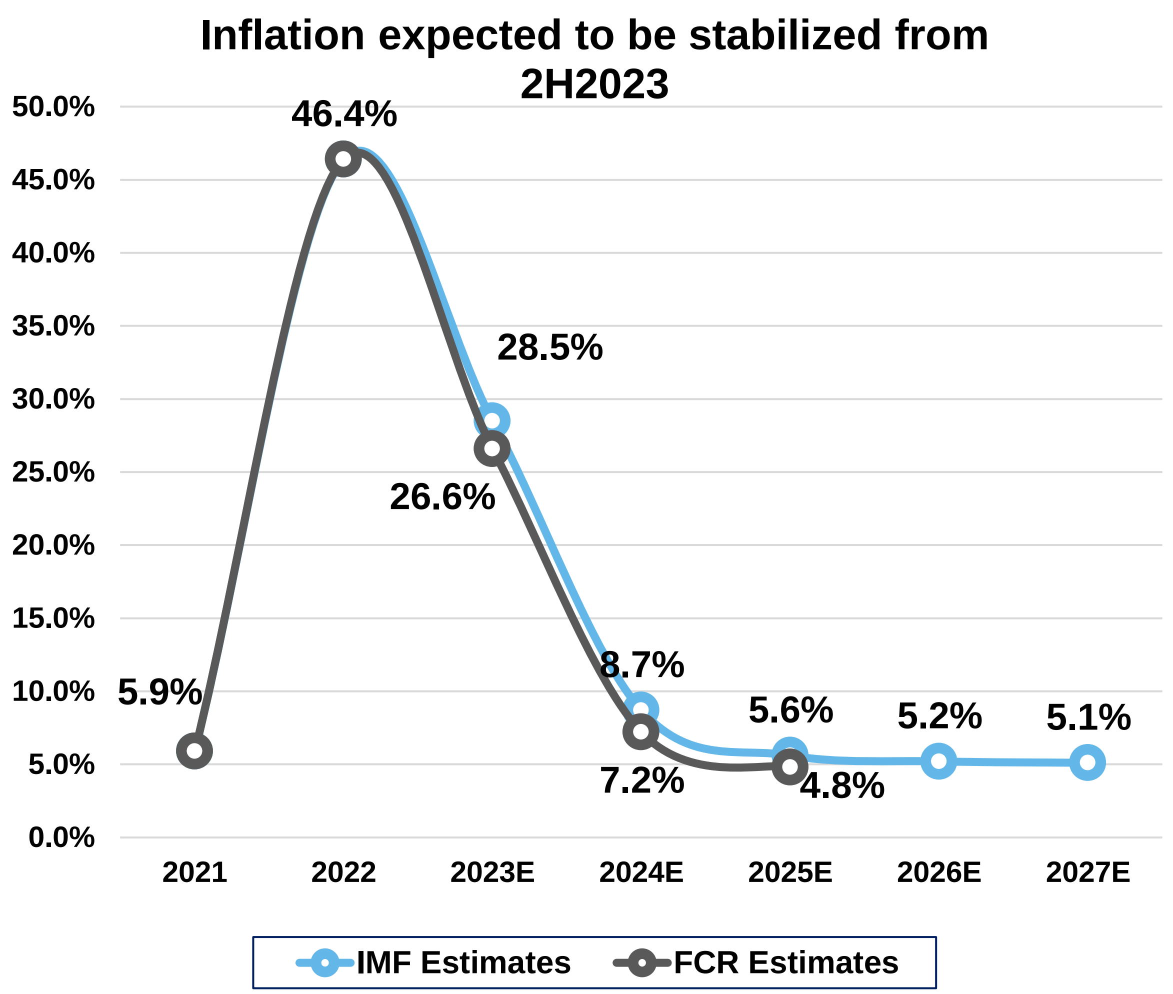
- Introduction of reforms making the Minister of Power and Energy responsible for implementing cost-recovery based fuel and electricity price adjustments
- Introduction of a property tax, a gift and an inheritance tax

Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance)

IMF review is scheduled for every 6 months:
1^{st} review - Sep 2023
4^{th} review – Mar 2025

…which may allow the economy to fully recover and restore macroeconomic stability…

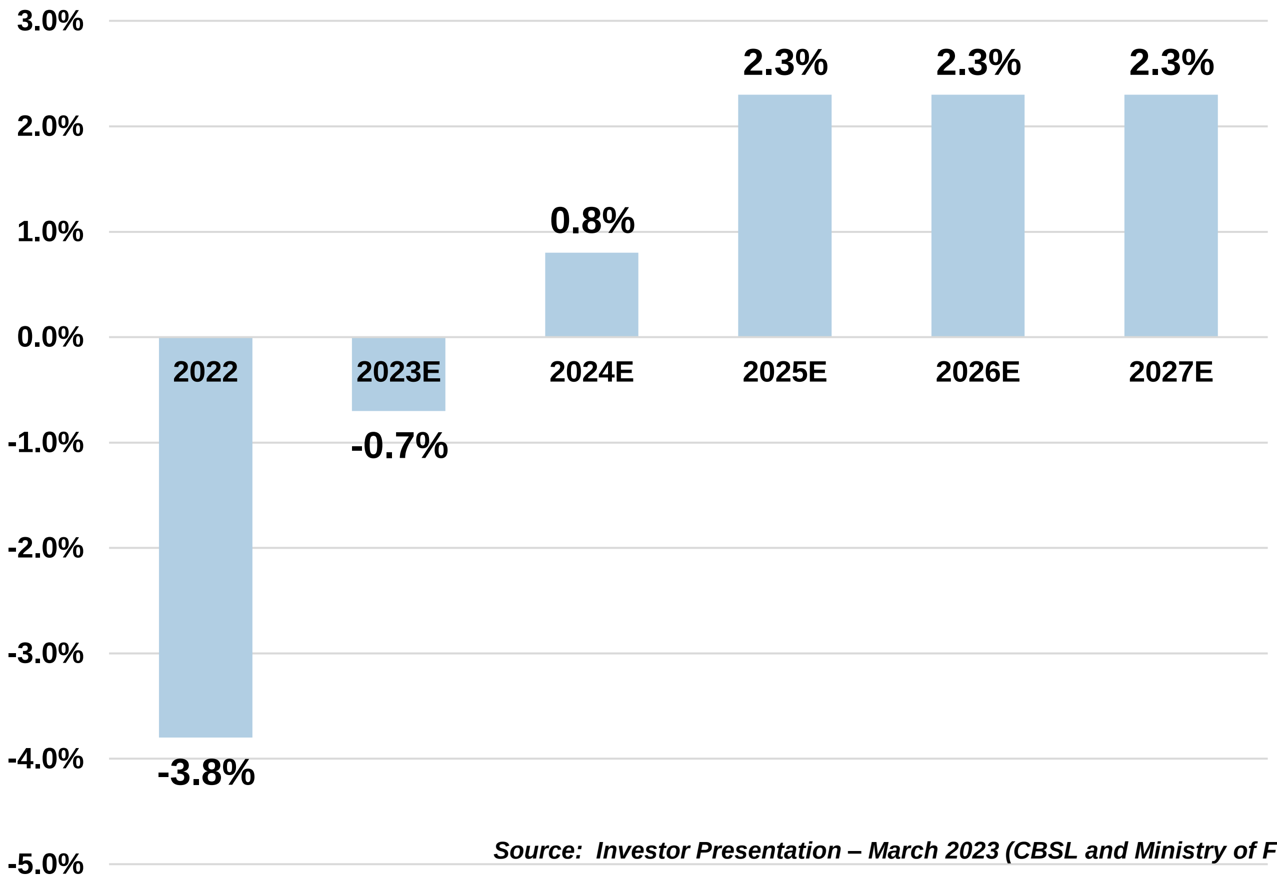




Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance), First Capital Research

