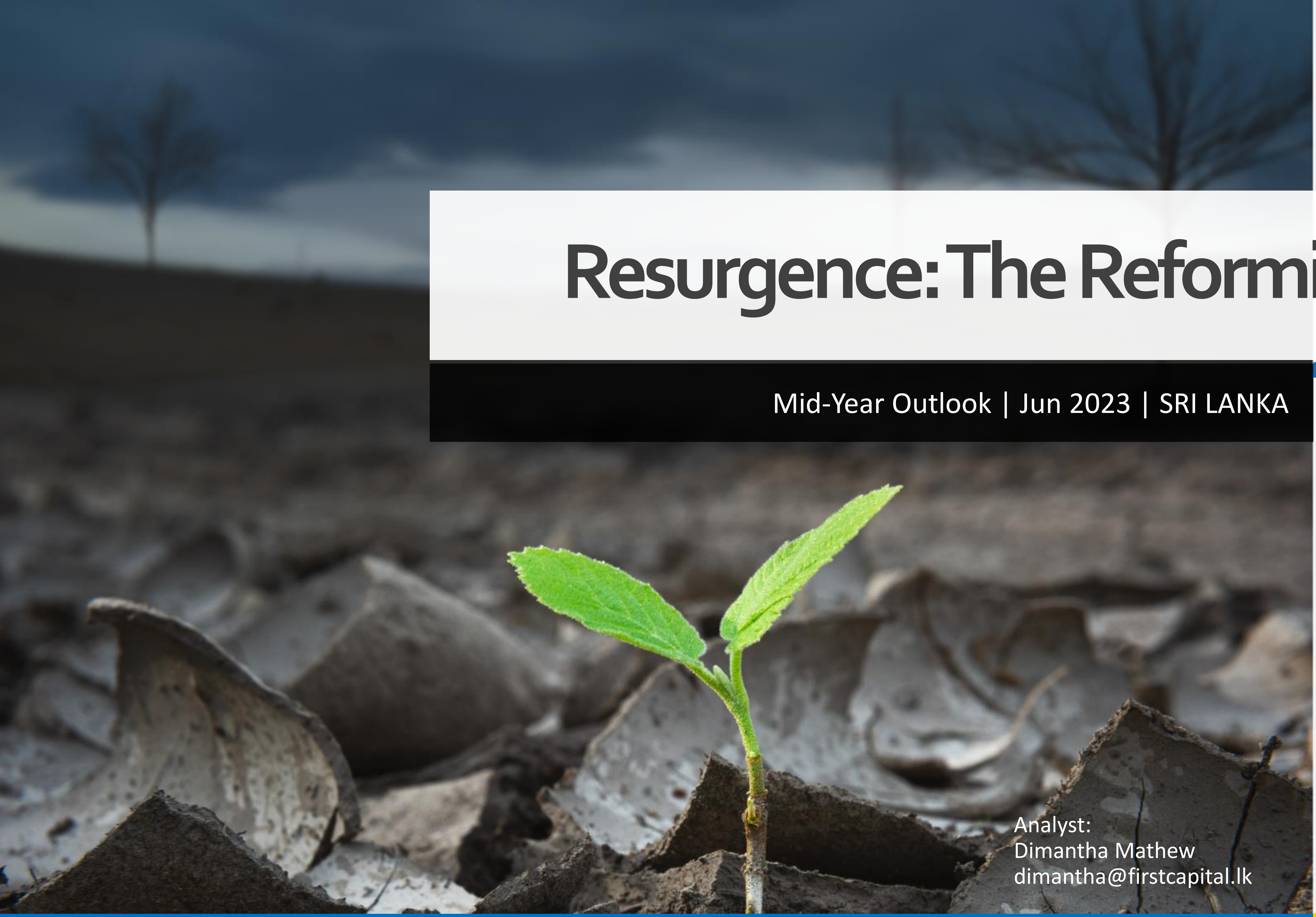
Resurgence: The Reforming Phase

Mid-Year Outlook | Jun 2023 | SRI LANKA



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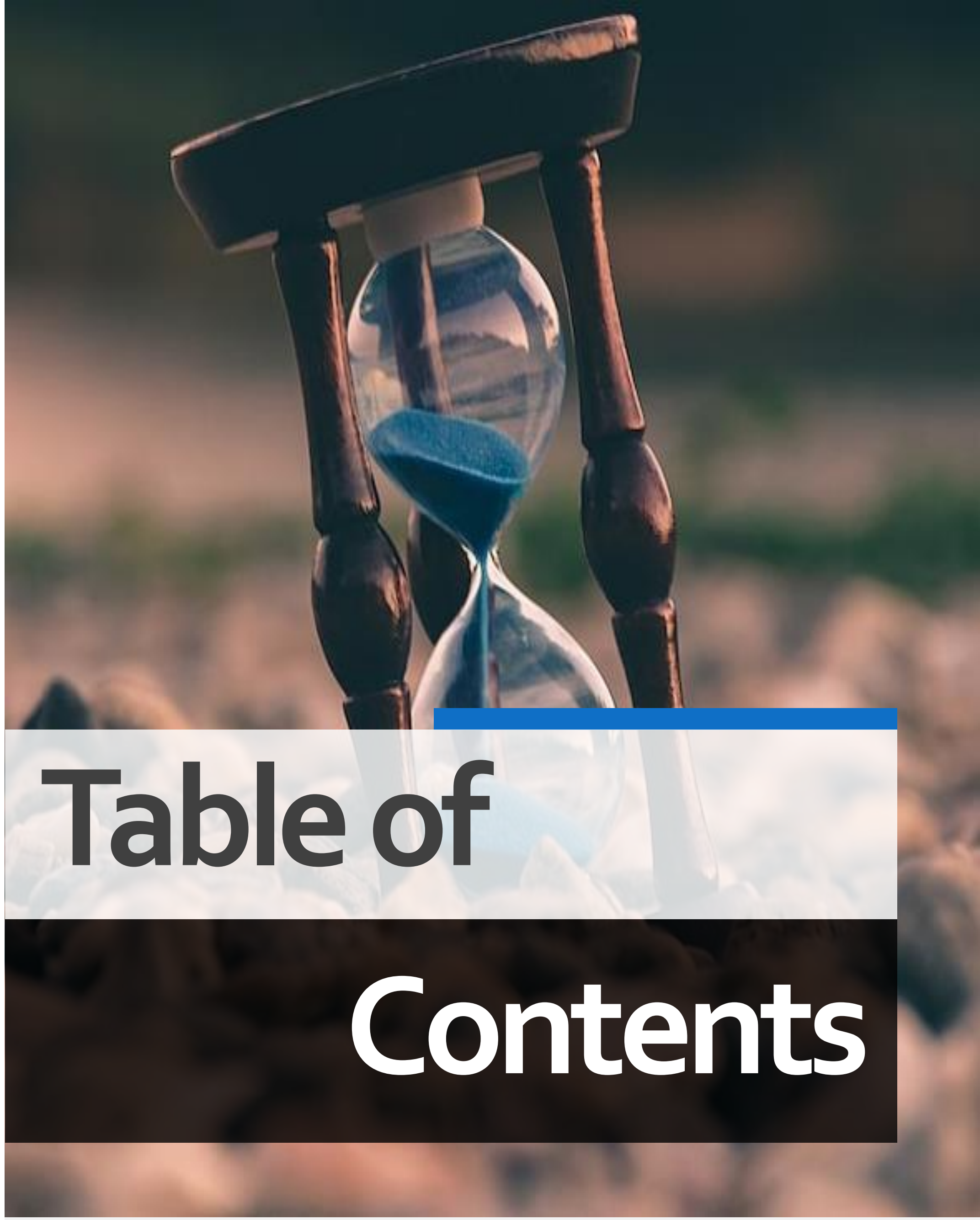
First Capital
A Janashakthi Group Company



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EXECUTIVE SUMMARY

Bond Yields to continue downtrend; Partly book profits with ability to BUY post DDO

- As the premiums attached to the bonds have significantly reduced and in some cases completely eliminated, we would like to advice investors adopt a wait and see approach on their portfolios. We would like to further advice to book profits on part of the bondholding. Post DDO Govt is likely to re-enter the market to raise debt via bond auctions. Considering the uncertainty, possible volatility in yields and new bond auctions post DDO, it is advisable for investors to create some buying capacity to take advantage of the volatility in rates post DDO.
- With the completion of domestic debt restructuring or towards Dec-23 we believe the overall yield curve is likely to drop below 20% and reach a range of 13%-15%. Bond Yields in 1H2024 is expected further drop to a range 11%-13.5%.

AWPR to dip to 10%-15% over the next 12 months

- We expect AWPR to further decline towards 16.0%-18.0% by Dec-23 and further dip to 10.0%-15.0% by Jun-24.

Exchange Rate outlook upgraded to LKR 320.0-360.0

- Govt plans to gradually ease import restrictions which could potentially exert a downward pressure on the currency, especially considering the ongoing recovery in GDP growth. The exchange rate is expected to gradually depreciate towards 2H2023 to a range of LKR 320.0-360.0 for Dec-23 while the target for Jun-24 also remains the same at LKR 320.0-360.0.

ASPI to reach 12,000 by Dec 2023 & 15,000 by Dec 2024; Equity exposure upgraded to 85%

- With visible signs of economic recovery aided by plunge in inflation and steep rate cuts, we expect we expect ASPI to re-rate to 12,000 by Dec-23, and we advise to increase the equity allocation from 65% to 85%, whilst reducing the cash allocation from 35% to 15%.

Track Record
[Sep 2022 & Feb 2023]

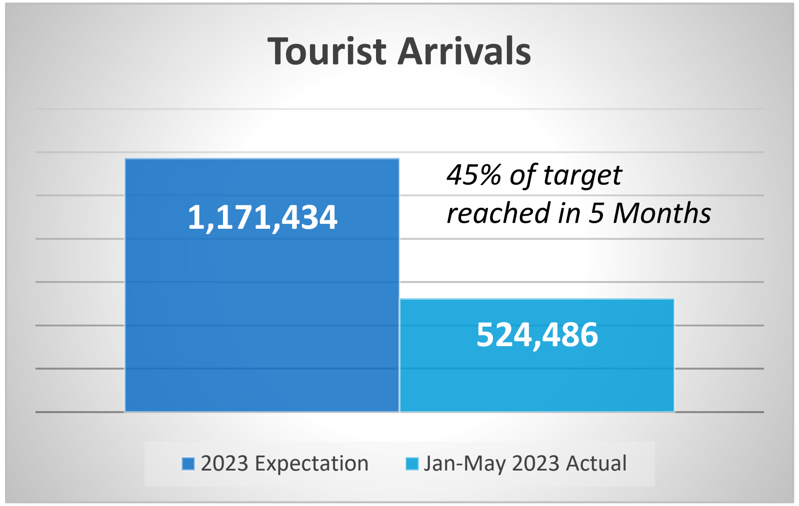
Section 1.0

First Capital Levels of Accuracy

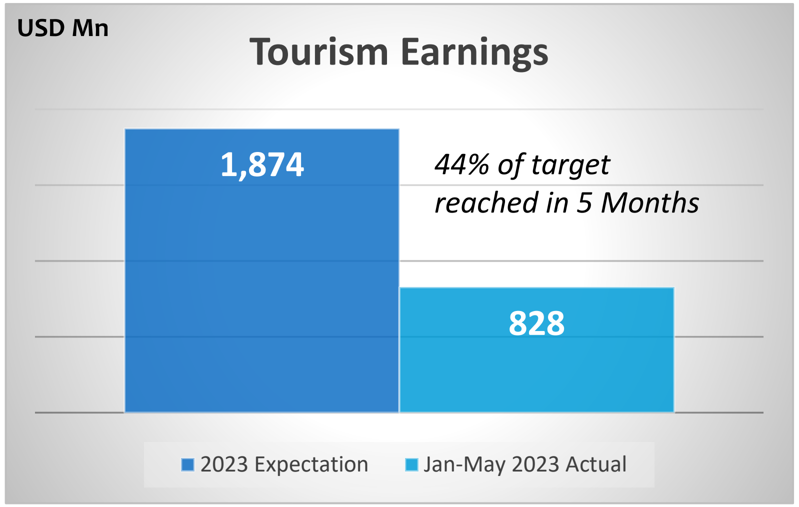
- 81% - 100% accuracy - Accurate
- 61% - 80% accuracy - Mostly Accurate
- 41% - 60% accuracy - Partly Accurate
- 20% - 40% accuracy - Weak Accuracy
- 00% - 20% accuracy - Inaccurate

Previous Forecasts of Economic Indicators

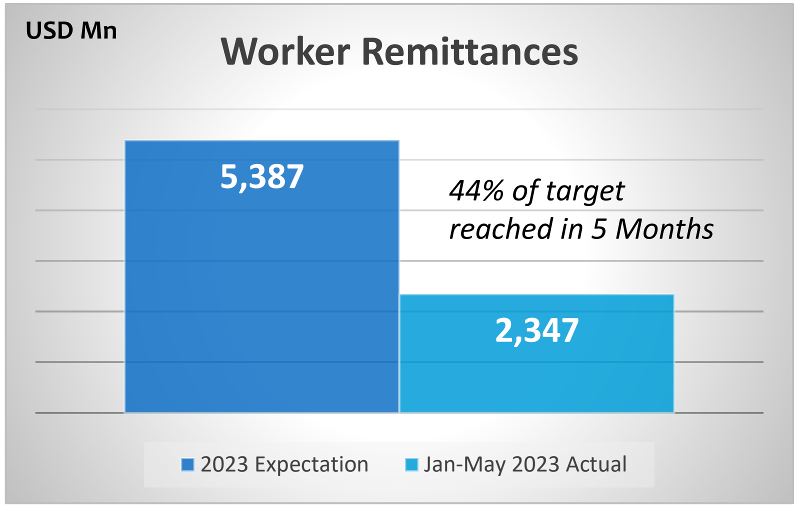
Forecast: **In line with expectations**



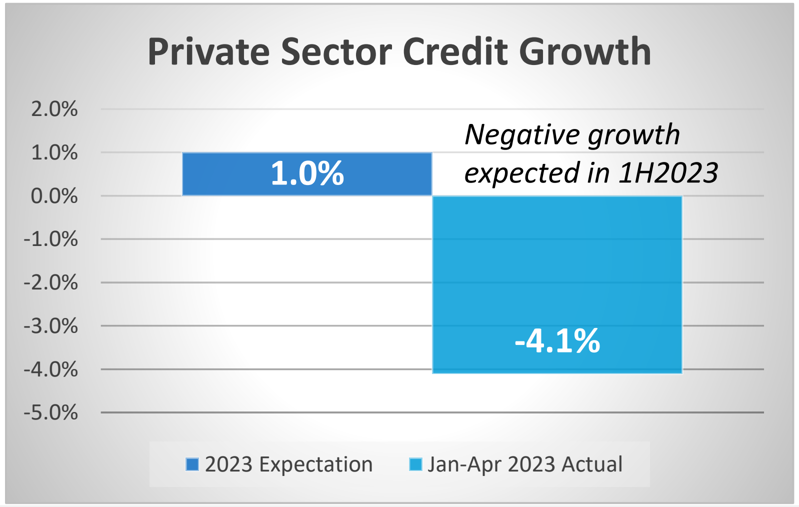
Forecast: **In line with expectations**



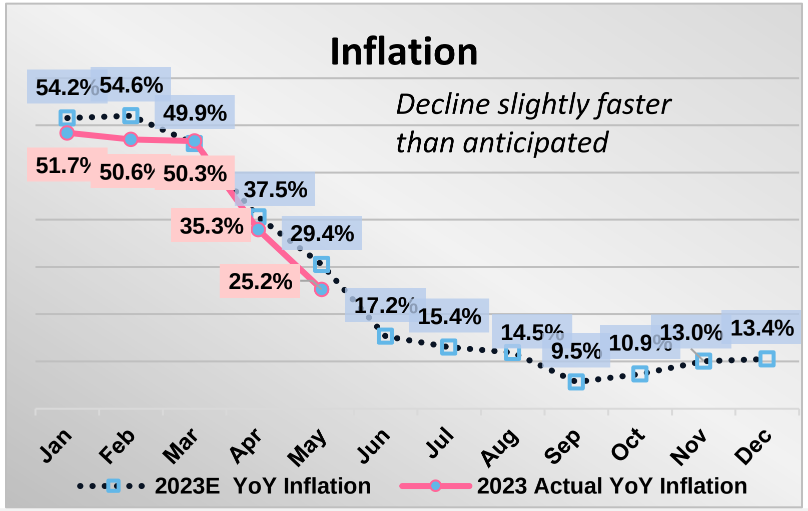
Forecast: **In line with expectations**



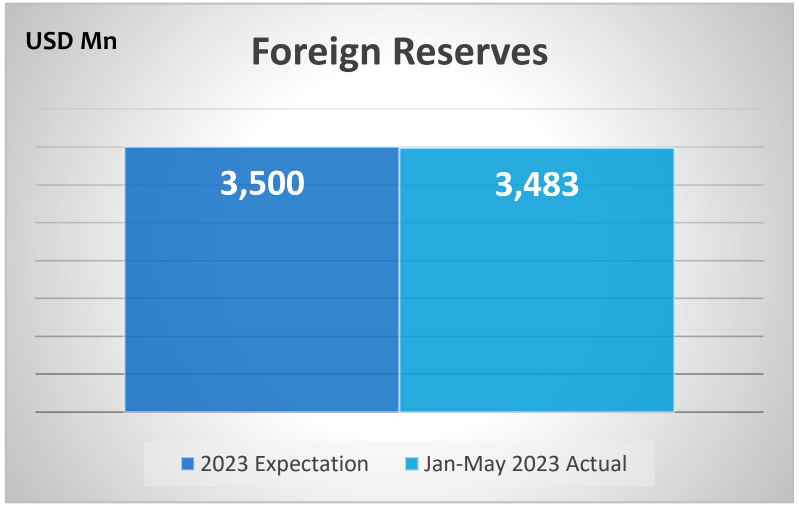
Forecast: **In line with expectations**



Forecast: **Decline slightly faster than anticipated**



Forecast: **Full year target achieved in 1H2023**



Previous Recommendations - Bonds

21st Sep 2022 [Mid-Year Outlook 2022 Report]

"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

Delay in IMF stalls downward trend of Short-Mid tenor yields

28th Feb 2023 [Investment Strategy 2023 Report]

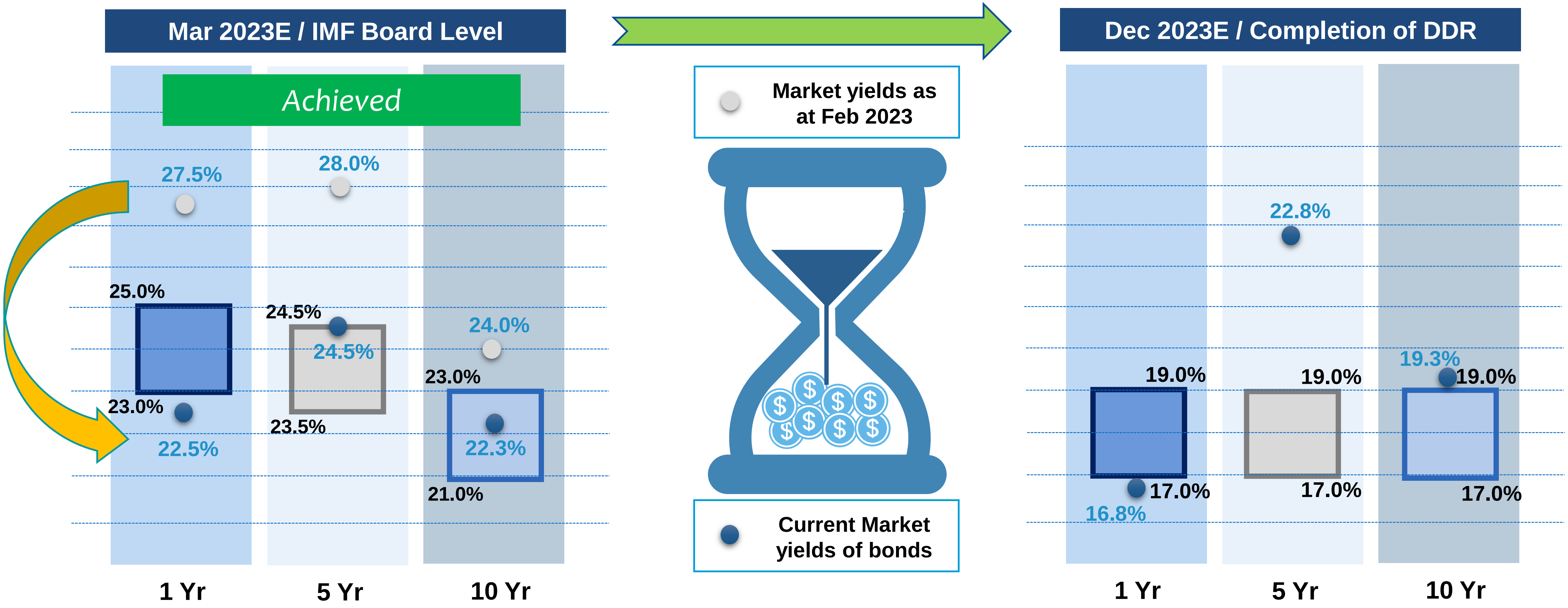
"Yields are likely to witness a continuous dip towards Mar-23 on successful progression that is likely to be made on the board level agreement. With the completion of DDR or towards Dec-23 we believe the overall yield curve is likely to drop below 20%."