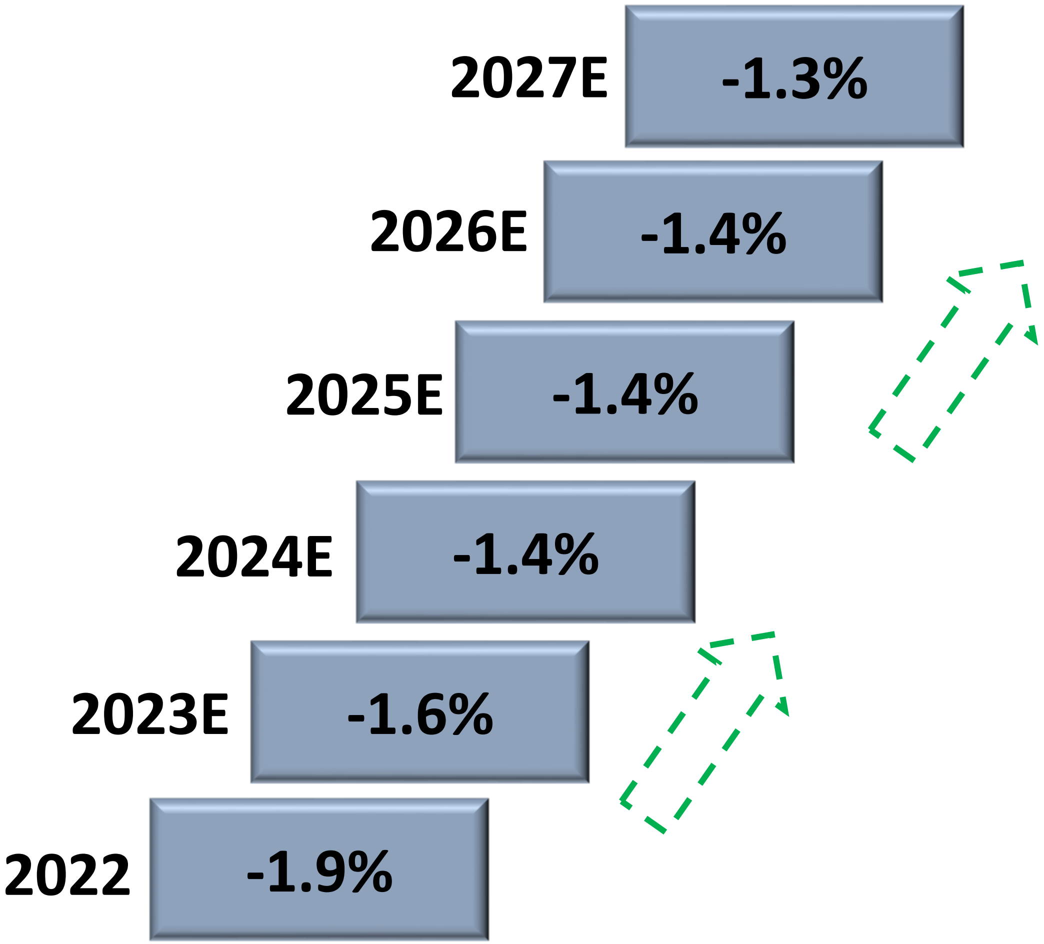
…and improves business confidence and the trade potential of the country

Primary Account surplus to be stabilized at 2.3% as a percentage of GDP by 2025



Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance)

Current Account deficit expected to contract and remain -1.4% as a percentage of GDP by 2025

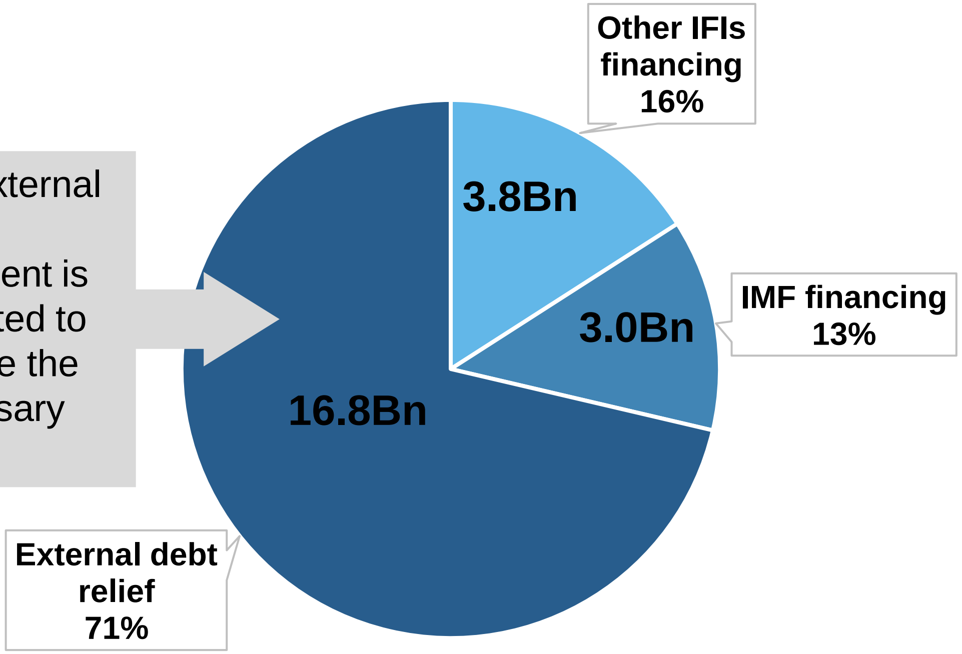


Sri Lanka aims to achieve Gross International Reserve target of USD 14.0Bn by end-2027

Sri Lanka's estimated external financing gap of USD 23.6Bn from 2023E-2027E to be bridged through multiple financing:

(USD Bn)

The external debt treatment is expected to provide the necessary relief.