Accurate

Yield curve recorded an accelerated downward shift in line with expectations

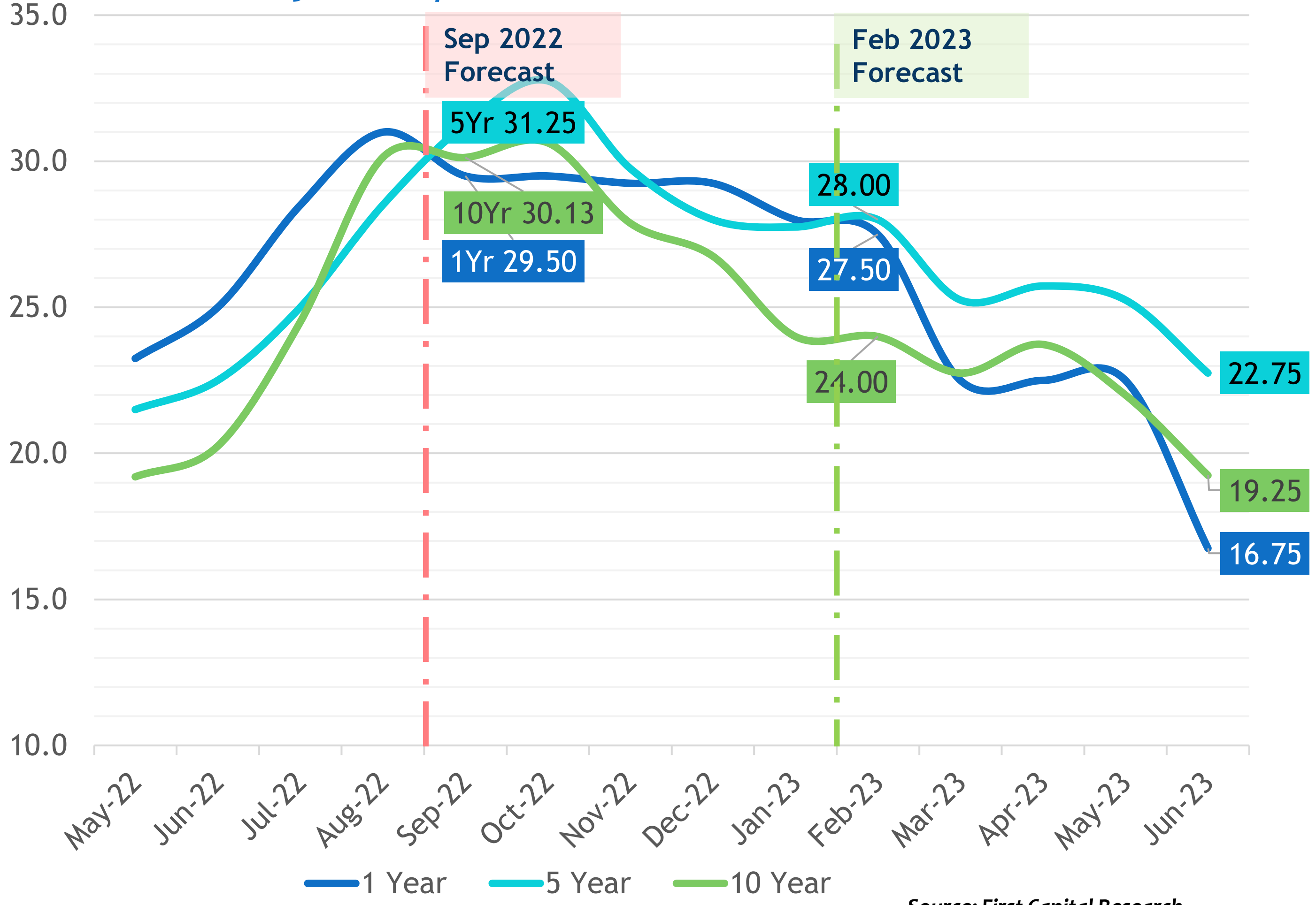
Previous Recommendations – Bonds - Accurate

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%.



Bonds – Sep-22 & Feb-23 Re cap: Accurate

Yields are likely to witness a continuous dip towards Mar-23 on successful progression that is likely to be made on the board level agreement. With the completion of DDR or towards Dec-23 we believe the overall yield curve is likely to drop below 20%.



Source: First Capital Research

1Y - YTD 200 bps

5Y - YTD 325 bps

10Y - YTD 613 bps

5 Months 2023

Sep - Feb

1Y - YTD 1075 bps

5Y - YTD 525 bps

10Y - YTD 475 bps

4 Months 2023

Feb - Jun

Policy Rates – Sep-22 & Feb-23 Re cap: Mostly Accurate

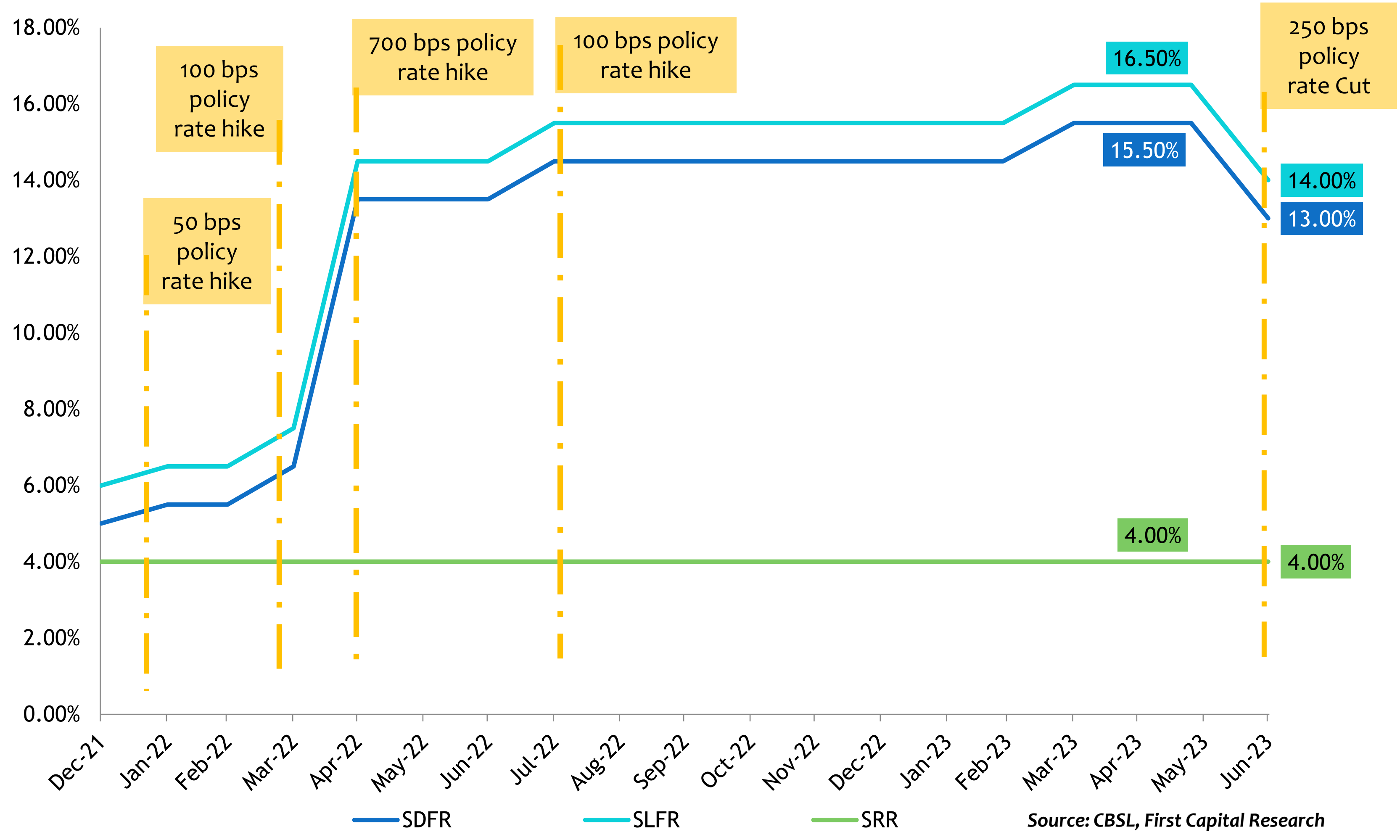
Policy rates to remain unchanged and trend downwards from 2Q2023 onwards

Surprise hike and a massive cut in policy rates in 1H2023

Following negotiations with the IMF, CBSL decided to hike rates by 100bps, immediately ahead of the IMF Board approval in Mar-23.

However, with the accelerated decline in inflation, CBSL cut policy rates by 250bps.

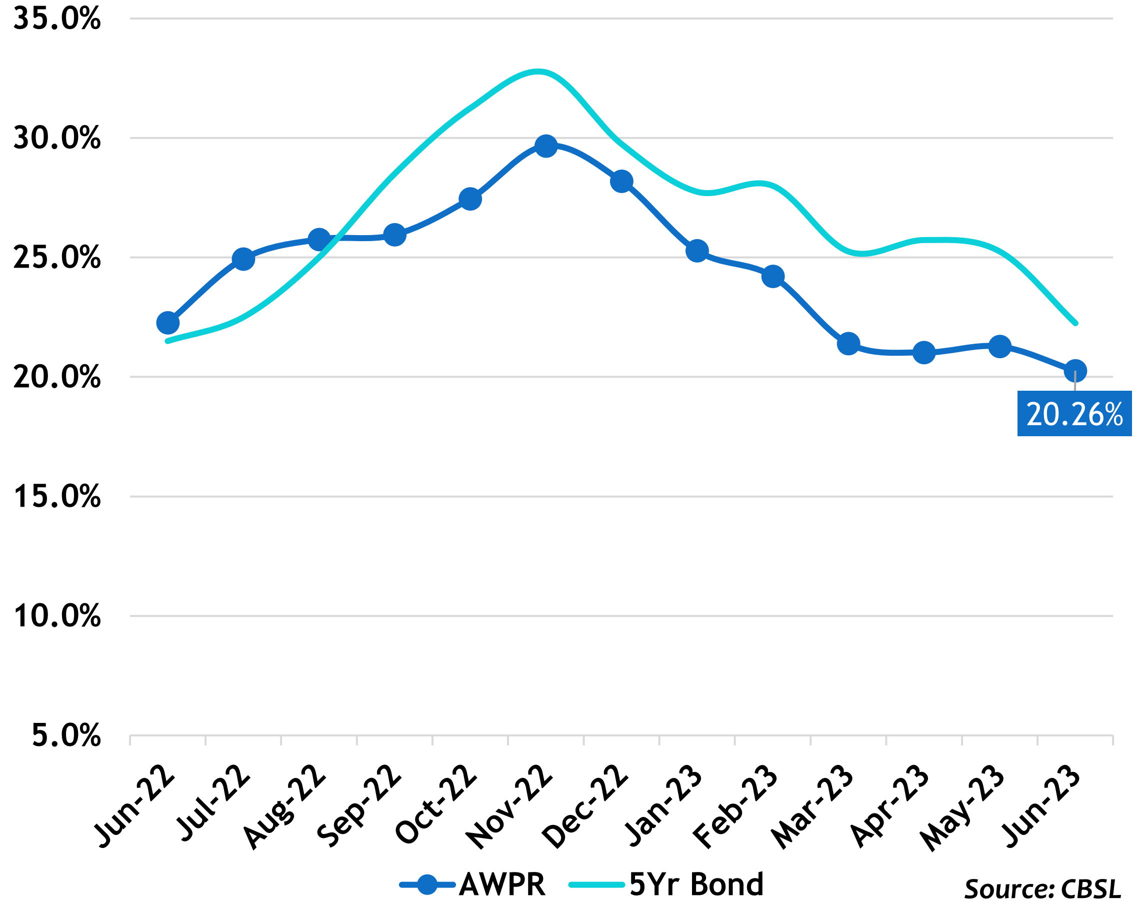
FC Research (Feb 2023): "**Rate cut is likely to be a strong probability towards 2Q-3Q2023 where we target about 3 rate cuts amounting to a cumulative dip of about 250bps**".



Source: CBSL, First Capital Research

Bank Rates – Sep-22 & Feb-23 Re cap: Accurate

We expect AWPR to reverse and decline towards 23.0%-25.0% by Jun-23 and further dip to 18.0%-20.0% by Dec-23



Source: CBSL

Review

In line with expectations AWPR reversed following the reversal of the trend of the 5Yr Bond. However, the decline was faster than anticipated resulting from the contraction of private sector credit.

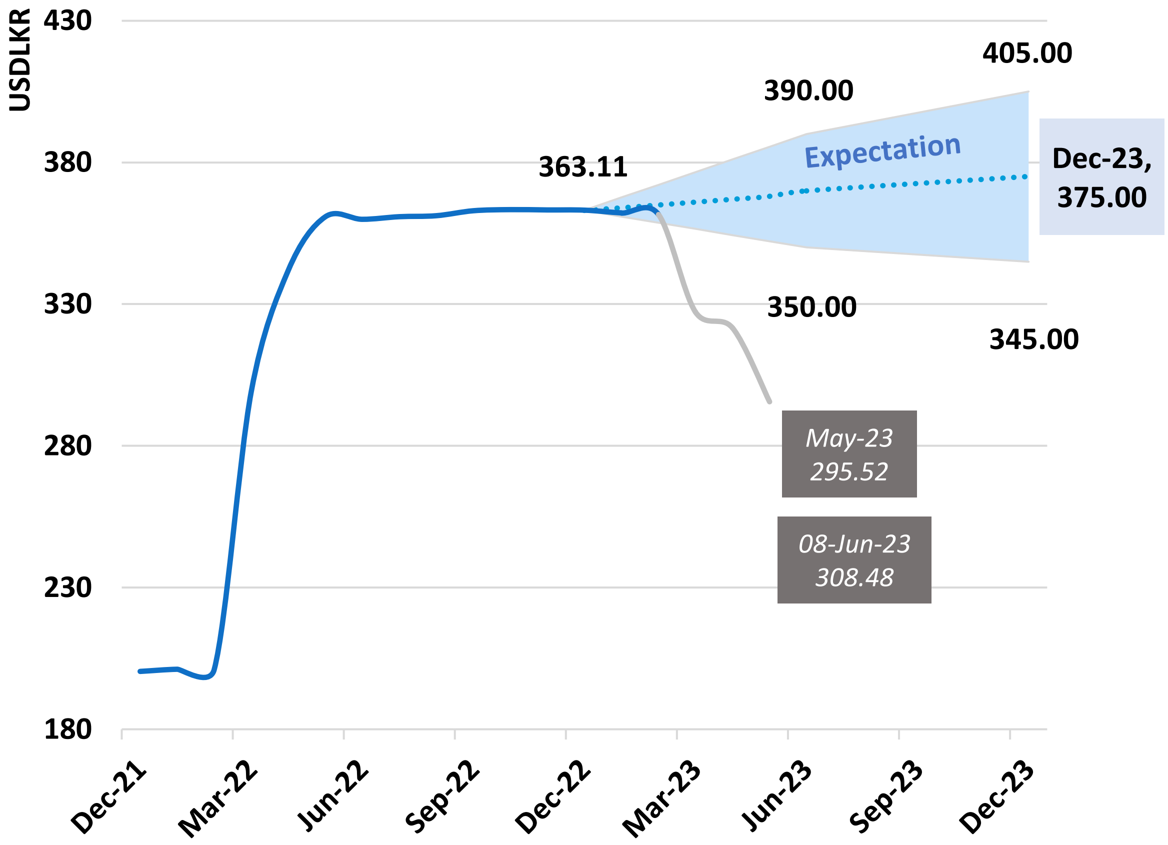
Exchange Rate – Sep-22 & Feb-23 Re cap: Inaccurate

Exchange Rate is likely to be stable throughout 2023E with possible marginal depreciation amidst trade relaxation. CBSL is likely to use the opportunity of high inflows to buy USD in the market

Review

In line with our expectations, CBSL continued to purchase dollars from the market. However, inflows accelerated over the months beyond First Capital Research expectations, as CBSL purchased over USD 1.6Bn YTD and 0.6Bn in May-23 alone supported by the significantly high level of inflows.

In the recent interviews, CBSL announced that they do not intend to change the course or trend of the currency through their interventions. With this development, the excessive inflows have allowed the LKR to appreciate even though CBSL has been actively buying dollars from the market.



Source: CBSL, First Capital Research

Equity – Sep-22 & Jan-23 Re cap: Accurate

We expect market to re-rate allowing the index to showcase strong positive returns in 2H2023E with the index likely to reach 12,000

Equity allocation: 50% by Sep-22, increased to 65% by Jan-23

Source: CSE, First Capital Research

Review

ASPI gains

+9.1% (Jan - 15th Jun 2023)
+0.6% (Jan – May 2023)

+26% (12 Months)

Almost zero returns during Jan – May 2023 period justifies the delay to increase equity exposure

Key Elements of consideration

for Mid-Year Outlook 2023

Section 2.0

Resurgence: The Reforming Phase

SL enters Debt Restructuring negotiations…

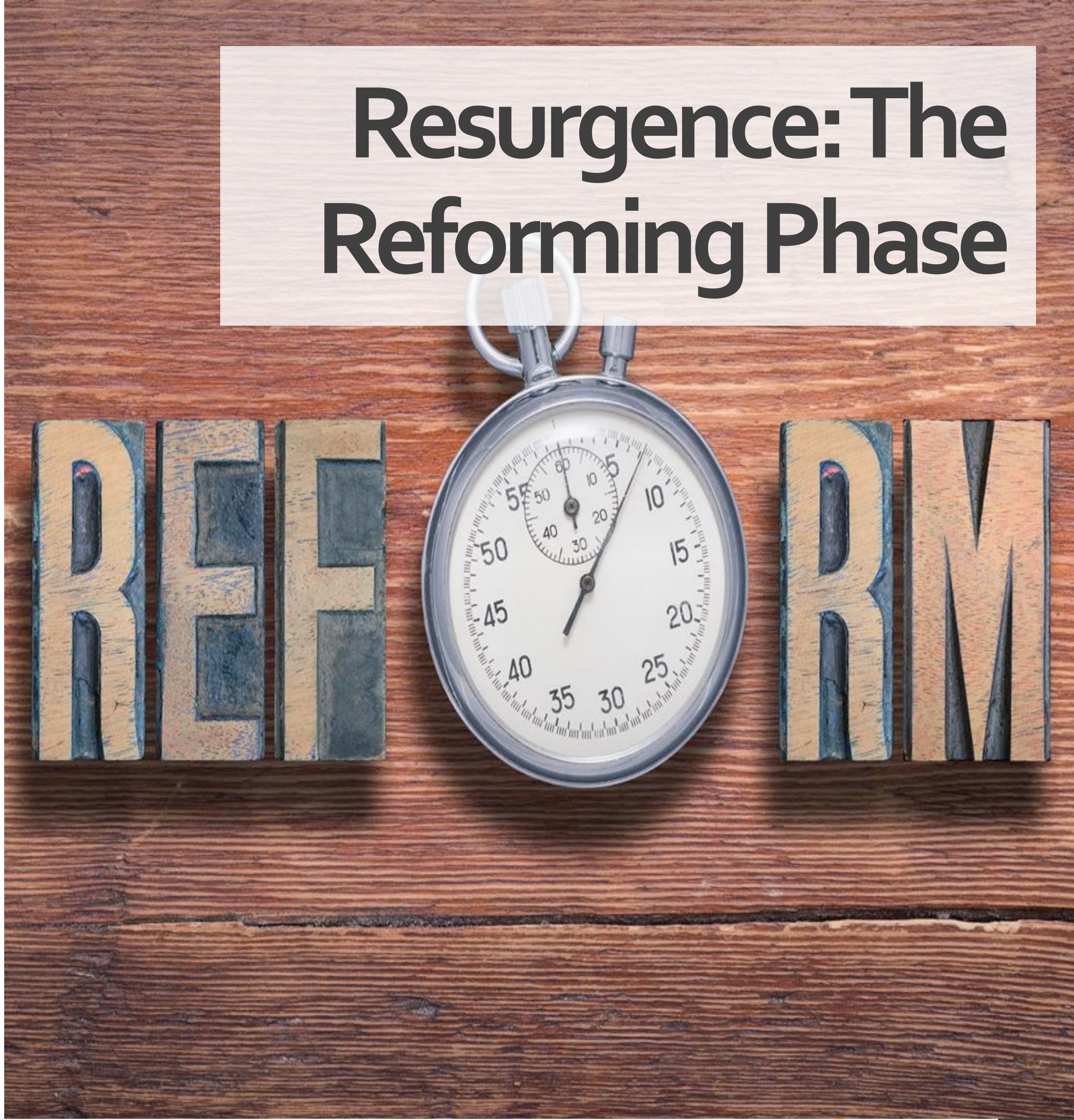
Sri Lanka went through an eventful 2022, while 1Q of 2023 was equally difficult with the new taxes being implemented resulting in a significant reduction in purchasing power which was further hampered by another electricity hike.

Sri Lanka managed to move into an IMF program by fulfilling most of the conditions which was a major challenge for the economy.

First Capital believes debt restructuring is Sri Lanka's most difficult challenge in the IMF program. Implementing Domestic Debt Optimization is the primary task of the CBSL which needs to be done carefully without harming the financial system and future growth of the economy.

Sri Lanka has now entered the reform phase in its journey of resurgence. DDO and Foreign debt restructuring in only part of it while SOE reform is another major component.

A continuous reform agenda needs to be implemented in order to fully recover from the crisis…



Key Elements to consider for investments

Political

- Local Govt elections postponed indefinitely
- Govt and President to serve their full term

Economical

- GDP may turn positive in 4Q2023
- SL enters IMF Program
- Inflation plunge
- DDO and external debt restructuring
- Liquidity at lower positive territory
- Credit to turn positive in 2H2023

External

- Possible rating upgrade post debt restructuring
- Bridging Finance opportunities
- Stable Rupee
- Global Recession & Fund Flow

Elections postponed; Policy stability intact

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

Section 3.0

Elections postponed due to lack of funds

- Though the Local Government election has no bearing on the Parliament or the President, the results of the election could have created political and policy uncertainty.
- Elections were forced to be postponed due to lack of funds and no date has been mentioned for the elections to be held which means the elections are postponed indefinitely.
- With that out of the way, there is a high probability that the Govt and the President may desire to govern for their full term. In that sense, with no elections around for the next 16 months until the Presidential Election in Nov-24, we could expect increased level of political and policy stability with the Govt repeatedly proving its 2/3 power in parliament.

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

Economy to gradually recover; Debt Restructuring and Reforms critical

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

Section 4.0

First Capital upgrades GDP expectations for 2023; 2024 marginally downgraded

2022
(-7.8%)
Expectation: (-9.0%) – (-12.0%)

2023E
(-3.0%) – (-4.0%)
Previous Expectation: (-4.0%) – (-6.0%)

2024E
+3.0% – +4.0%
Previous Expectation: (+4.0%) – (+5.0%)

Economy performs better than anticipated

Private consumption rose beyond our expectations resulting in stronger than anticipated production and volumes.

FCR *upgrades* 2023 amidst better 2022 performance

With 2022 performing slightly better than anticipated, 1Q2023 grew -11.5% again slightly better than the expectation of -12.4%. Inflation too dropped below expectations. As a result, FCR upgrade growth for 2023E

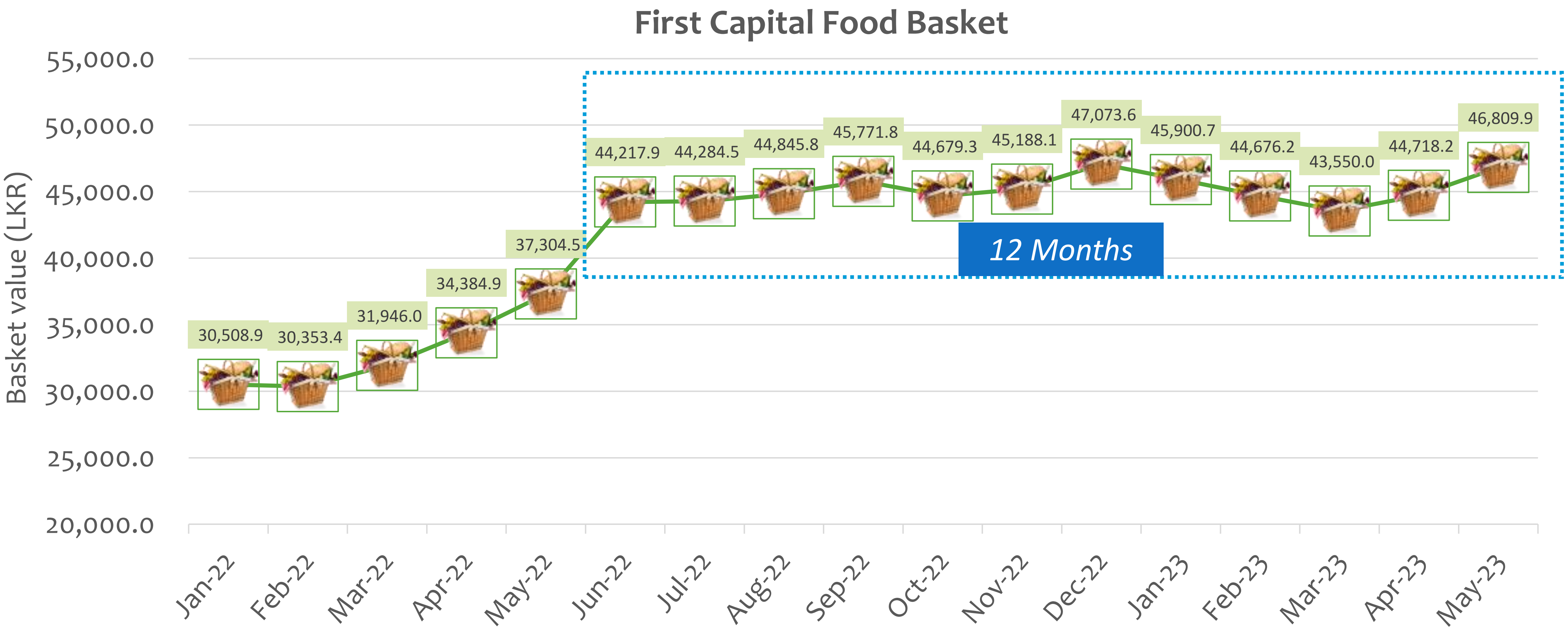
Stronger 2023 *dims* 2024 growth on higher base

FCR expected a stronger dip in 2023 and a bounce back. But 2023E likely to perform slightly better, higher base effect reduces expectations for 2024E.

Source: CBSL, First Capital Research

Food Inflation stabilizes…

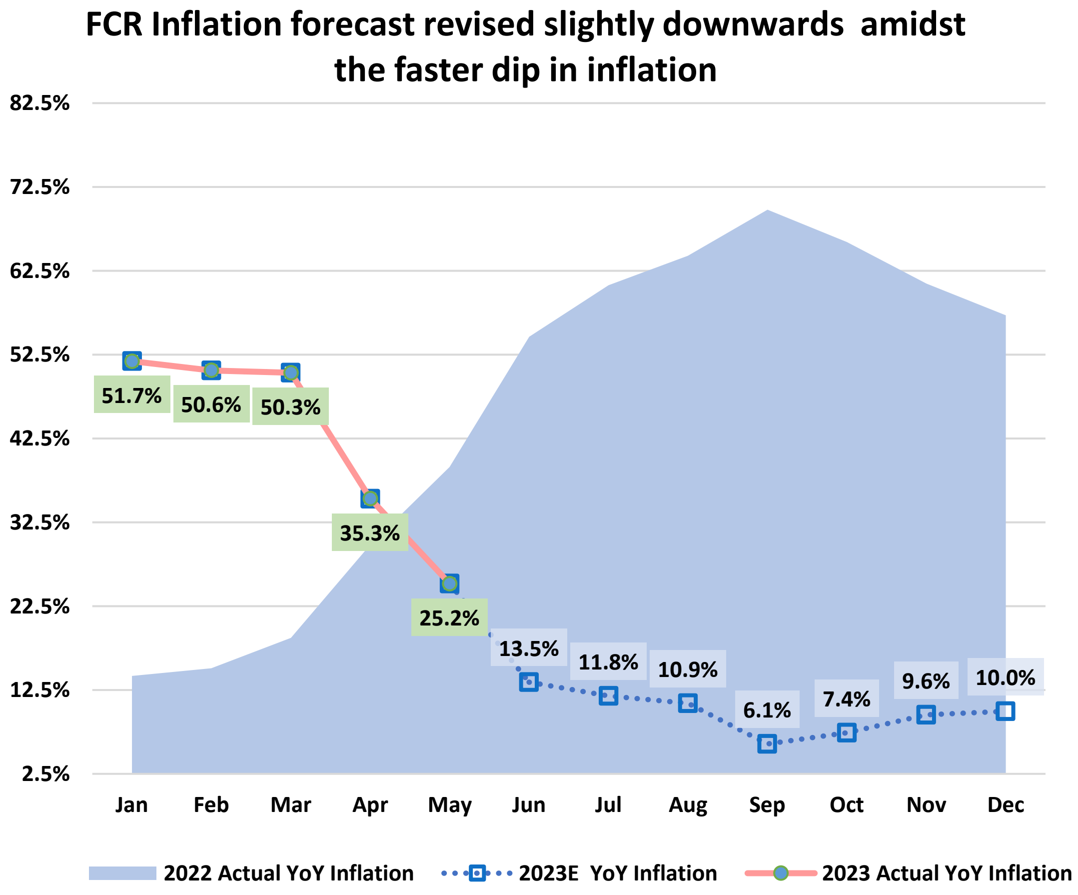
First Capital Food Basket indicated signs of stabilization in food inflation



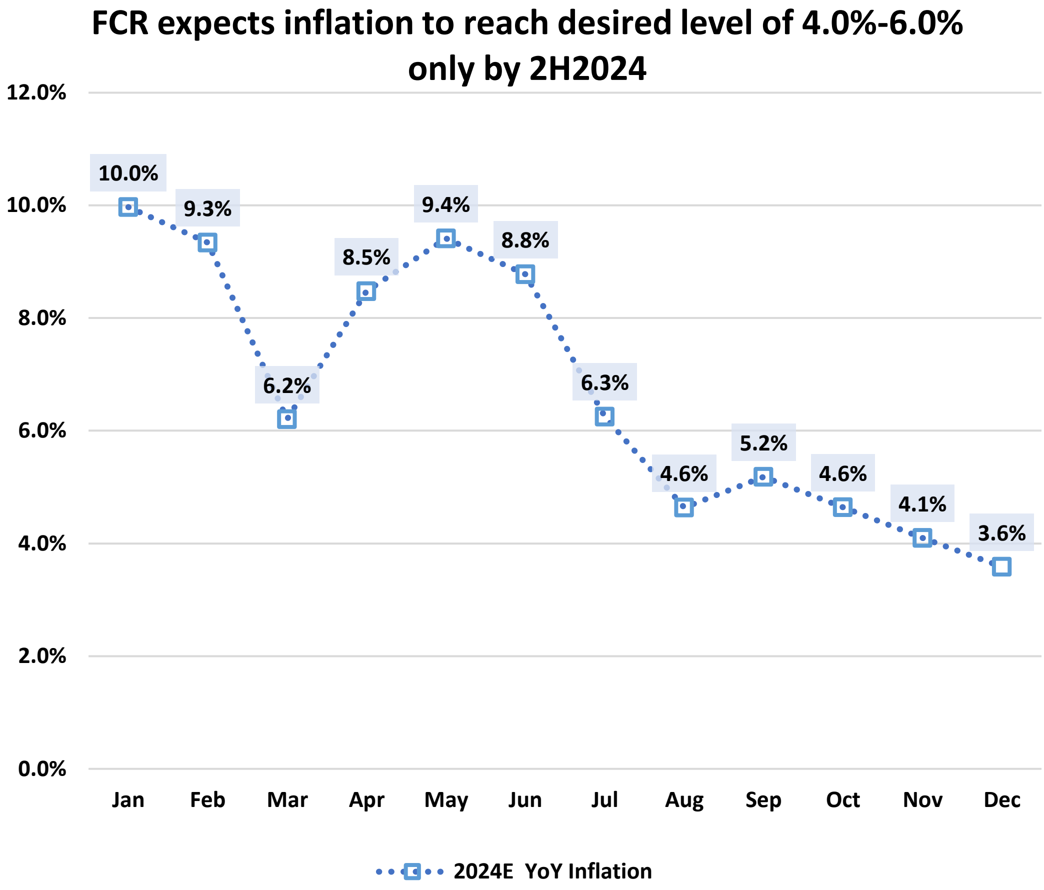
Source: Dept. Census and Statistics, First Capital Research

…supporting overall inflation to die down

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



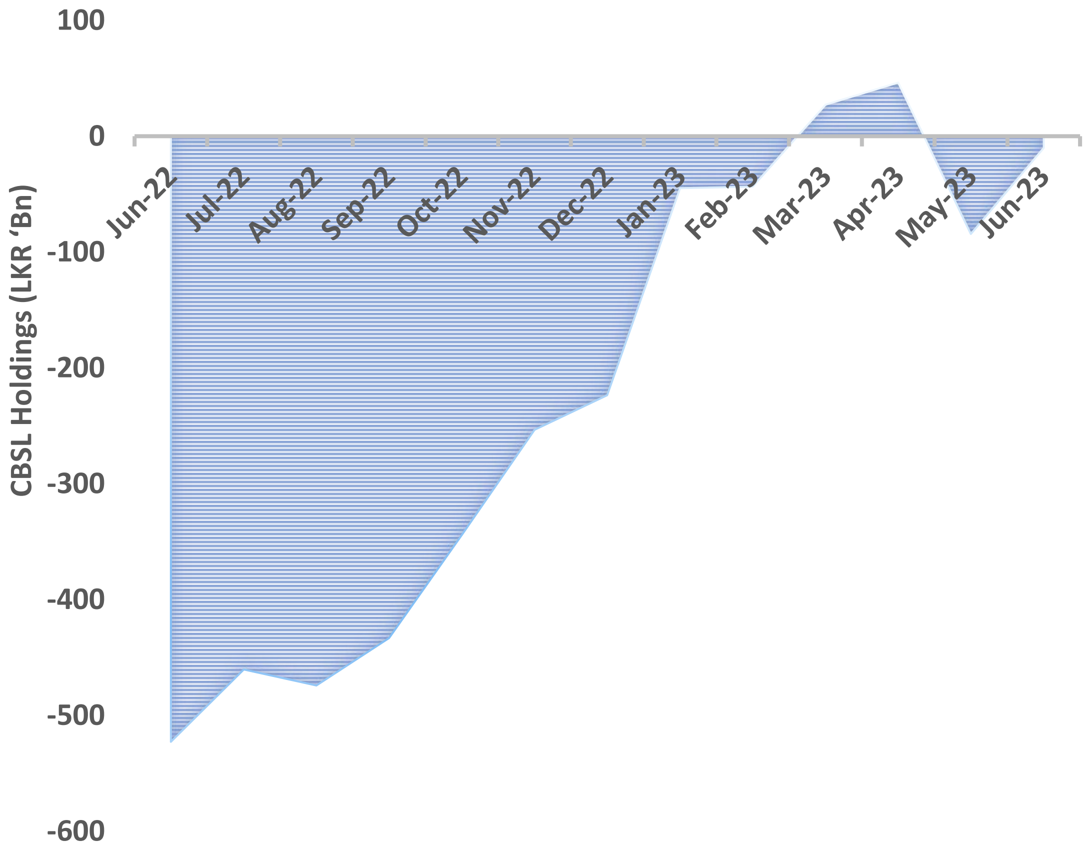
Source: Dept. Census and Statistics, First Capital Research