The contemplated debt treatment enable the country to reach <u>Debt sustainability targets</u> reflected in the IMF framework

Debt stock target: 95% of GDP by 2032

GFN target: 13% of GDP in 2027-32

FX debt service target: 4.5% of GDP in 2027-32

Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance)

68% of the external debt is considered for debt treatment

Central Government and Guaranteed SOEs Foreign Currency Debt (USD 45.5Bn)

Considered for debt treatment (USD 30.8Bn, 68%)

- Bilateral creditors (USD 10.6Bn, 34%)
- Private creditors (USD 20.3Bn, 66%)

Excluded for debt treatment (USD 14.7Bn, 32%)

- Multilateral creditors (USD 11.5Bn)
- Emergency assistance credit lines (USD 0.8Bn)
- Bilateral Swap Lines (USD 2.0Bn)
- CPC and CEB forex payables (USD 0.3Bn)

Considered

Not Considered

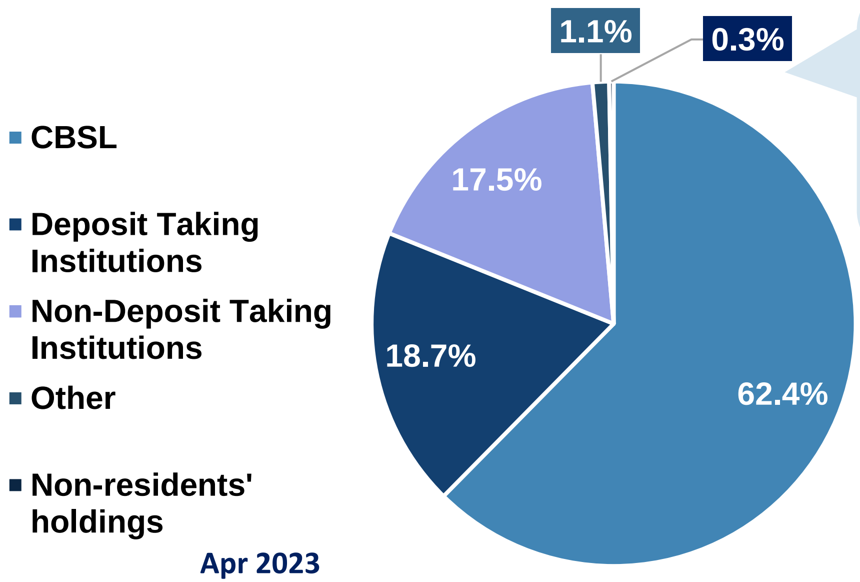
Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance)

Debt treatment for local currency debt

Central Government Local Currency Debt
LKR 13,189Bn (USD 36.3Bn)

T-Bills	T-Bonds	Other Loans	CBSL Advances
LKR 4,126Bn (USD 11.4Bn)	LKR 8,722Bn (USD 24.0Bn)	LKR 104Bn (USD 0.3Bn)	LKR 236Bn (USD 0.6Bn)

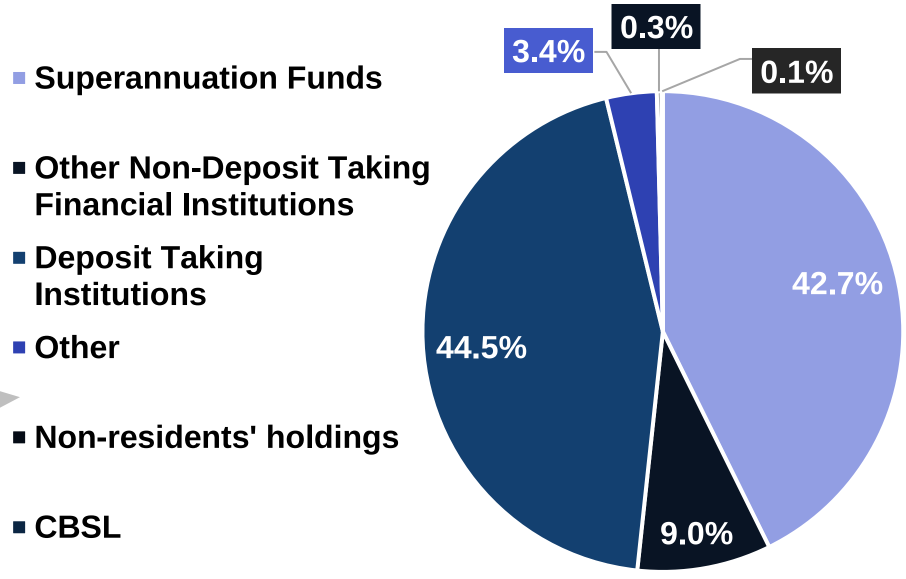
T-Bills Holders



only **T-Bills held by the CBSL, will be considered for treatment** (restructuring) in order to free up some fiscal space

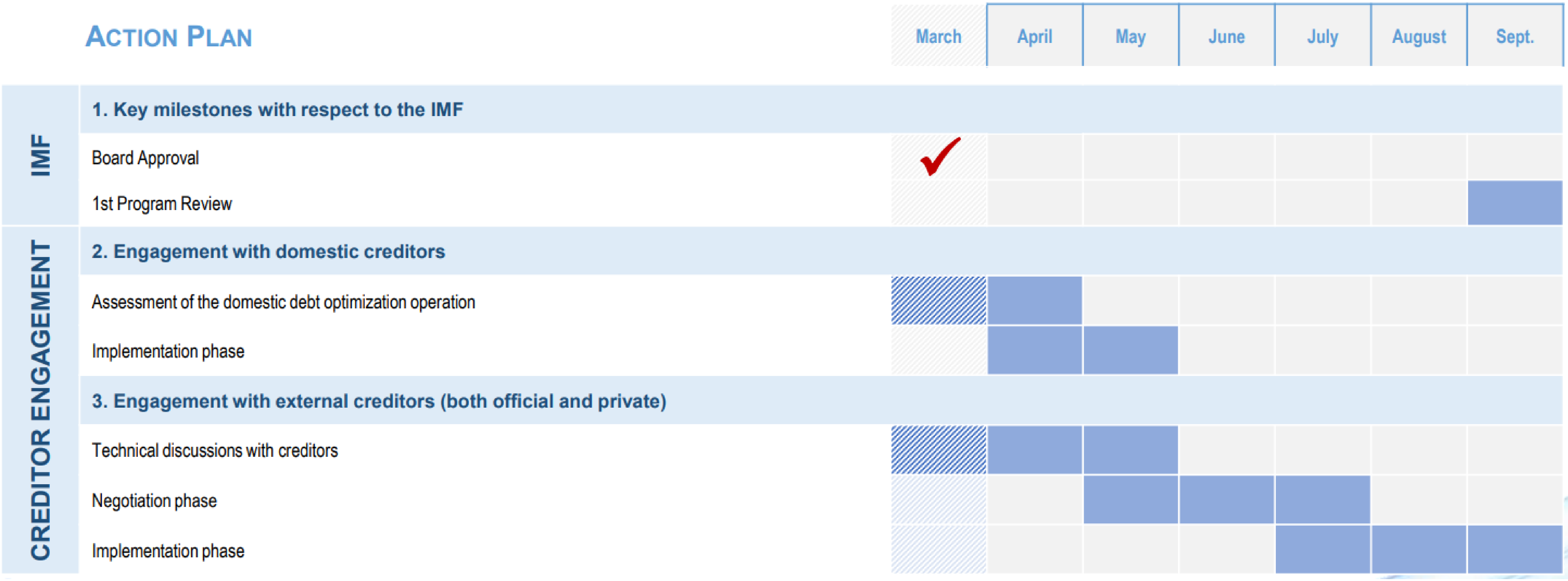
For T- Bonds, **a voluntary domestic debt optimization** operation without coercion is planned

T-Bonds Holders



Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance)

Targeted timeline for the Debt Restructuring Process



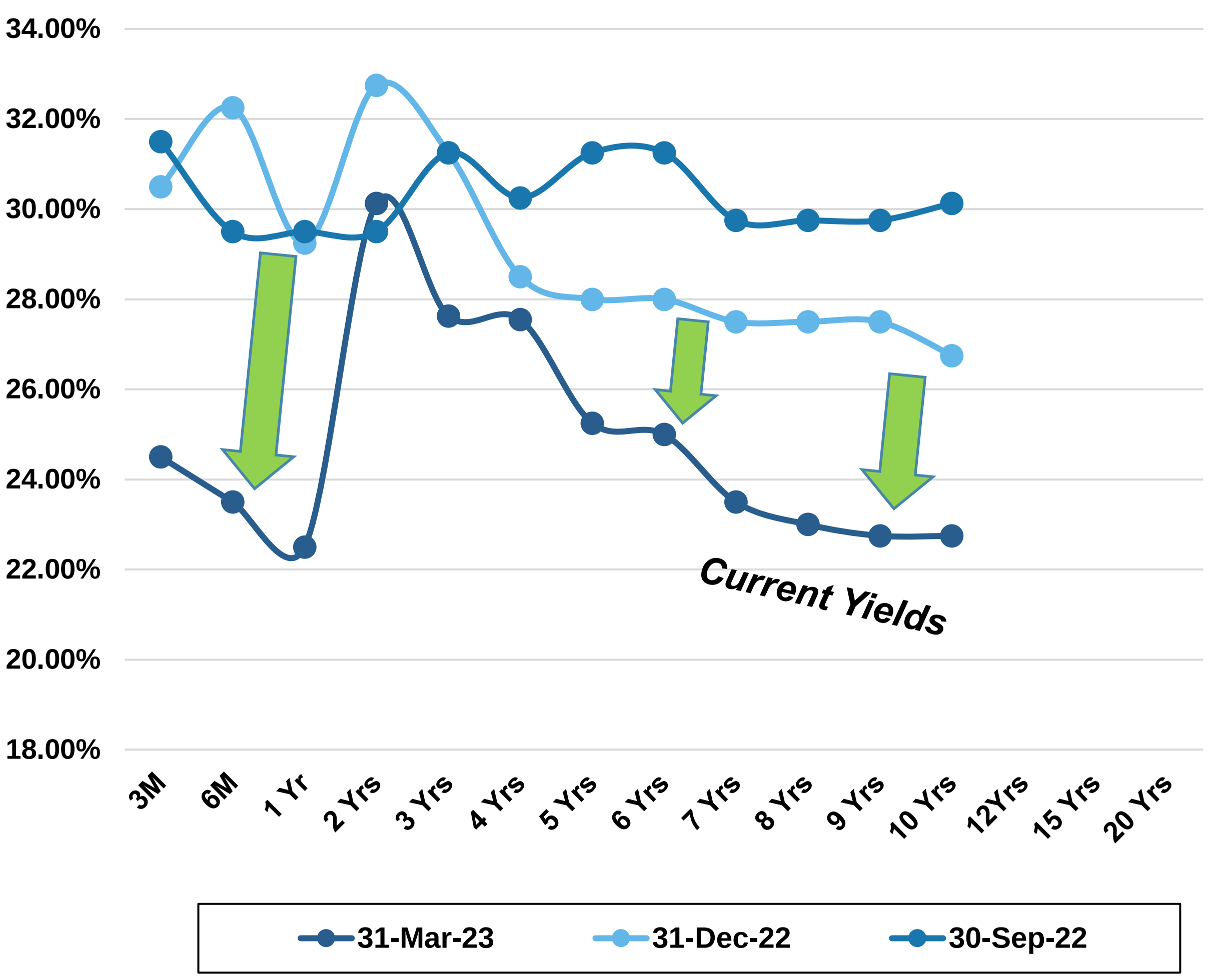
Source: Investor Presentation – March 2023 (CBSL and Ministry of Finance)

1.0 FCR - Previous Recommendation

"Yields returning to normalcy after Sri Lanka secured the USD 3.0Bn IMF deal "

Overall yield curve movement

Yield curve quarter end comparison

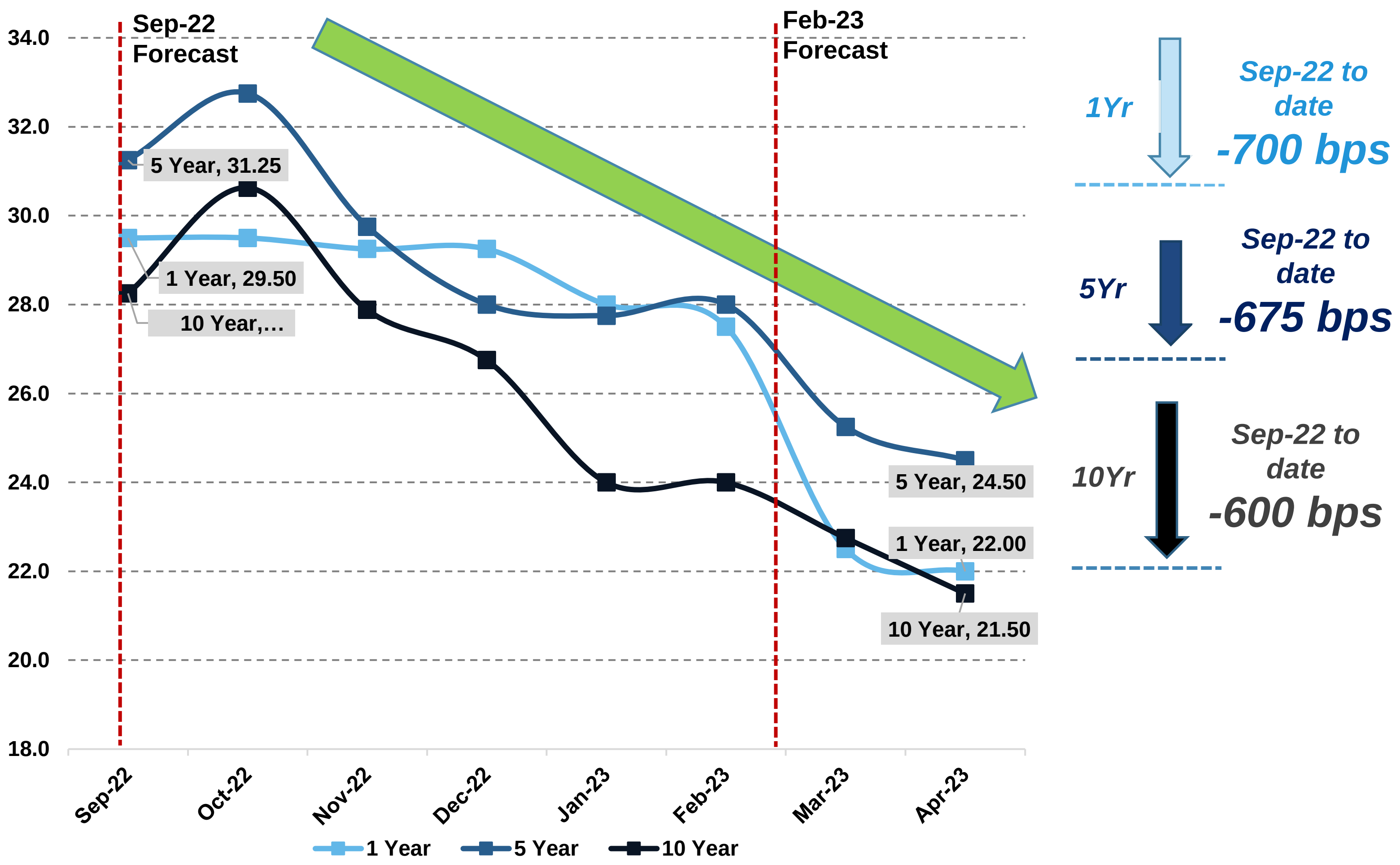


Interest Rate Change (bps)