Source: Dept. Census and Statistics, First Capital Research

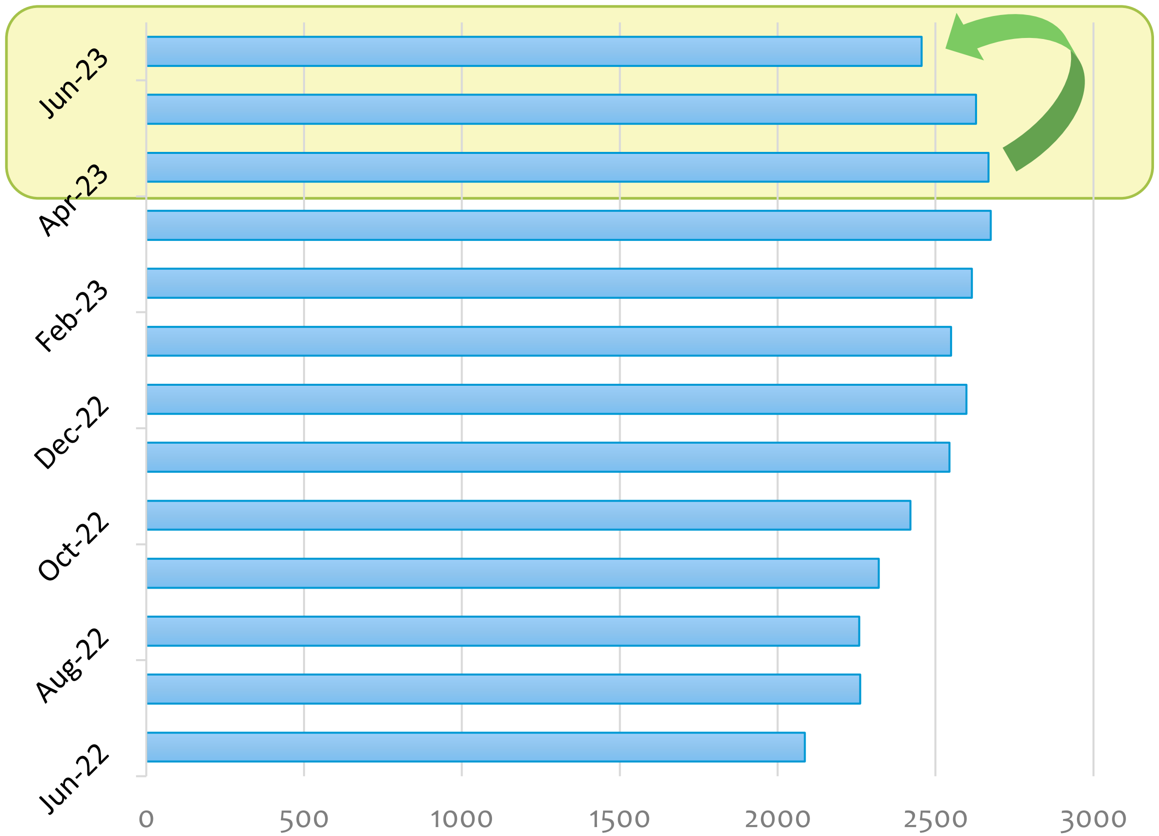
Liquidity continues to remain volatile but marginally negative…

Liquidity moves closer to zero



Source: CBSL

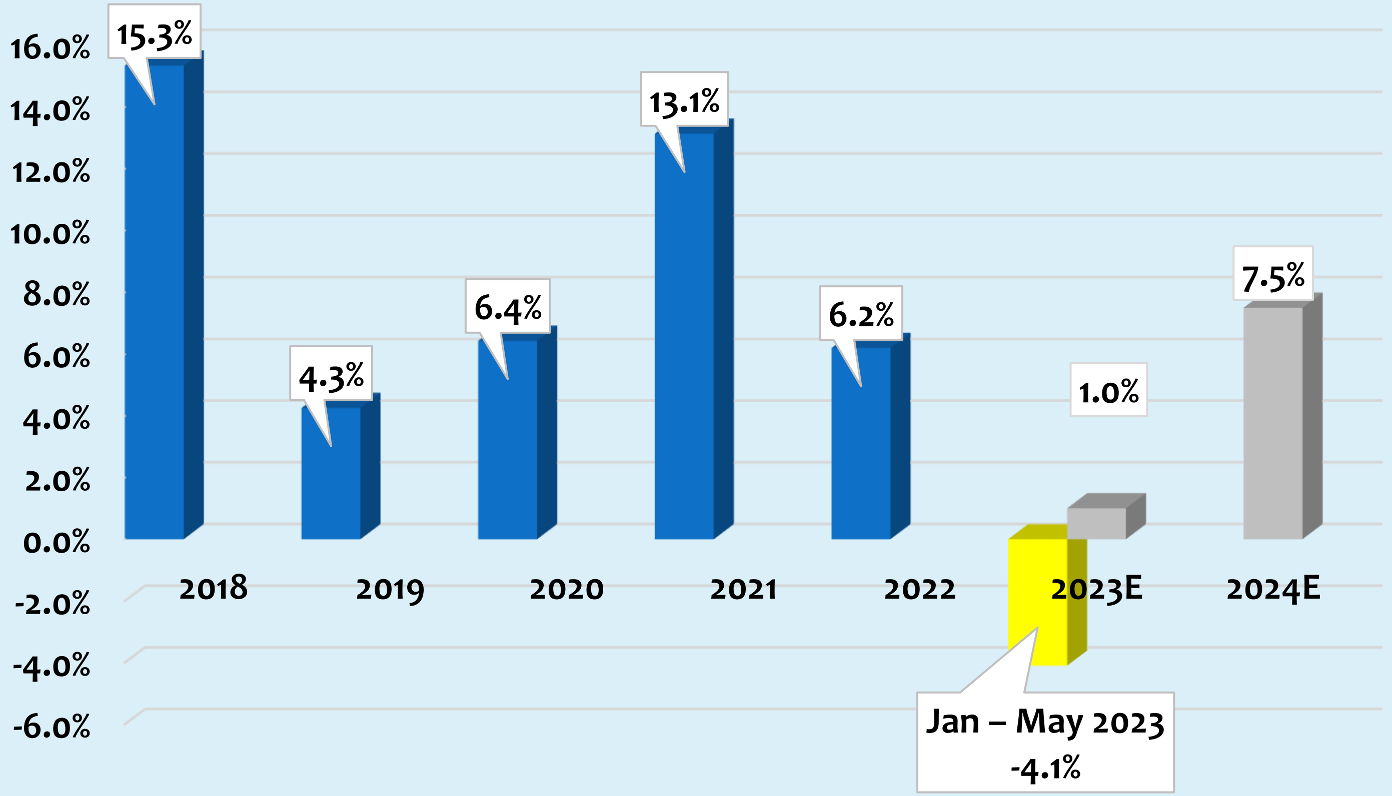
CBSL initiates unwinding of CBSL Holdings



Source: CBSL

…delaying the recovery in credit

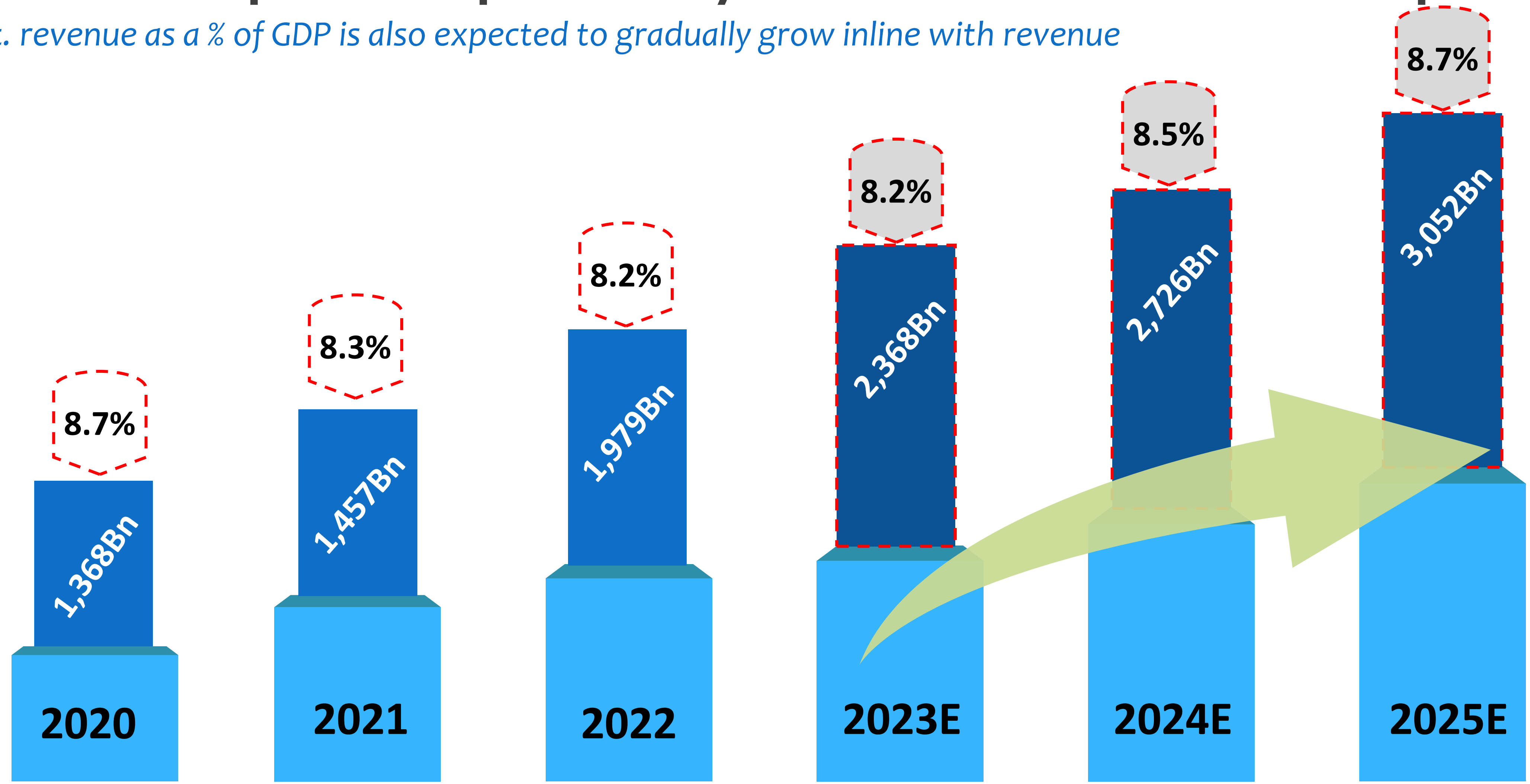
First Capital Research expects private sector credit to recover 3Q2023 onwards to reach +1% for 2023E



Source: CBSL

Spike in multiple taxes potentially allows Govt. Revenue to expand…

Govt. revenue as a % of GDP is also expected to gradually grow inline with revenue



*% - As a % of GDP
*Figures are in LKR

Source: CBSL, First Capital Research

…positively impacting Budget deficit

But budget deficit continues to remain high compared to peer economies!

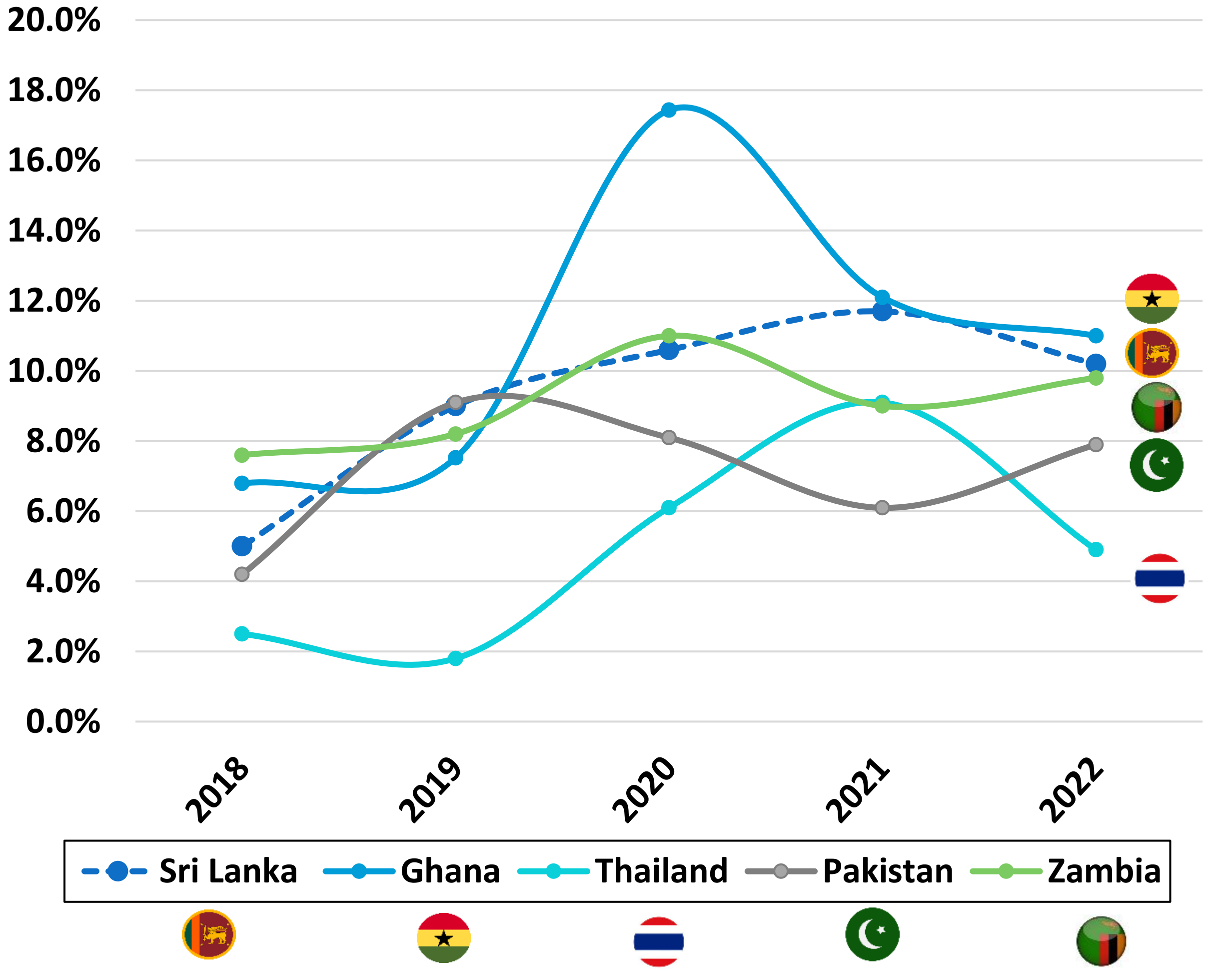
OVERALL BUDGET DEFICIT IN SRI LANKA
(Net Domestic and Foreign Financing)

2021	LKR -2,058Bn	**-11.7%**
2022	LKR -2,460Bn	**-10.2%**
2023E	LKR -2,126Bn	**-7.4%**
2024E	LKR -1,488Bn	**-4.7%**
2025E	LKR -1,549Bn	**-4.4%**

* % - As a percentage of GDP

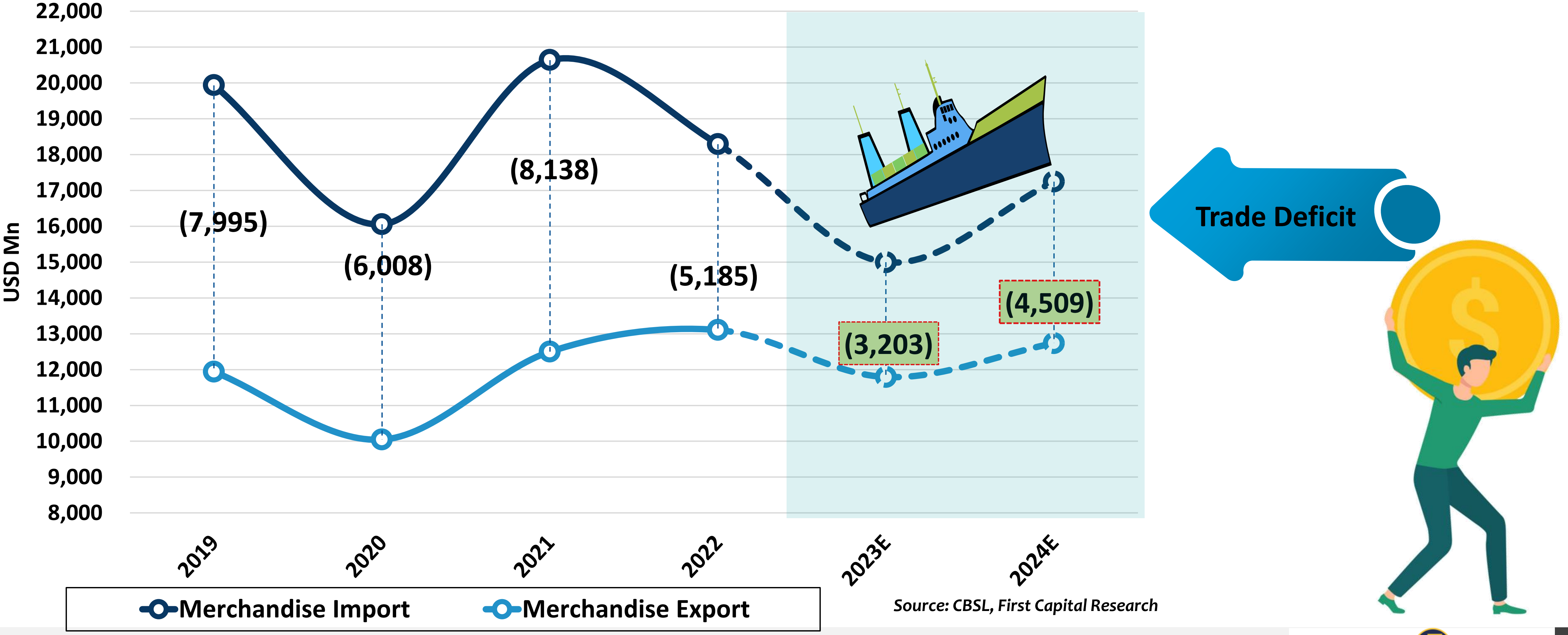
Source: CBSL, First Capital Research

Peer economies Budget balance as a % of GDP



Trade deficit contracts significantly with import restrictions & fuel quota system; But may expand amidst the gradual relaxation of restrictions…

However, as the economy recovers in 2024E Trade deficit may tend to expand as FCR anticipated it to reach USD -4.5.Bn