Tenure	Mar-23	Dec-22	Change (bps)	Sep-22	Change (bps)
3M	24.50%	30.50%	-600	31.50%	-700
6M	23.50%	32.25%	-875	29.50%	-600
1 Yr	22.50%	29.25%	-675	29.50%	-700
2 Yrs	30.13%	32.75%	-262	29.50%	+ 63
3 Yrs	27.63%	31.25%	-362	31.25%	-362
4 Yrs	27.55%	28.50%	-95	30.25%	-270
5 Yrs	25.25%	28.00%	-275	31.25%	-600
6 Yrs	25.00%	28.00%	-300	31.25%	-625
7 Yrs	23.50%	27.50%	-400	29.75%	-625
8 Yrs	23.00%	27.50%	-450	29.75%	-675
9 Yrs	22.75%	27.50%	-475	29.75%	-700
10 Yrs	22.75%	26.75%	-400	30.13%	-738
12 Yrs	N/A	N/A	N/A	N/A	N/A
15 Yrs	N/A	N/A	N/A	N/A	N/A
20 Yrs	N/A	N/A	N/A	N/A	N/A

Source: First Capital Research

30th Sep-22 to 03rd Apr-23 bond yields plunged by nearly 600bps



Source: First Capital Research

Previous Recommendations

21st Sep 2022

"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"

\- **Mostly Accurate**

28th Feb 2023

"Bond yields are likely to witness a continuous dip towards Mar 2023 on successful progression that is likely to be made on the board level agreement and receiving of the 1st tranche from the IMF"

\- **Accurate**

3.0 Fixed Income Health Score

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

FI Economic Health Score – Mar-23

Fixed Income Health Score records a significant improvement during the 1Q2023 supported by multiple factors in primary and secondary criteria inclining the health score to 41 points.

Primary Criteria	- 25	+	05	=	30
Secondary Criteria	- 08	+	03	=	11
Economic Health Score [Mar 2023]				=	41

[As against 33 in Dec 2022 & 15 in Mar 2023 (1 Year ago)]

Source: First Capital Research

Changes to Health Score
Primary Criteria – Jan-Mar 2023

30/ 75

	Foreign Reserves	Liquidity	Inflation	Foreign Activity	Credit	CBSL Holdings
Mar 2023- Score	03/15	03/15	02/15	02/10	10/10	10/10
Change	+2		+2	+1		
Dec 2022- Score	01/15	03/15	00/15	01/10	10/10	10/10

Foreign Reserves

Foreign reserves improved gradually and recorded at USD 2.2Bn for Feb 2023.

Liquidity

Liquidity level was highly volatile and closed the month of Mar 2023 positively at LKR 27.4Bn compared to LKR -129.4Bn recorded at the beginning of the month.

Inflation

CCPI continued to decline for the 6th consecutive month and recorded at 50.3% in Mar 2023, and expected to stabilize from 2H2023.

Foreign Activity

Foreign Investment in Govt. securities significantly inclined to LKR 71.6Bn amidst the high interest rates.

Credit

Private sector credit further contracted to LKR 7,318.0Bn in Jan 2023 compared to LKR 7,414.1Bn in Dec 2022 due to the sharp escalation in lending rates.

CBSL Holdings

CBSL holdings remained steady above LKR 2,600.0Bn during the month of Mar 2023.

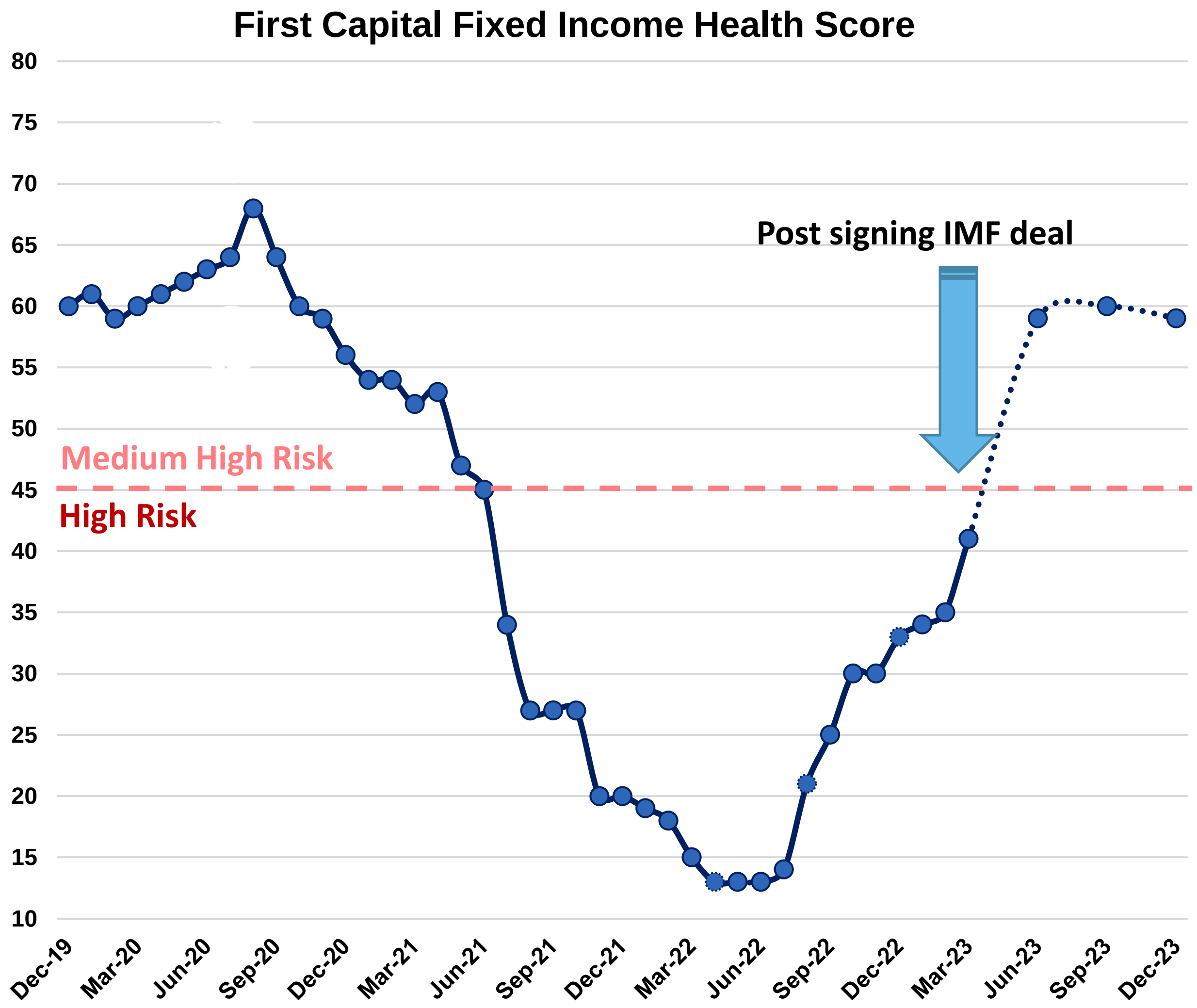
Changes to Health Score
Secondary Criteria – Jan-Mar 2023

	Rating Outlook	External Environment	BOT & BOP	Political Risk	Investor Confidence
Mar 2023- Score	01/05	03/05	04/05	02/05	01/05
	S&P has downgraded Sri Lankan bonds to ‘D’, representing default. Meanwhile, Moody’s downgraded Sri Lanka's debt rating to 'Ca' from ‘Caa2 in Apr 2022. Fitch downgrades SL Long-Term Local-Currency Issuer Default Rating (IDR) to 'CC', from 'CCC.	Foreign exchange market remains highly volatile, while USD/LKR has appreciated by 10.9% YTD and 9.5% during the month of Mar 2023.	Trade deficit contracted and recorded at USD 449.0Mn in Feb 2023 while BOP turned into surplus and recorded at USD 317.0Mn amidst the rise in foreign inflow from tourism and worker remittances.	Political stability is maintained. However, popularity of the govt. is deteriorating due to uncertainties.	The BCI registered only a marginal decline of one basis points to 34 in 4Q2022 *cf.* 35 in 3Q2022. However, we believe business confidence to improve gradually considering the economic rebound post IMF
	+1	+1	+1	-1	+1
Dec 2022- Score	00/05	02/05	03/05	03/05	00/05

4.0 New Recommendation

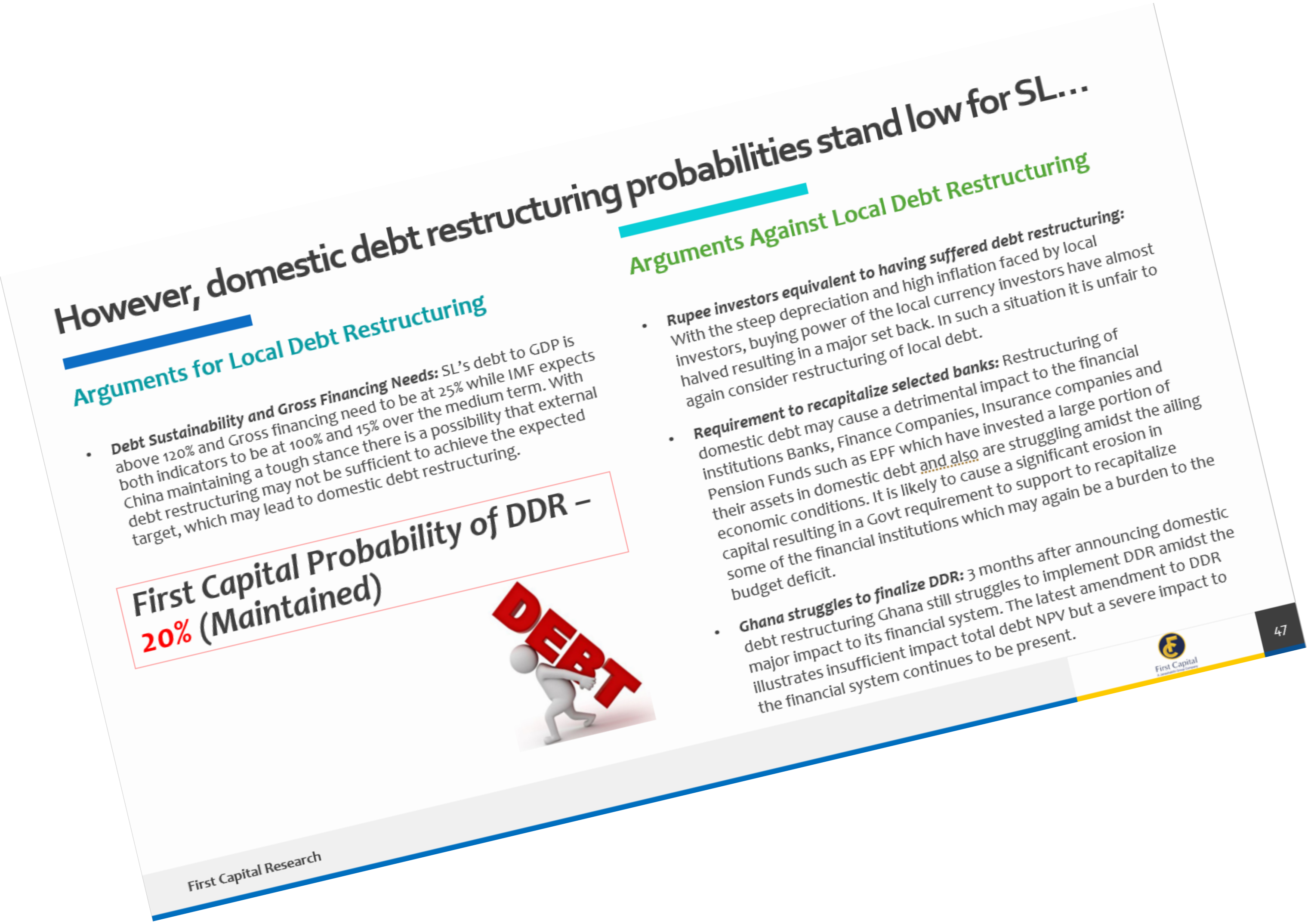
"Maintain bullishness on Bonds"

FI Health score nosedived in Jun-22 and is gradually on the uptrend after Sri Lanka secured the IMF staff level agreement in Sep 2022. We expect it to further improve from 2Q2023 considering the potential development in key economic indicators (mainly IMF reforms)



Bond Yield risk premiums reduce with CBSL clarifying stance

Mostly Accurate



First Capital Research accurately predicted that domestic debt restructuring probabilities stand low at 20%.

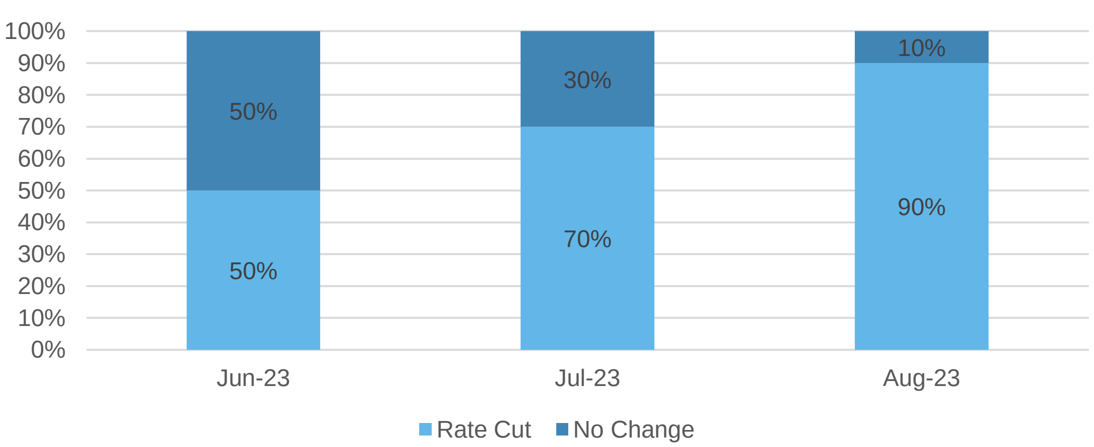
At the creditor meeting held on 30th of Mar 2023, CBSL clearly highlighted the way forward on domestic debt restructuring. As illustrated in slide 9, out of T-Bills, only the instruments held by CBSL are expected to be reprofiled, while in relation to T-Bonds, a voluntary domestic debt optimization operation without coercion will be performed.