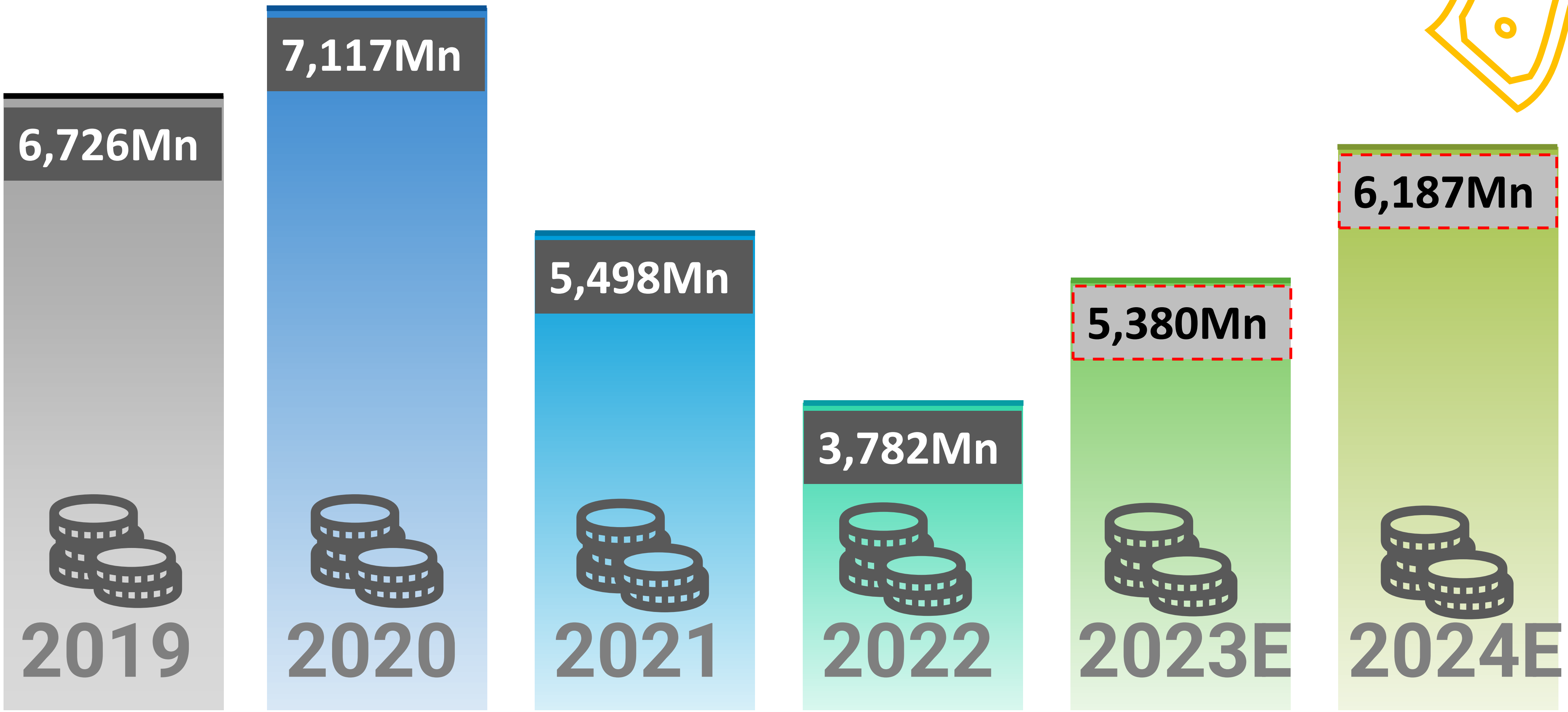
Source: CBSL, First Capital Research

…supported by the surge in Tourist Arrivals and Tourism Earnings…

	Tourist Arrivals	Earnings from Tourism
2021	194,495	USD 0.5Bn
2022	734,101	USD 1.1Bn
2023E	1,171,434	USD 1.9Bn
2024E	1,818,440	USD 2.9Bn
2025E	2,530,192	USD 4.0Bn

Source: SLTDA and First Capital Research

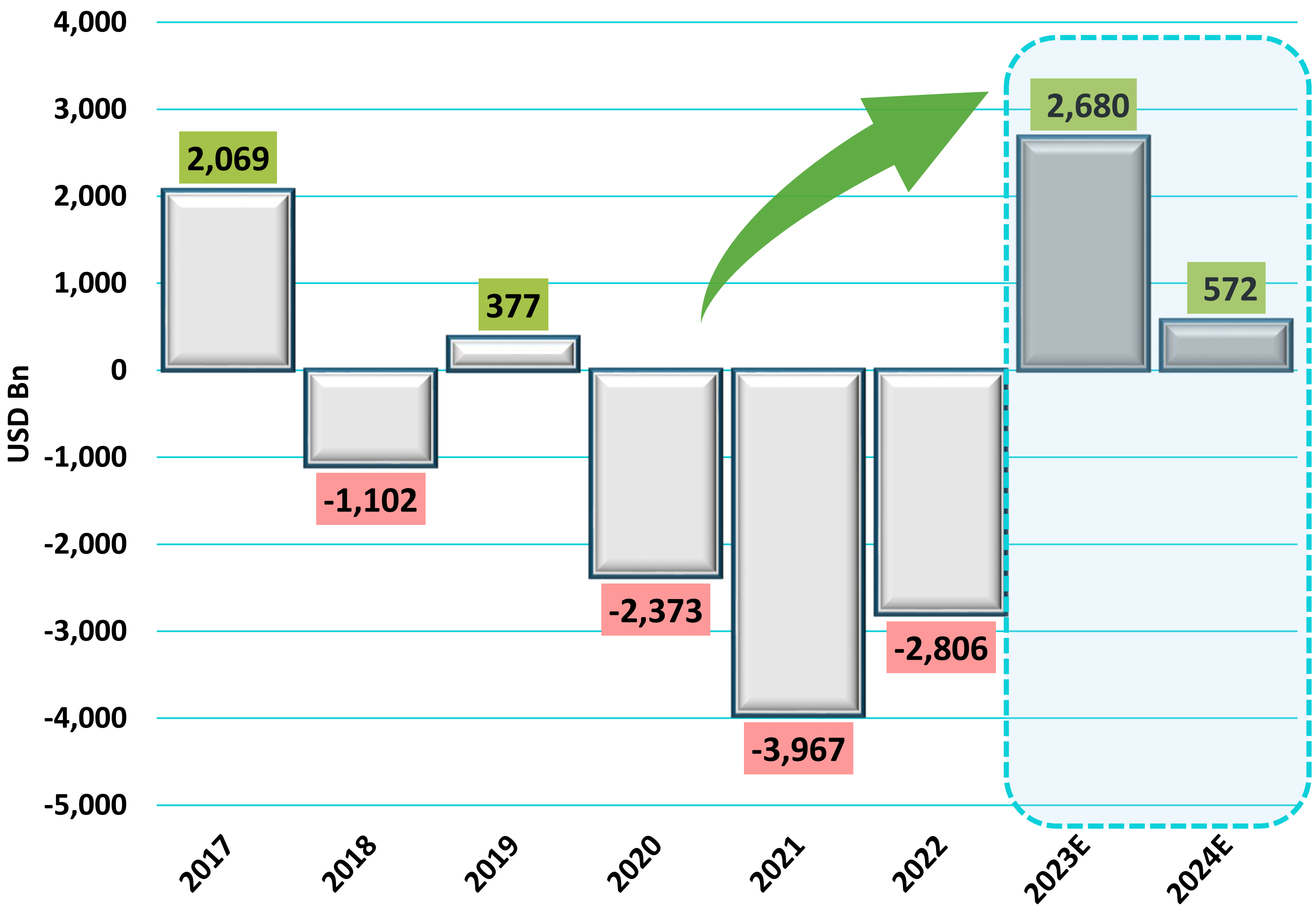
…while worker remittances also recovers at an accelerated pace…



*All values are in USD Mn

Source: CBSL, First Capital Research

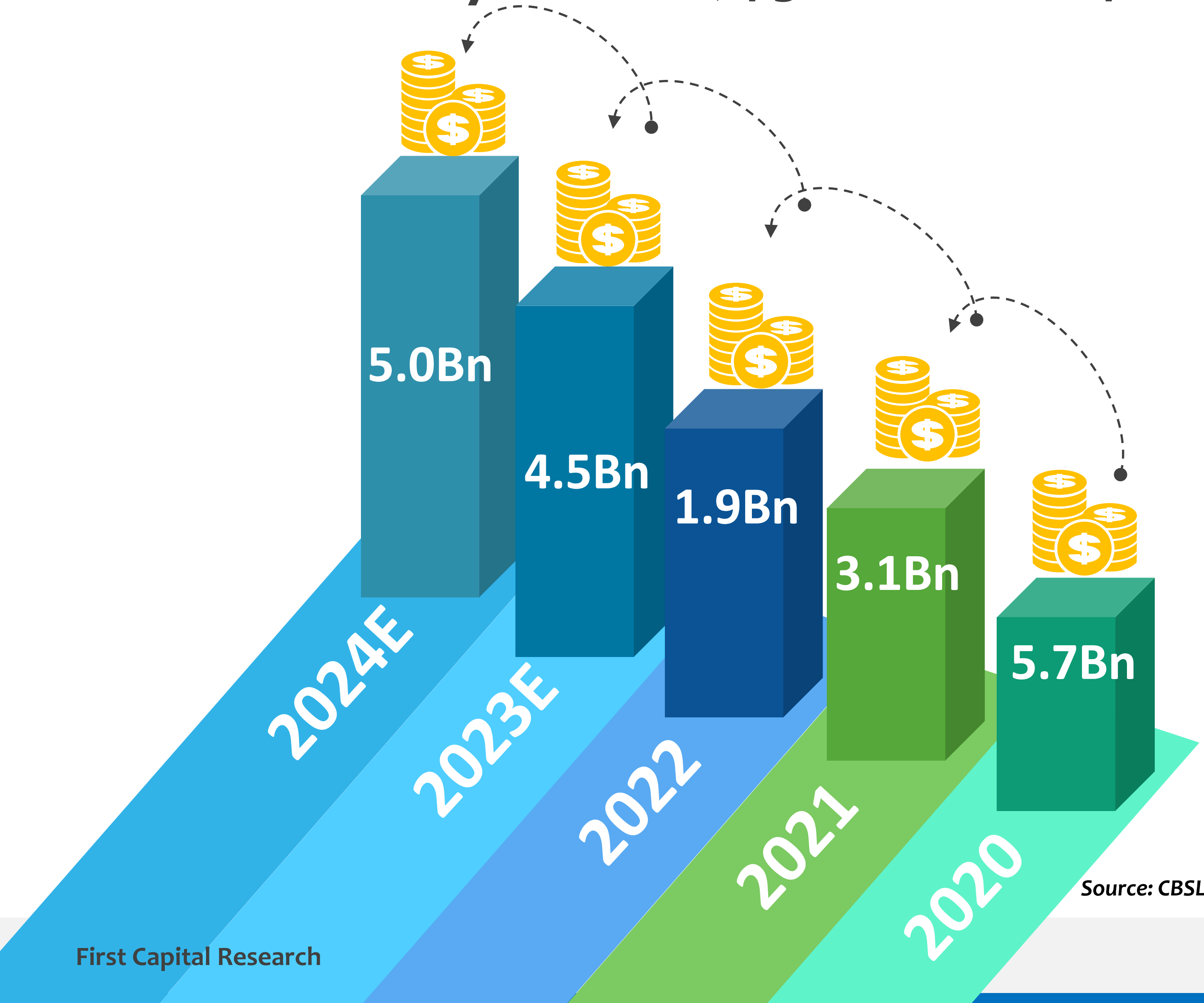
…coupled with the support of multilateral lenders and foreign inflows, Balance of Payments is expected to turn positive…



Source: CBSL, First Capital Research

BOP already seen recovery and is expected to register a surplus of USD 2.7Bn in 2023E and surplus of USD 0.6Bn in 2024E.

…supporting to reach a Foreign Reserves target of USD 4.5Bn by Dec-23 & USD 5.0Bn by Dec-24 (upgraded from our previous target of USD 3.5Bn by Dec-23)



Amidst the improvement in the tourist arrivals and worker remittances, we expect Foreign Reserves to see consistent growth from 2023 onwards.

Source: CBSL, First Capital Research

*All values are in USD Bn

Sri Lanka so far on target to achieve the release of the 2nd tranche during Oct-Dec 2023 period

Sep 2022

Sri Lanka successfully reaches a staff level agreement with the IMF

Jan-Feb 2023

Completing Pre-conditions

Mar 2023

IMF Board level agreements

Mar 2023

Receiving the 1st tranche of IMF Funds

In Progress

Apr-Sep 2023

Debt restructuring discussions

Oct-Dec 2023

2nd Tranche from IMF

Debt Restructuring Process

Initiation

- To initiate the process, a country must first determine whether it can continue servicing its debt or whether a restructuring is necessary.
- Based on the findings of a DSA, if a country is deemed insolvent, the IMF will move forward with a program—but only if the government implements the IMF's recommended policy changes to restore debt sustainability

Negotiation

- Once a country commits to pursuing a restructuring, it must then negotiate a relief agreement with its creditors.
- The IMF DSA will have outlined the level of relief required to restore the country to sustainable levels.

SL is here with negotiation on going

Application

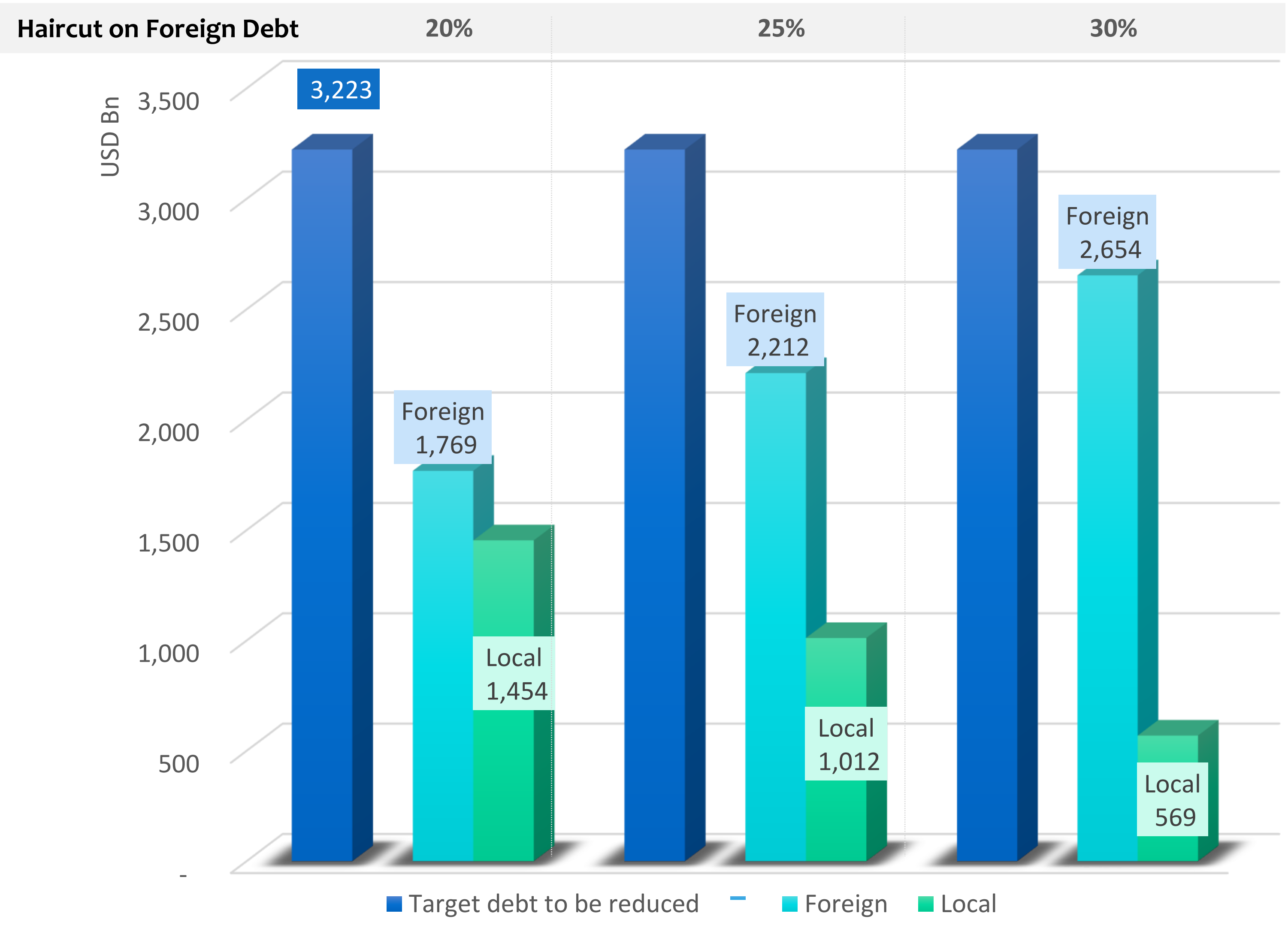
- After negotiations on the terms of debt relief conclude, a country must maximize creditor participation and apply comparable treatment to all creditors to successfully close out a restructuring.
- This effort can be hampered by "holdout" creditors that avoid making any concessions to collect payment in full once other parties have provided relief

Foreign debt restructuring scenarios impacts DDO

Negotiations with Bilateral lenders seems to be taking longer than anticipated with negotiations expected to be tough.

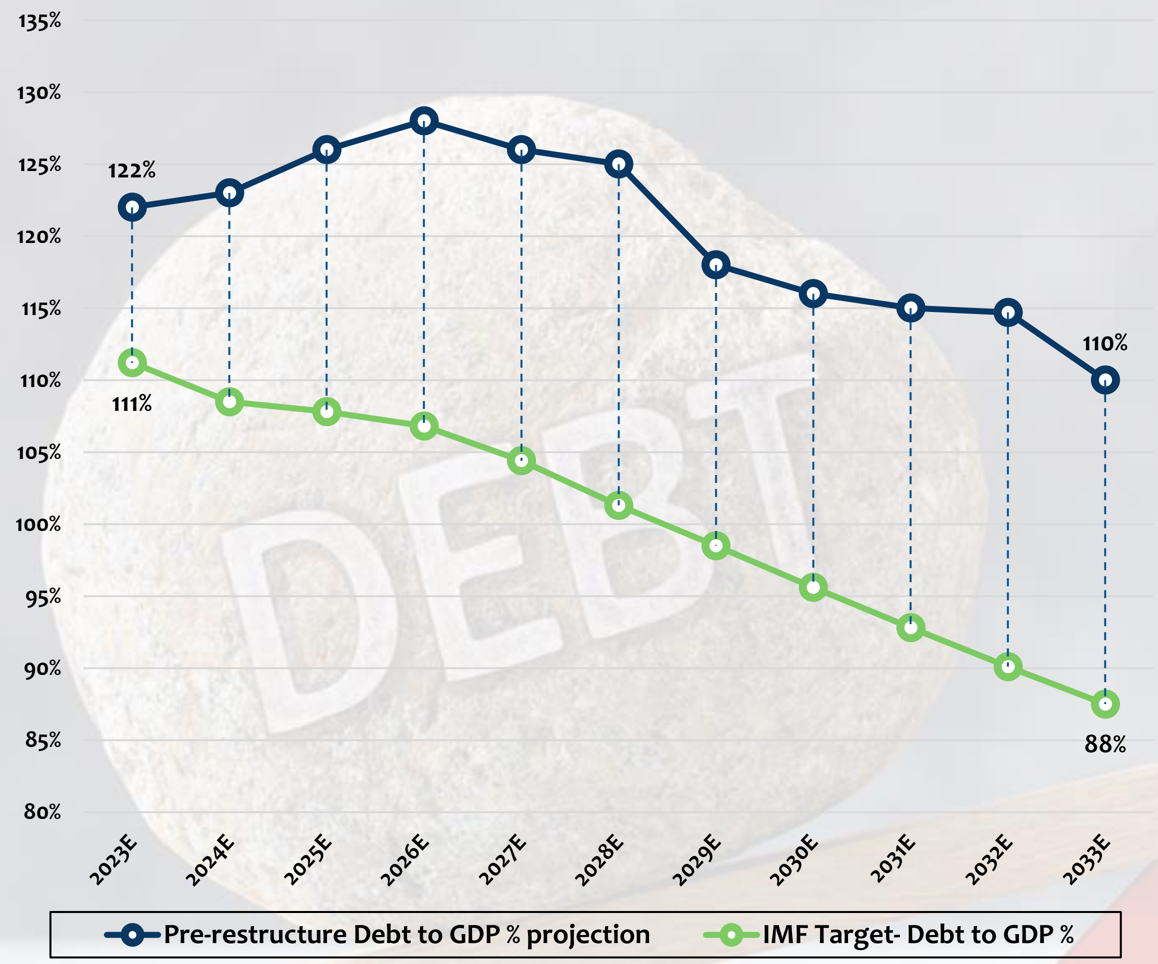
Considering the requirement to reduce Debt to GDP, the success of the negotiations with foreign lenders has a significant impact on the DDO requirement on the local borrowings.

A 30% haircut on foreign debt may significantly reduce impact required from local to a very negligible level.

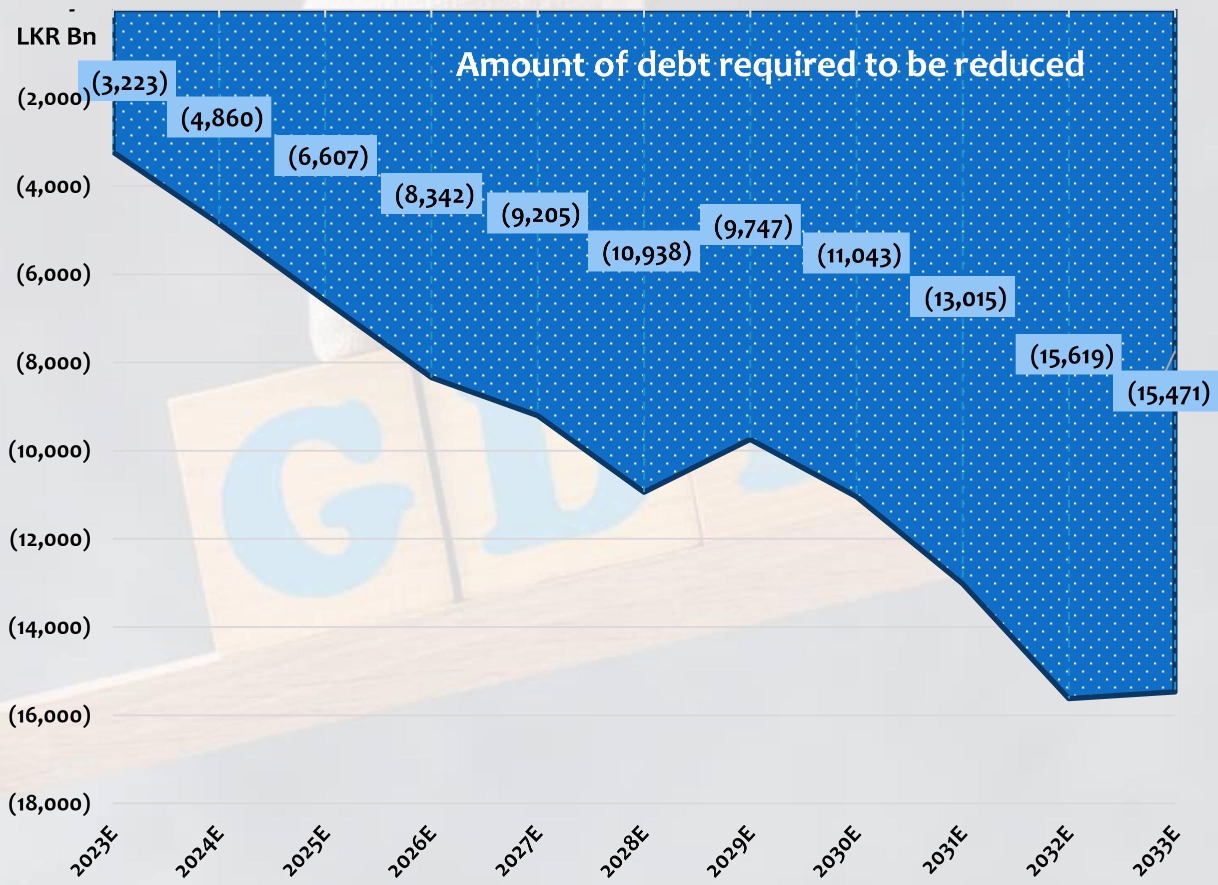


Source: IMF Estimates, First Capital Research

Debt Restructuring continues to be the major hurdle with Debt to GDP required to be brought down below 100%...



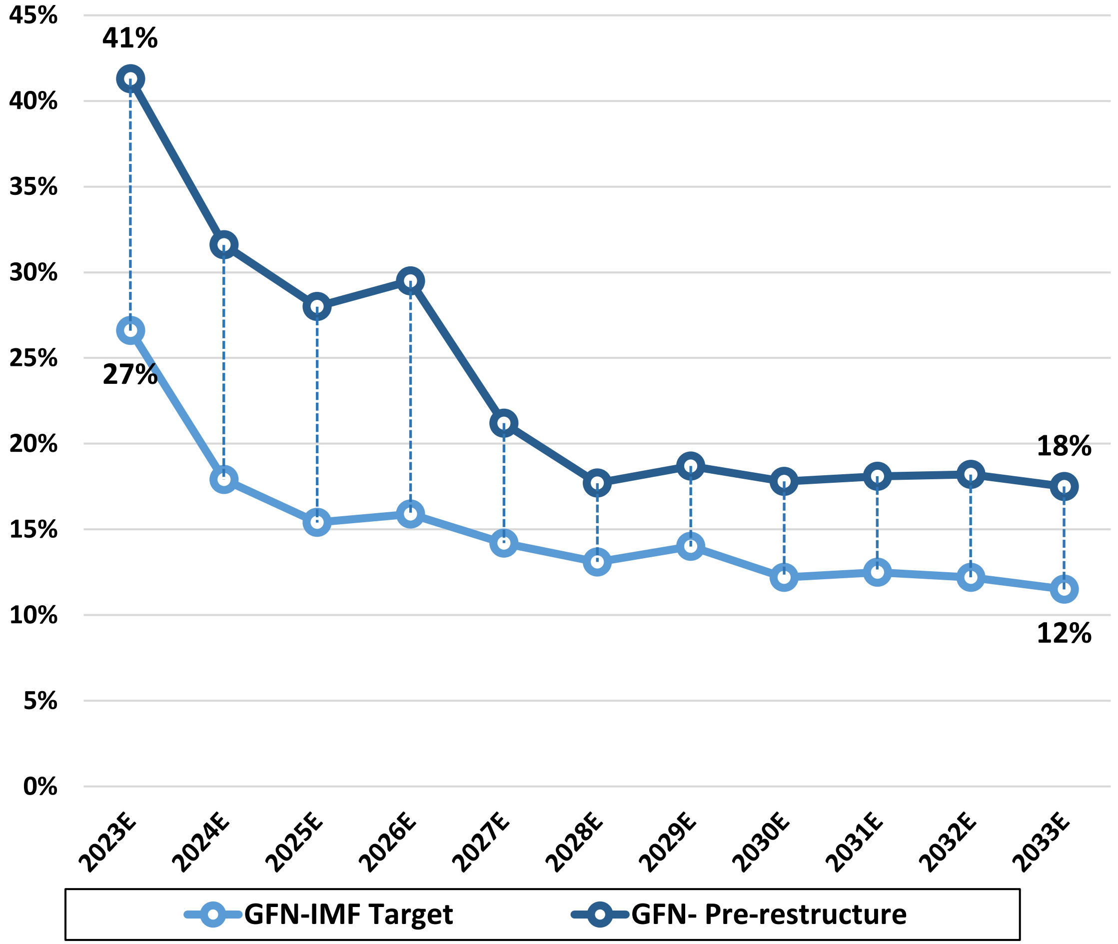
Source: IMF Estimates, First Capital Research



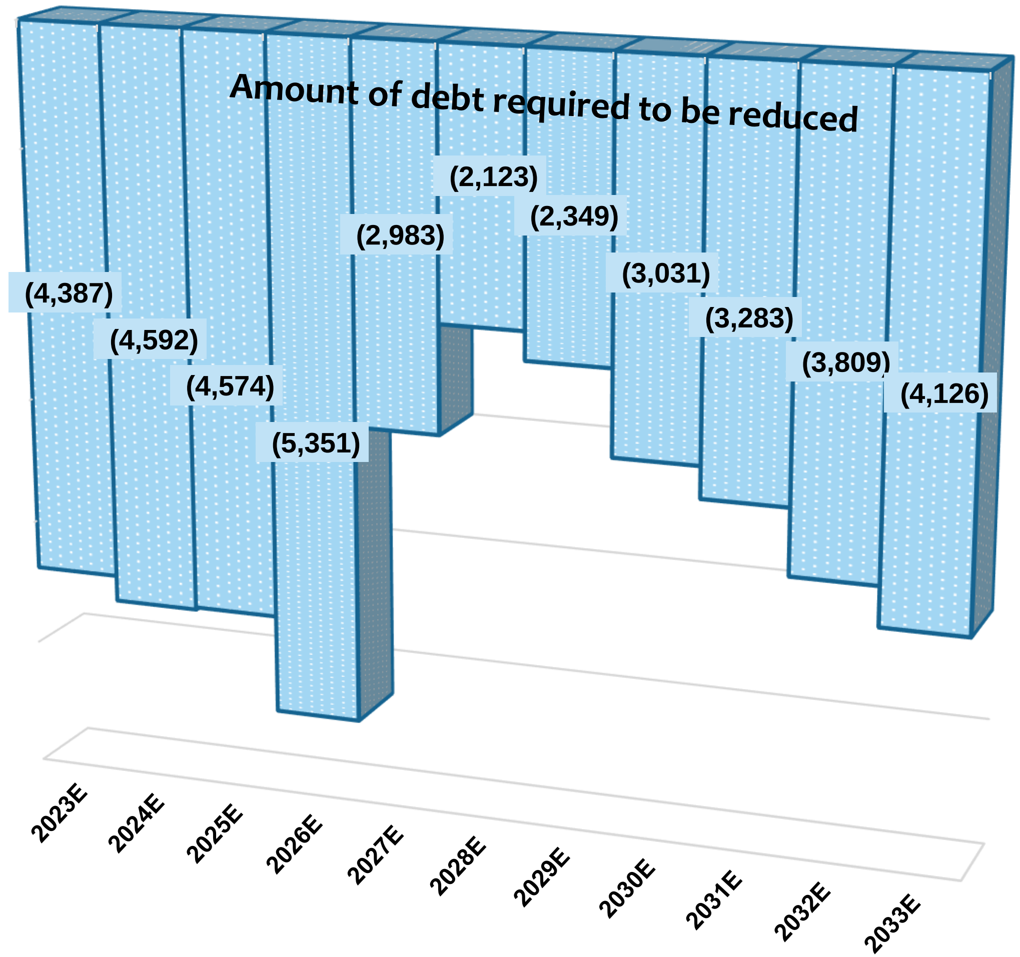
Source: IMF Estimates, First Capital Research

…while GFN target requires to be reduced below 13.0%

GFN targets unlike the Debt to GDP can be achieved via coupon reductions and maturity extensions without going principal haircuts



Source: IMF Estimates, First Capital Research



Source: IMF Estimates, First Capital Research

Debt restructuring process may prevent Sri Lanka from accessing the global financial markets

IMF Assumptions:

"To be robust to delays in market access, the DSA assumes that external market access is only restored in 2027—in line with the experience of similar EM restructuring cases"

IMF EFF Program Plan provide USD 2.5Bn – USD 2.0Bn as budgetary support to bridge budget deficit within 2023-26 period

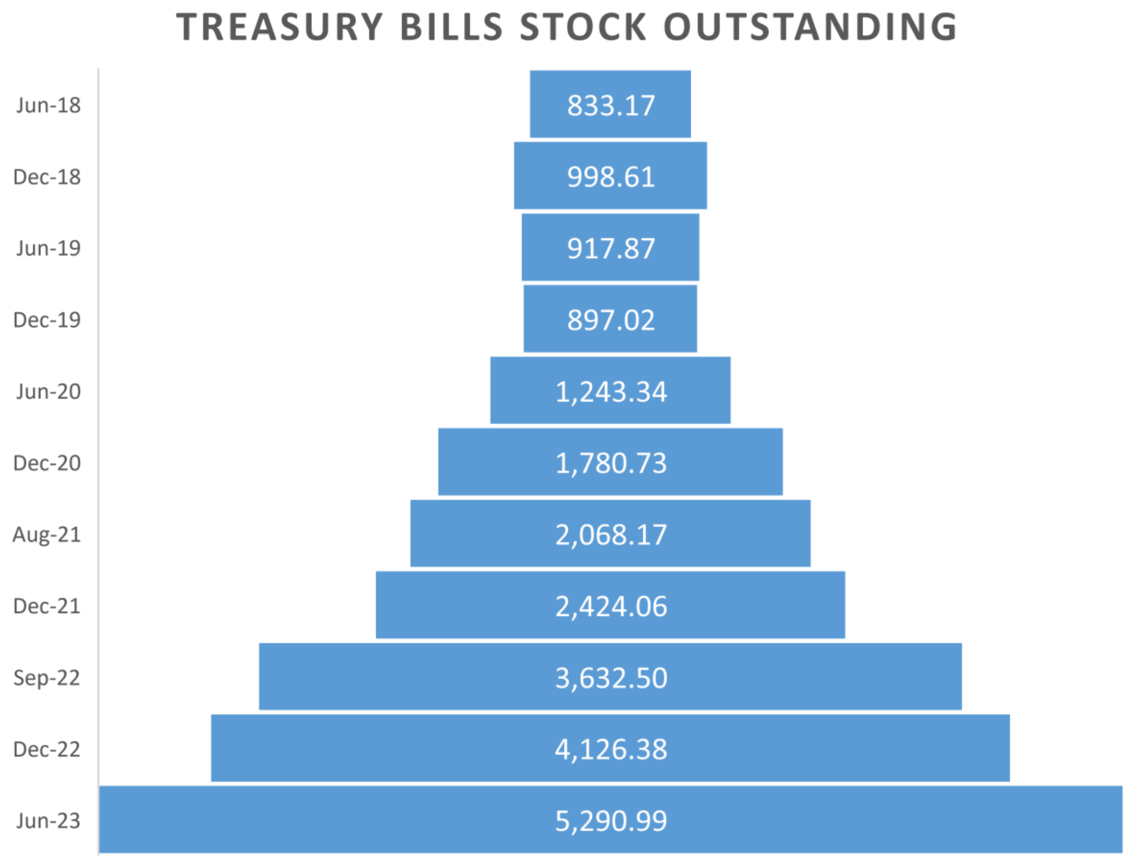
Plan to access global capital markets only by 2027

Source: IMF Estimates, First Capital Research

(in USD millions)	2022	2023	2024	2025	2026	2027	Total 2022-27
Financing Gap (A)	-2,834	-4,939	-4,843	-5,018	-3,608	-3,911	-25,153
Program Financing (B)	2,834	4,939	4,843	5,018	3,608	3,911	25,153
IMF EFF	0	663	665	663	662	329	2,982
IFI budget support	0	900	850	700	700	600	3,750
World Bank		250	400	400	400	300	1,750
ADB		650	450	300	300	300	2,000
Other		0	0	0	0	0	0
Debt moratorium: external arrears accumulation	2,834						2,834
Debt relief		3,376	3,328	3,655	2,246	1,482	14,087
Sovereign bonds (market access)		0	0	0	0	1,500	1,500
Shortfall (A+B)	0	0	0	0	0	0	
Memorandum:							
Gross International Reserves	1,898	4,431	6,128	8,520	10,888	14,208	
Project loans	1,473	1,400	1,542	1,585	1,633	1,682	

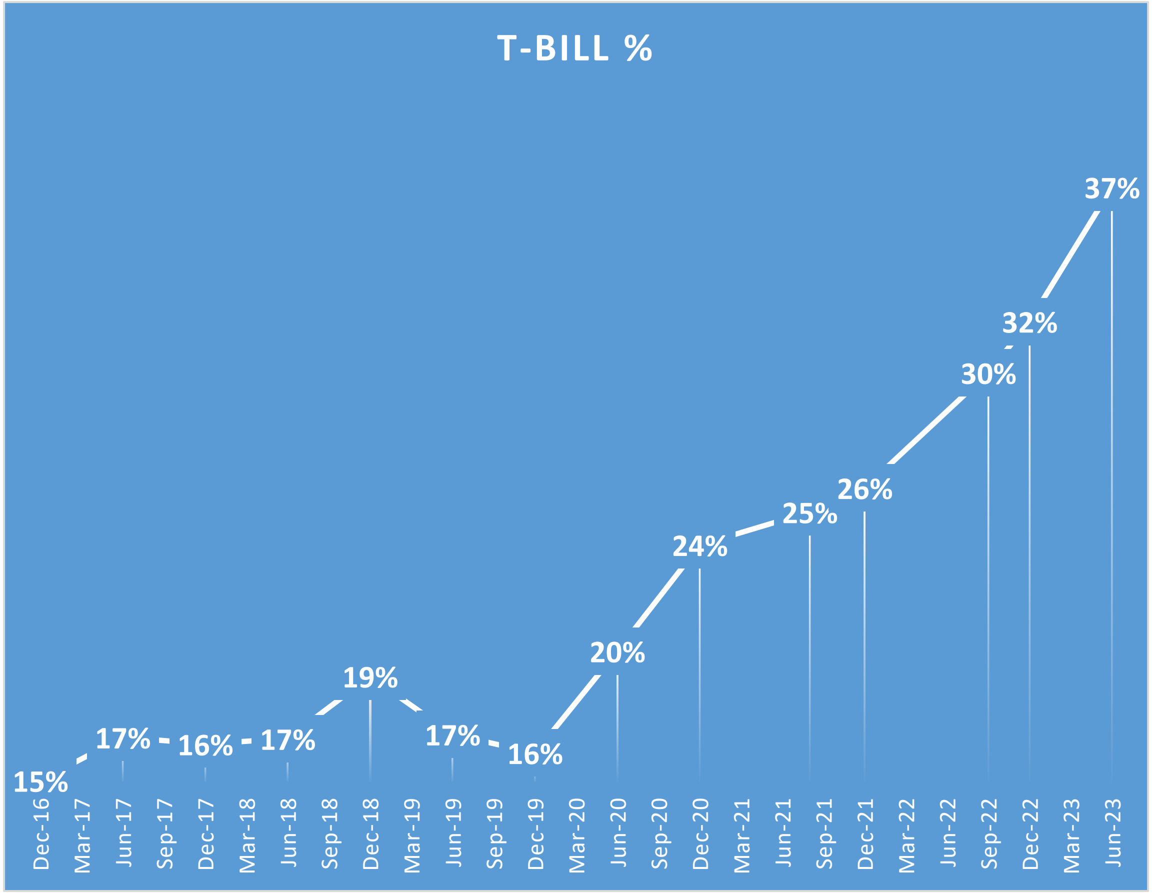
Treasury Bill stock skyrockets as CBSL stops issuing bonds amidst DDO