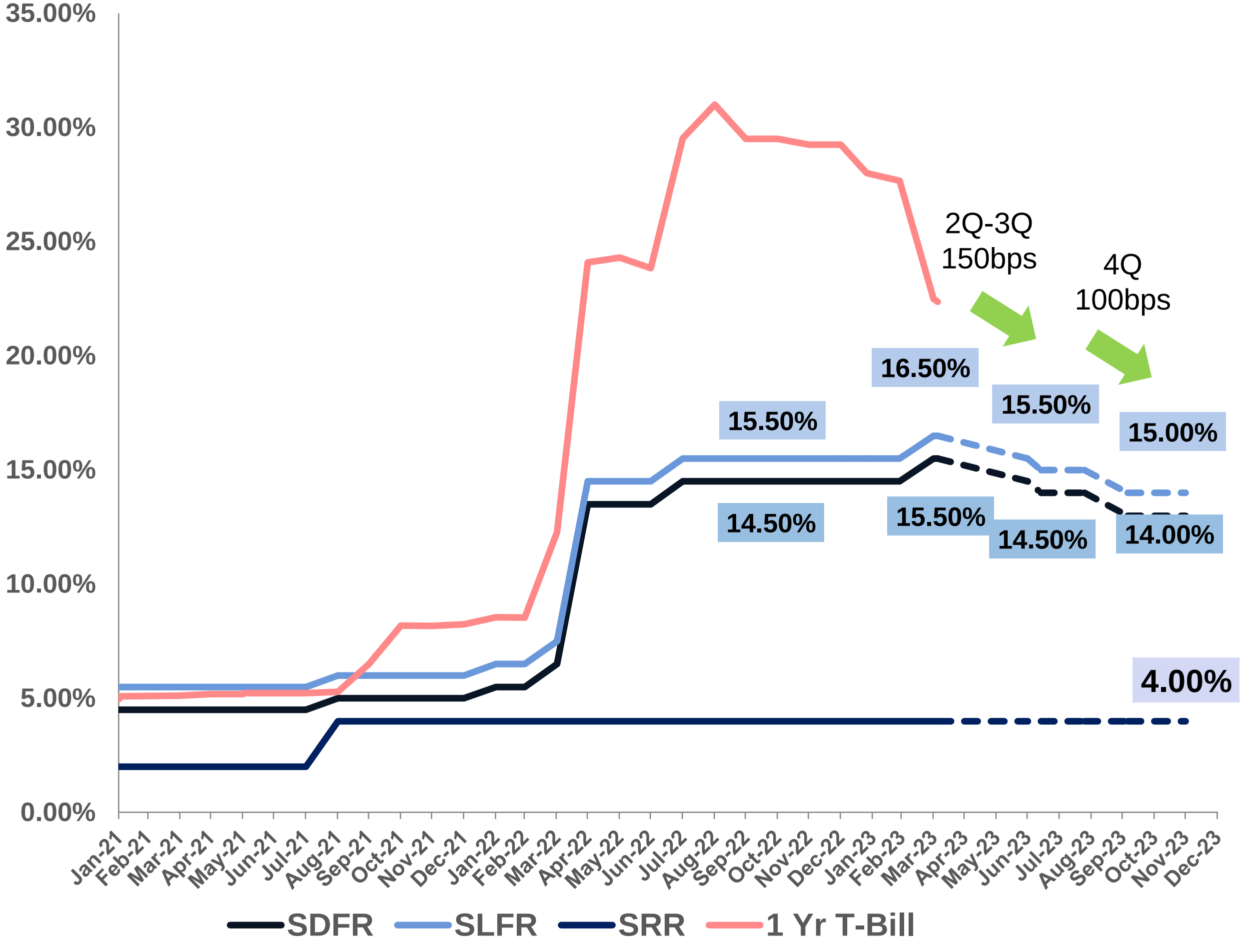
We believe that most of the reprofiling in the T-Bonds are likely to be for the superannuation funds while the deposit taking financial institutions are likely to have minimal impact.

Recap: Bond Yield Expectations of Feb 2023 (Investment Strategy): *Maintained*

We expect the complete normalization of the economy with the country entering 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 cuts from 2Q2023 onwards.**

Rate cut is likely to be a strong probability towards 2Q-3Q2023 where we target about 2 rate cuts amounting to a cumulative dip of about 150bps and another 100bps in 4Q2023

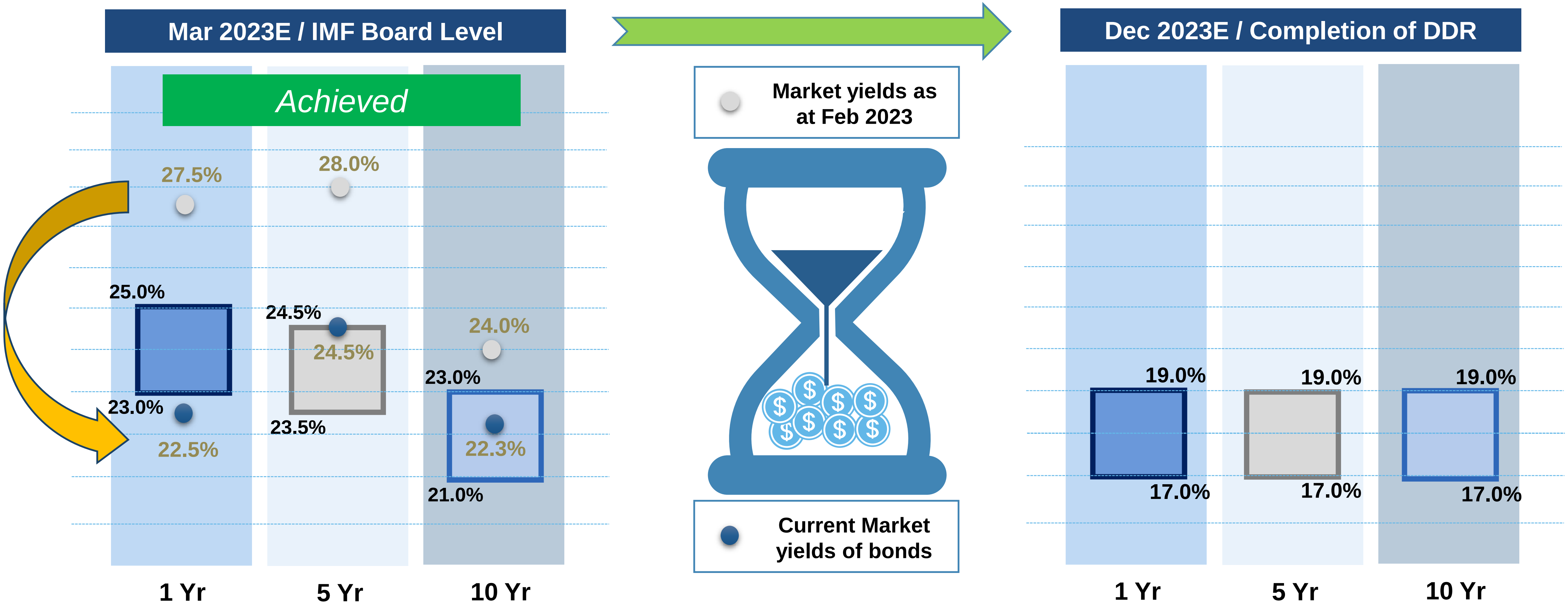




Source: First Capital Research

Recap: Bond Yield Expectations of Feb 2023 (Investment Strategy): *Maintained*

In line with the expectations following the IMF Board Level Agreement and the subsequent creditor meeting bond yields recorded a steep drop falling into the targeted ranges of First Capital Research. With the completion of domestic debt restructuring or towards Dec-23 we believe the overall yield curve is likely to drop below 20%.