T-Bill stock exceed LKR 5Tn



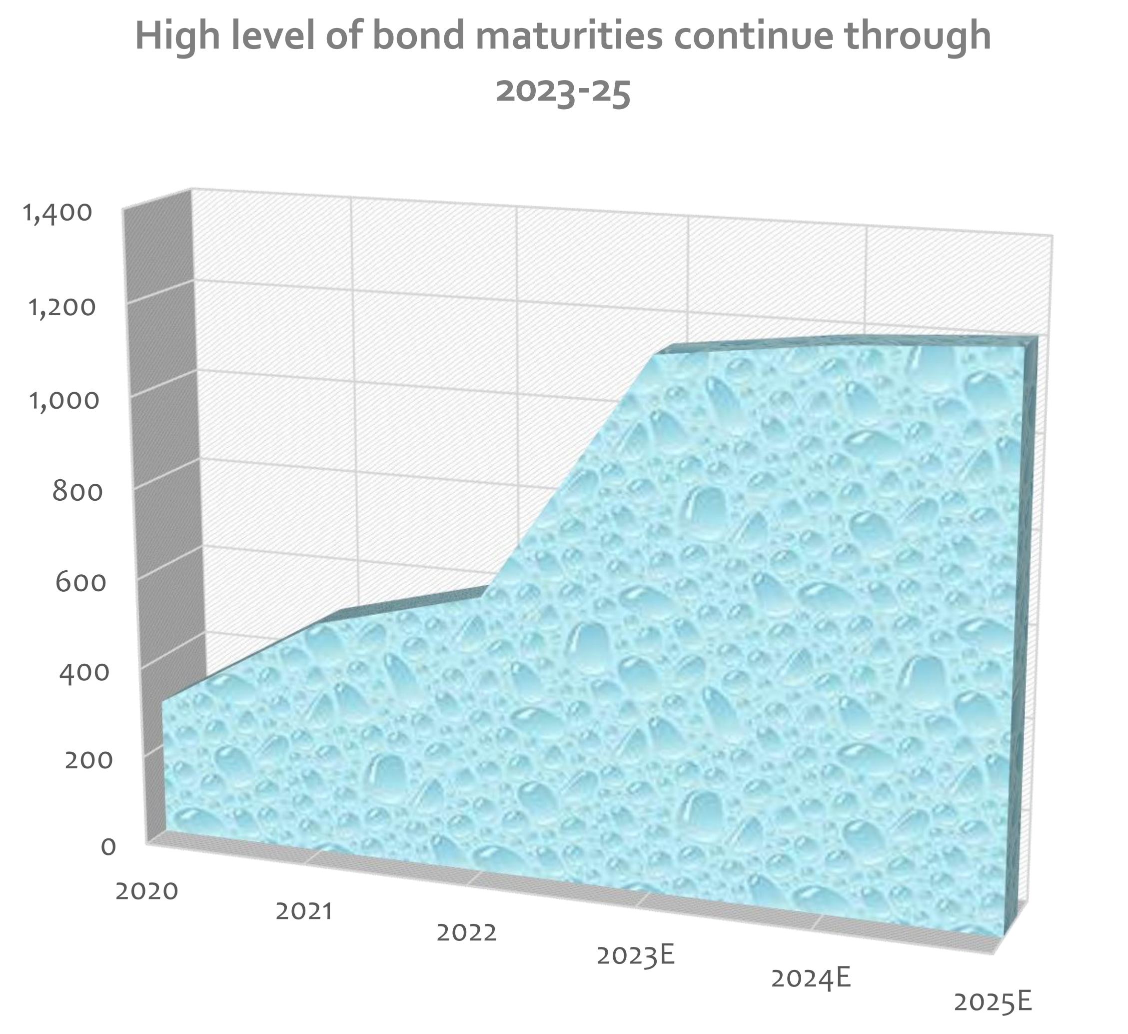
Source: CBSL, First Capital Research

T-Bills rise to 37% out of total G-Secs

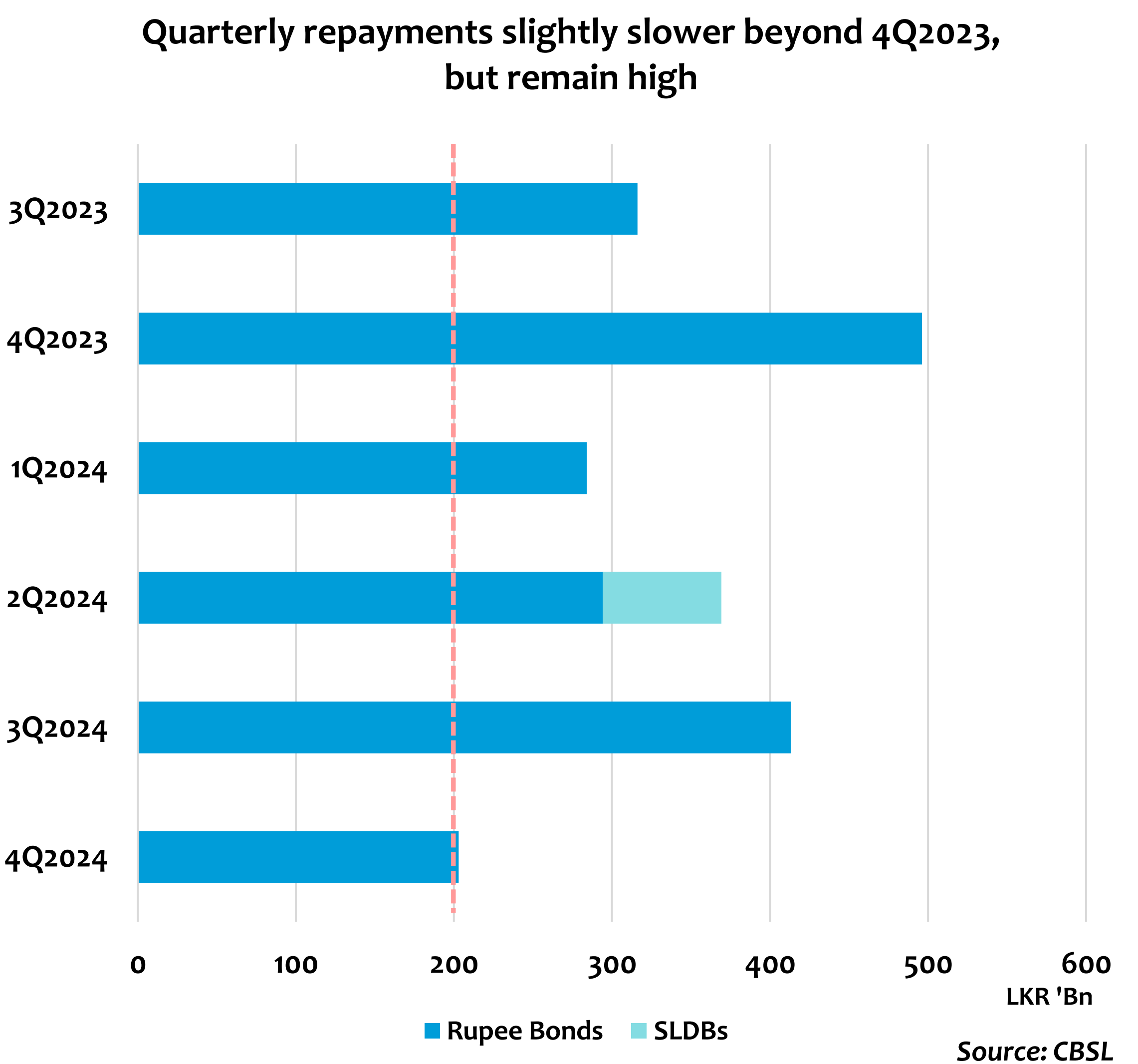


Source: CBSL, First Capital Research

Domestic debt obligations currently stands high



Source: CBSL



Source: CBSL

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)

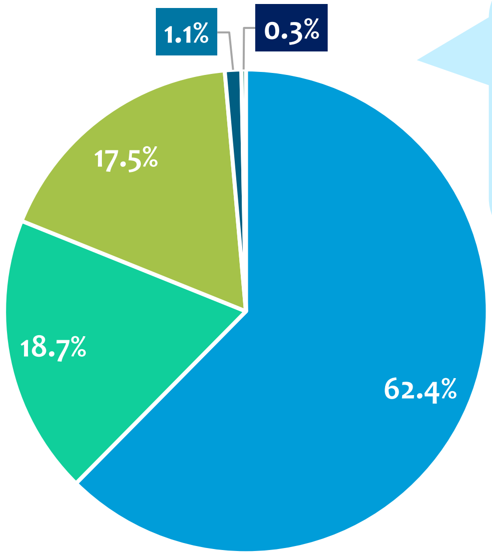
Some level of clarity provided on debt treatment for local currency debt

Central Government Local Currency Debt

T-Bills	T-Bonds	Other Loans	CBSL Advances
LKR 5,291Bn	LKR 9,032Bn	LKR 104Bn	LKR 236Bn

T-Bills Holders

- CBSL
- Deposit Taking Institutions
- Non-Deposit Taking Institutions
- Other
- Non-residents' holdings

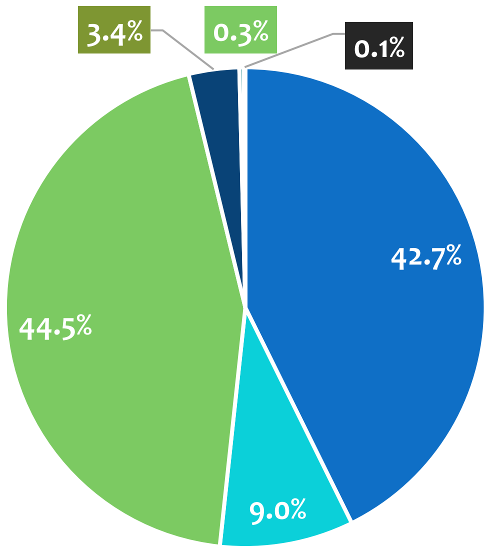


only **T-Bills held by the CBSL, will be considered for treatment** (restructuring) in order to free up some fiscal space

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

T-Bonds Holders

- Superannuation Funds
- Other Non-Deposit Taking Financial Institutions
- Deposit Taking Institutions
- Other
- Non-residents' holdings
- CBSL



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

Summary of Overall Economic Outlook

Positives

- IMF EFF Program
- Foreign Reserves Improvement
- Economic Reforms (Cost reflective pricing of electricity, water & fuel, Measures to increase Tax Revenue)
- Recovery in Tourism
- Recovery Worker Remittances
- Negative Private Credit
- Inflation gradually easing off
- Stable LKR
- Primary Surplus

Negatives

- Negative GDP growth
- High budget deficit may increase Govt borrowing requirement
- Negative liquidity
- High level of CBSL Holdings
- High Rupee and Dollar debt maturities
- Difficulty in raising foreign debt
- Delay in External Debt Restructuring

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

External Outlook pressure eases

Upgrade to Medium-Low Risk (from Medium-High Risk)

Section 5.0

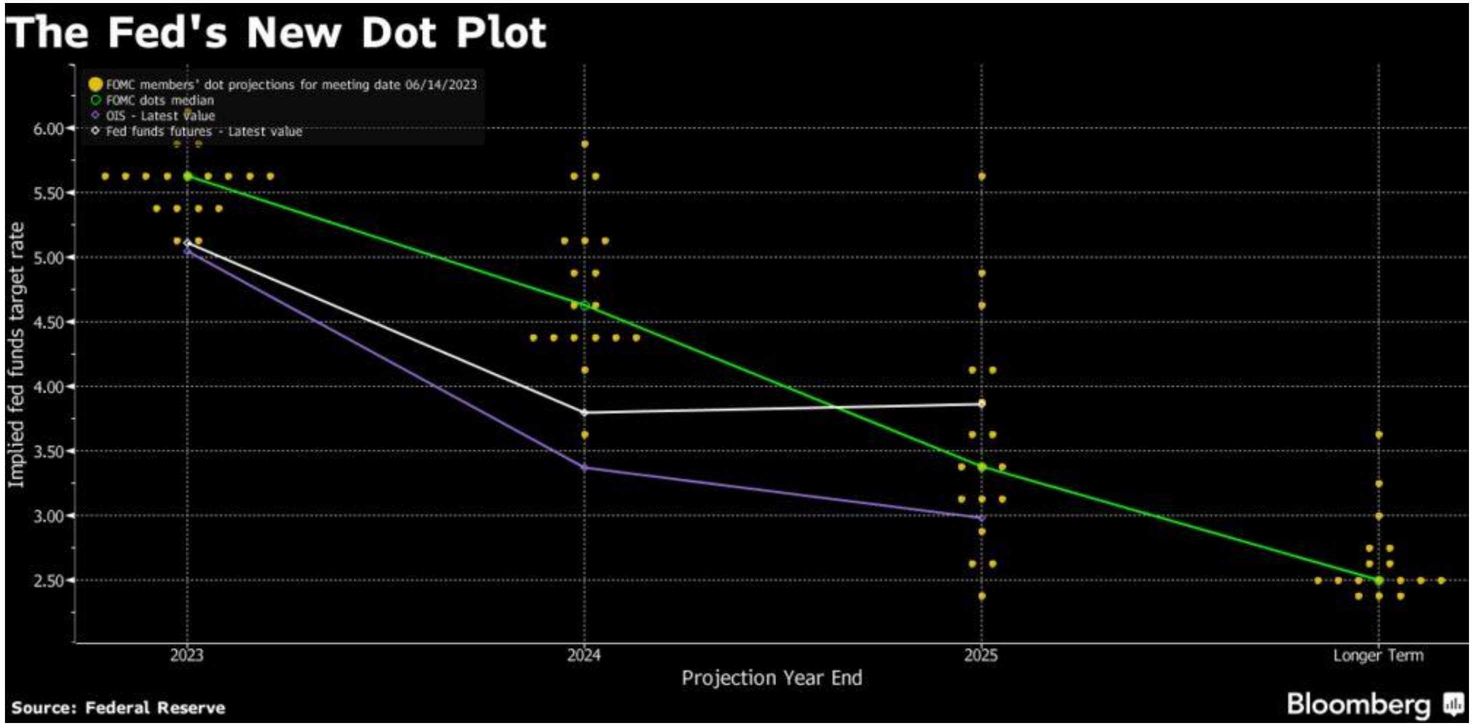
Fed to continue hikes with US signaling further acceleration in economy

In its latest monetary policy update, the Fed announced a pause in its 10-straight rate hike streak. With the objective of combating high inflation, the central bank chose to **maintain rates at the range of 5.00% to 5.25% leaving its benchmark at 5.1% (highest in 16-years).**

Amidst the prolonged hike in historically high Federal Reserve rates and recessionary pressure in the United States, the impact on the Sri Lankan economy remains are two-fold. SL's exports are likely to suffer further with the country already registering a significant slowdown in the Apparel Sector. However, on the other hand demand for oil and other commodities are likely to remain subdued resulting the global price levels to remain low.

SL being a net importer in goods while service sector with tourism gradually improving, we believe SL is currently a net beneficiary considering the fact that we have already come to the peak of the global interest rates as indicated in the Fed's new dot plot chart.

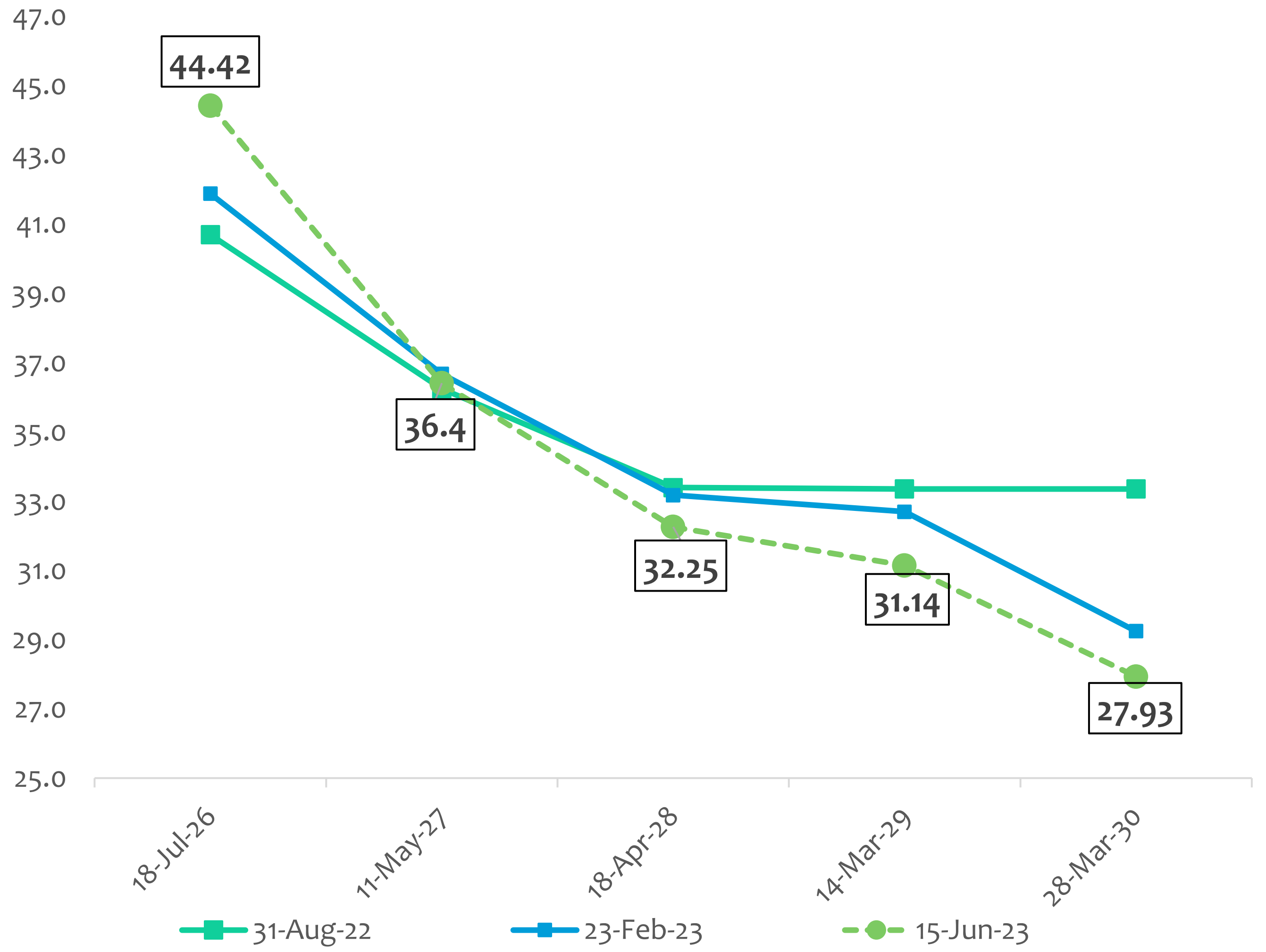
FOMC Meeting date	Rate change (bps)	Federal Rate
14th Jun 2023	**0**	**5.00%-5.25%**
3rd May 2023	+25	5.00%-5.25%
22nd Mar 2023	+25	4.75%-5.00%
1st Feb 2023	+25	4.50%-4.75%
14th Dec 2022	+50	4.25%-4.50%
2nd Nov 2022	+75	3.75%-4.00%
21st Sep 2022	+75	3.00%-3.25%
27th Jul 2022	+75	2.25%-2.50%
16th Jun 2022	+75	1.50%-1.75%



ISBs long tenor slightly come off as market awaits Debt Restructuring finalization…

ISB yields trimmed down by 100bps on the long end of the curve on the back of finalising the IMF board level agreement.