Source: First Capital Research

First Capital Research remains Bullish on bonds as yields stay attractive

Attractive BOND YIELDS

DDR impact, lower than anticipated: Bond yields remained on an accelerated moderation path, post creditor meeting by the CBSL where investors were given clear direction on the domestic debt restructuring process. With bills (excluding holdings by CBSL) not being subjected to any restructuring and bonds being restructured on a voluntary basis, the expected impact from debt restructuring is lesser than initially anticipated. Thereby the premium attached to bonds are likely to reduce amidst lower risk.

Attractive Yields: With economic indicators improving, clarity of DDR being provided, yields are expected to return to normalcy, possibly reaching a range of 17%-19% by the end of the year, with the yield curve across the board likely to shift downwards. Yield curve continue to remain attractive with short-mid tenors still hovering in the range of 25%-26%.

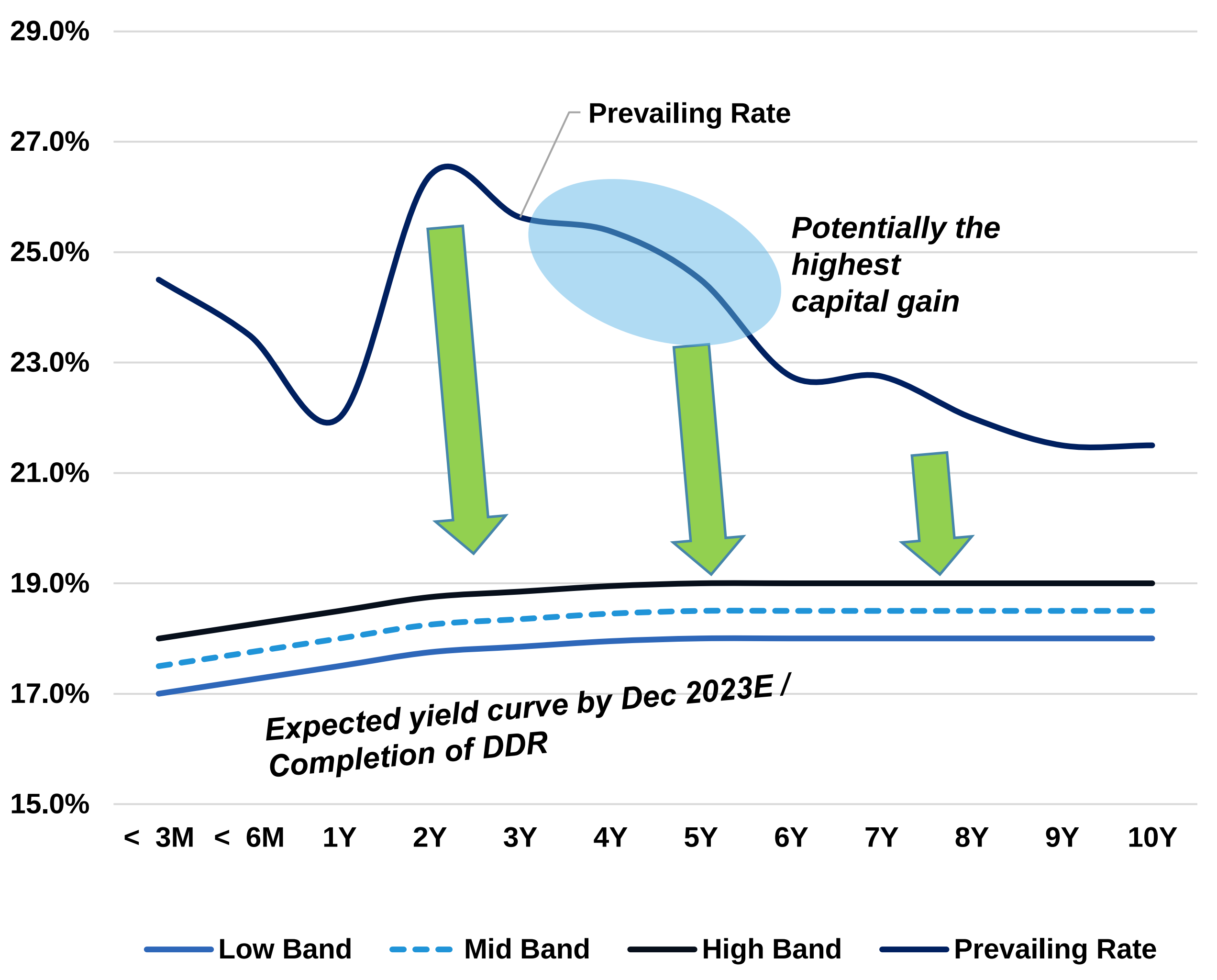
Higher coupon bonds: As the newly issued 5-10yrs bonds are providing a coupon rate of 18.00% to 20.00%, FCR recommends to take the opportunity to restructure the existing portfolio and reinvest or newly invest into higher coupon bonds.

With the sizeable supply to the market by CBSL the 2Yr-5Yr bonds are yet to fully adjust in the yield resulting in odd shaped yield curve.

Comparing the expectations by the end of the year of the completion of domestic debt restructuring, the *yield curve is expected to normalize* while also *dipping to a range of 17%-19%* as depicted in slide 22.

We believe that the *4Yr-5Yr bond range* provides the opportunity for investors to attain the best possible return.

FCR recommends to increase exposure to 4YR-5Yr Bonds



Potential Capital Gains if yield curve declines to targeted range

4YR-5Yr Bonds to provide stronger capital gains

Tenor	Maturity	Coupon	Purchase Yield	FV of Investment	Targeted Yield	Capital Gain
2Y	01-Jul-25	18.00%	26.38%	100,000,000	**18.25%**	*13,366,274.20*
3Y	15-May-26	22.50%	25.63%	100,000,000	**18.35%**	*14,183,069.17*
4Y	15-Sep-27	20.00%	25.38%	100,000,000	**18.45%**	*17,594,362.84*
5Y	15-Jan-28	18.00%	24.50%	100,000,000	**18.50%**	*16,461,540.80*
6Y	01-Jan-29	13.00%	22.75%	100,000,000	**18.50%**	*13,047,157.44*
7Y	15-May-30	11.00%	22.75%	100,000,000	**18.50%**	*13,086,300.71*
8Y	15-May-31	18.00%	22.00%	100,000,000	**18.50%**	*12,877,161.63*
9Y	01-Jul-32	18.00%	21.50%	100,000,000	**18.50%**	*11,823,996.83*
10Y	15-Jan-33	11.20%	21.50%	100,000,000	**18.50%**	*9,968,949.60*

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