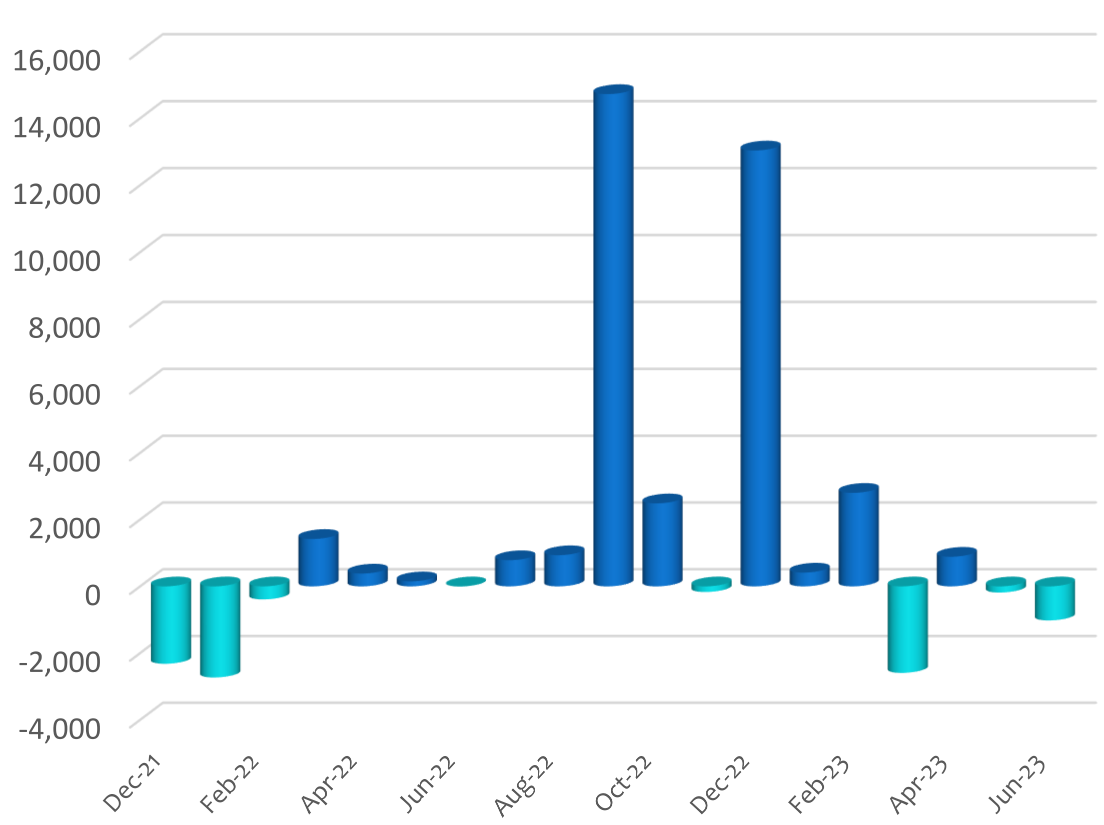
However, overall market remained broadly stable as foreign investors await on more clarity on debt restructuring which has been prolonged.



Source: CBSL, First Capital Research

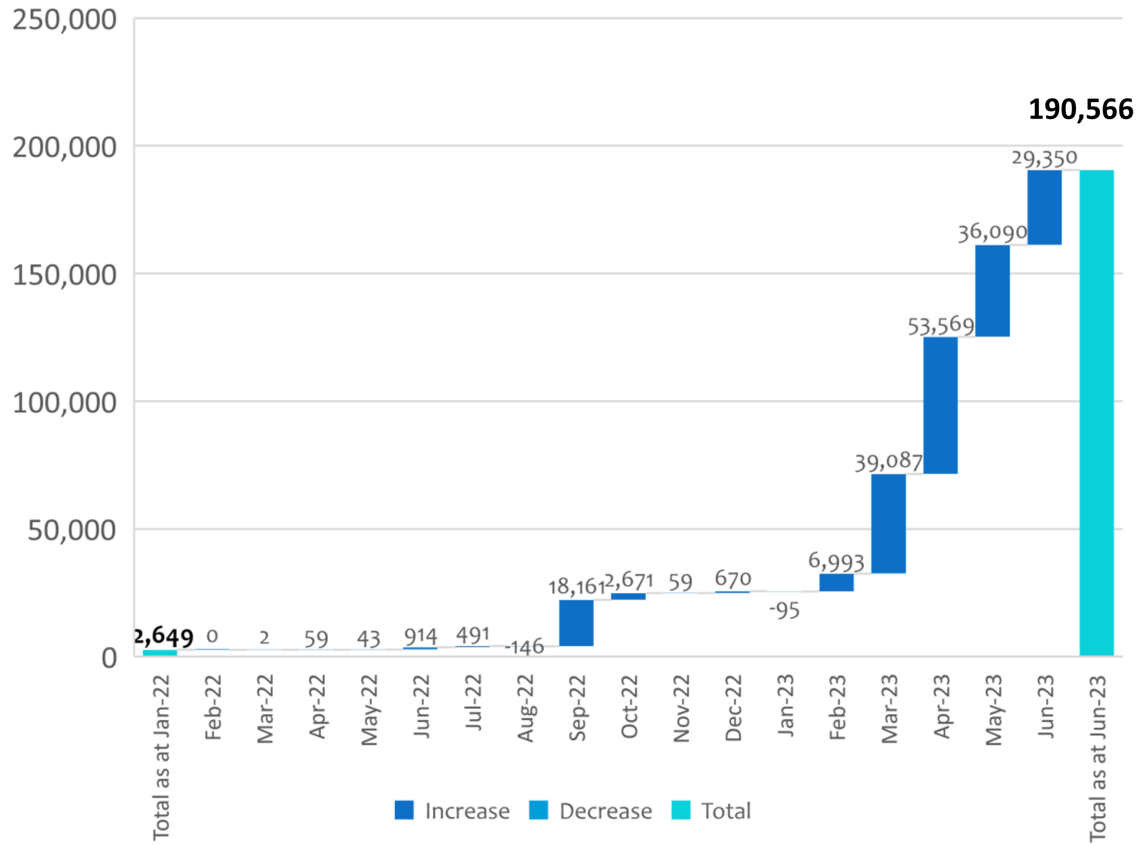
…while inflows continue to flow in, primarily to G-Secs amidst higher premiums

CSE yet to see surge in foreign in 2023



Source: CSE, First Capital Research

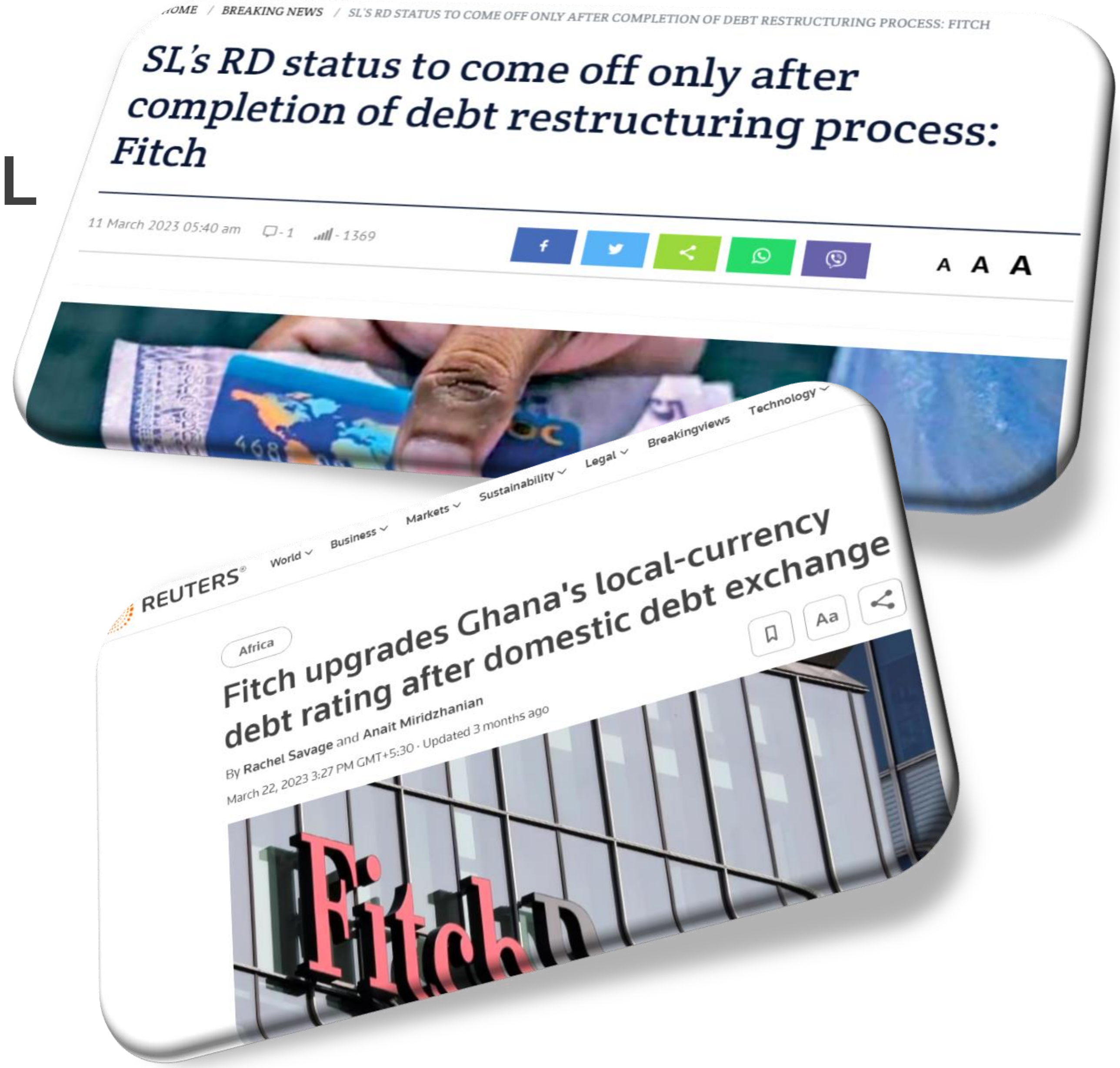
G-Sec YTD net inflow nearing to LKR 190Bn



Source: CBSL, First Capital Research

Potential Credit rating upgrade continues to be on the cards once SL completes the debt restructuring process

- SL is currently negotiating with external creditors while also building a framework for domestic debt optimization. Completing the debt restructuring process is likely to take the country towards more sustainable path with regard to debt.
- Most country's post debt restructuring have achieved a rating upgrade by 2-3 notches. As a result, Sri Lanka has the potential to achieve rating upgrade in the region of CCC+ following the completion of the debt restructuring process.



Summary of External Outlook

Rising Global Interest Rates may continue to support subdued prices on global commodities

ISBs to remain stable until the Govt finalizing the DDO

Net foreign inflows in the G-Sec accelerates in 2023 while relatively slows down in 2Q2023

Improved inflows as tourism, worker remittances and investments stabilize the exchange rate

Summary of External Outlook

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

Outlook Trend for Sri Lanka

Time Period	Political	Economical	External
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
Feb 2023	Medium-High Risk	Medium-High Risk	Medium-High Risk
Jun 2023	Medium-Low Risk	Medium-Low Risk	Medium-Low Risk

Risk Levels (Low-High)

- Low Risk
- Medium-Low Risk
- Medium-High Risk
- High Risk

Recommendations

Section 6.0

First Capital Research View on Bond Market Jul’23-Jun’24

Section 6.1

Primary Criteria

Foreign Reserves

Foreign reserves surpassed LKR 3.0Bn and recorded at USD 3.5Bn in May 2023, highest in 21 months.

Risk Level: Medium-High
(Upgraded from **High**)

Liquidity

Liquidity level was highly volatile and closed the month of May 2023 negatively at LKR 84.5Bn compared to LKR -146.7Bn recorded at the beginning of the month.

Risk Level: Medium-High
(Maintained)

Inflation

CCPI continued to decline for the 8th consecutive month and recorded at 25.2% in May 2023, indicating stabilization of inflation.

Risk Level: Medium-Low
(Upgraded from Medium-High)

Foreign Activity

Foreign Investment in Govt. securities significantly inclined to LKR 190.6Bn amidst the high interest rates.

Risk Level: Medium-Low
(Maintained)

Credit

Private sector credit continued to contract for the 11th consecutive month to LKR 7,109.6Bn in Apr 2023 amidst the sharp escalation in lending rates.

Risk Level: Low
(Maintained)

CBSL Holdings

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

Risk Level: High
(Maintained)

Secondary Criteria

Rating Outlook

Despite being at default level, SL secured the IMF EFF facility, and currently though delayed, are in process of debt restructuring which may result in potential upgrade in ratings

Risk Level: Medium-High

(Maintained)

External Environment

Foreign exchange market remains highly volatile, while USD/LKR has appreciated by 18.6% YTD and 8.1% during the month of May 2023.

Risk Level: Medium-Low

(Maintained)

BOT & BOP

Trade deficit contracted and recorded at USD 583.0.0Mn in Apr 2023 while BOP turned into surplus and recorded at USD 883.0Mn amidst the rise in foreign inflow from tourism and worker remittances.

Risk Level: Medium-Low

(Upgraded from Medium-High)

Political Risk

Political stability is maintained. However, popularity of the govt. is deteriorating due to uncertainties.

Risk Level: Medium-Low

(Upgraded from Medium-High)

Investor Confidence

The BCI registered surge of 29 bps to 63 in 2Q2023 *cf.* 34 in 1Q2023. We expect business confidence to further improve gradually considering the economic rebound post IMF.

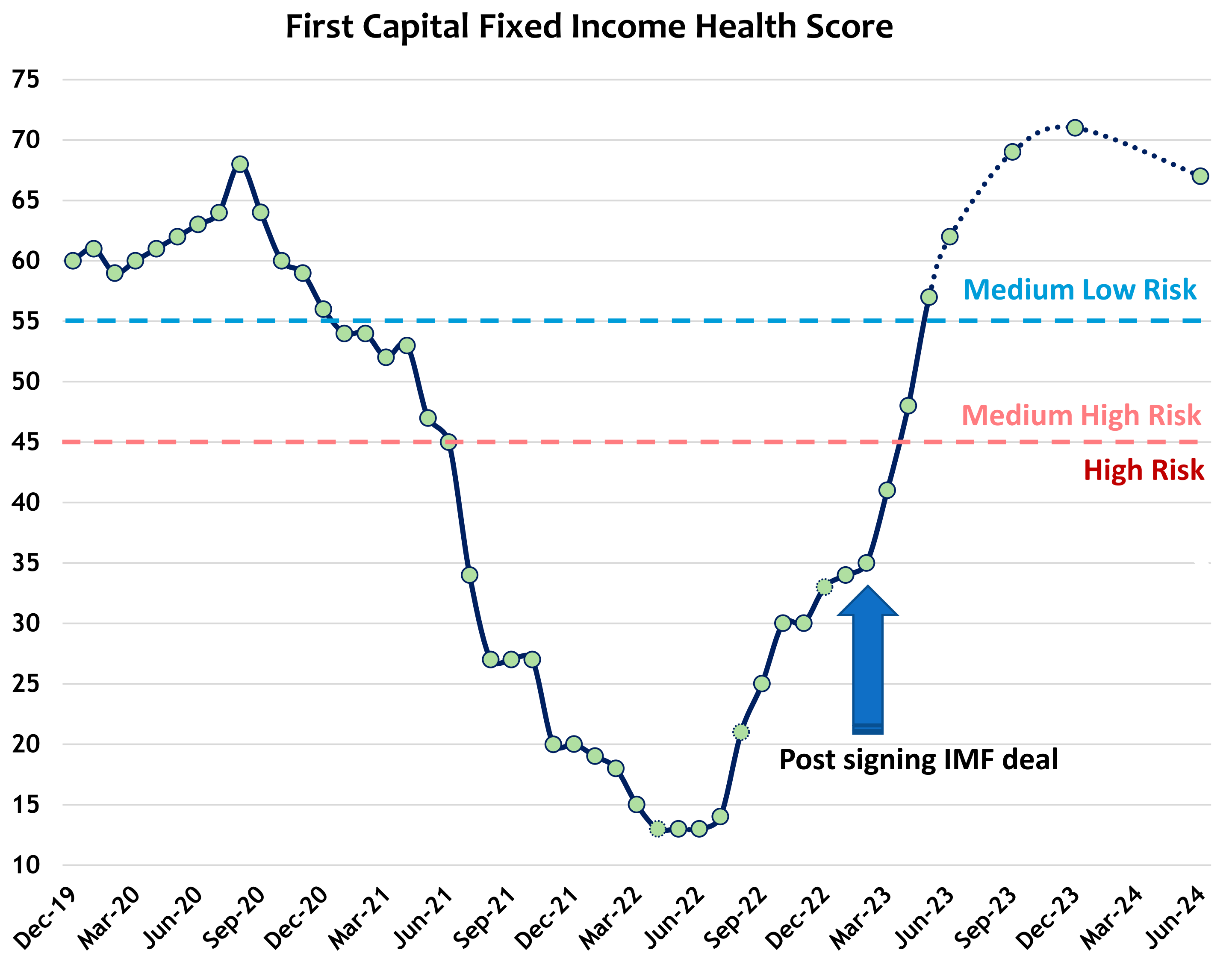
Risk Level: Medium-High

(Upgraded from **High**)

FI Health Score to improve further

Post signing the IMF deal in Mar-23, FI Health Score recorded a further accelerated improvement in 2Q2023 crossing over from the High Risk to Medium Low Risk in 2Q2023 supported by the development in key economic indicators.

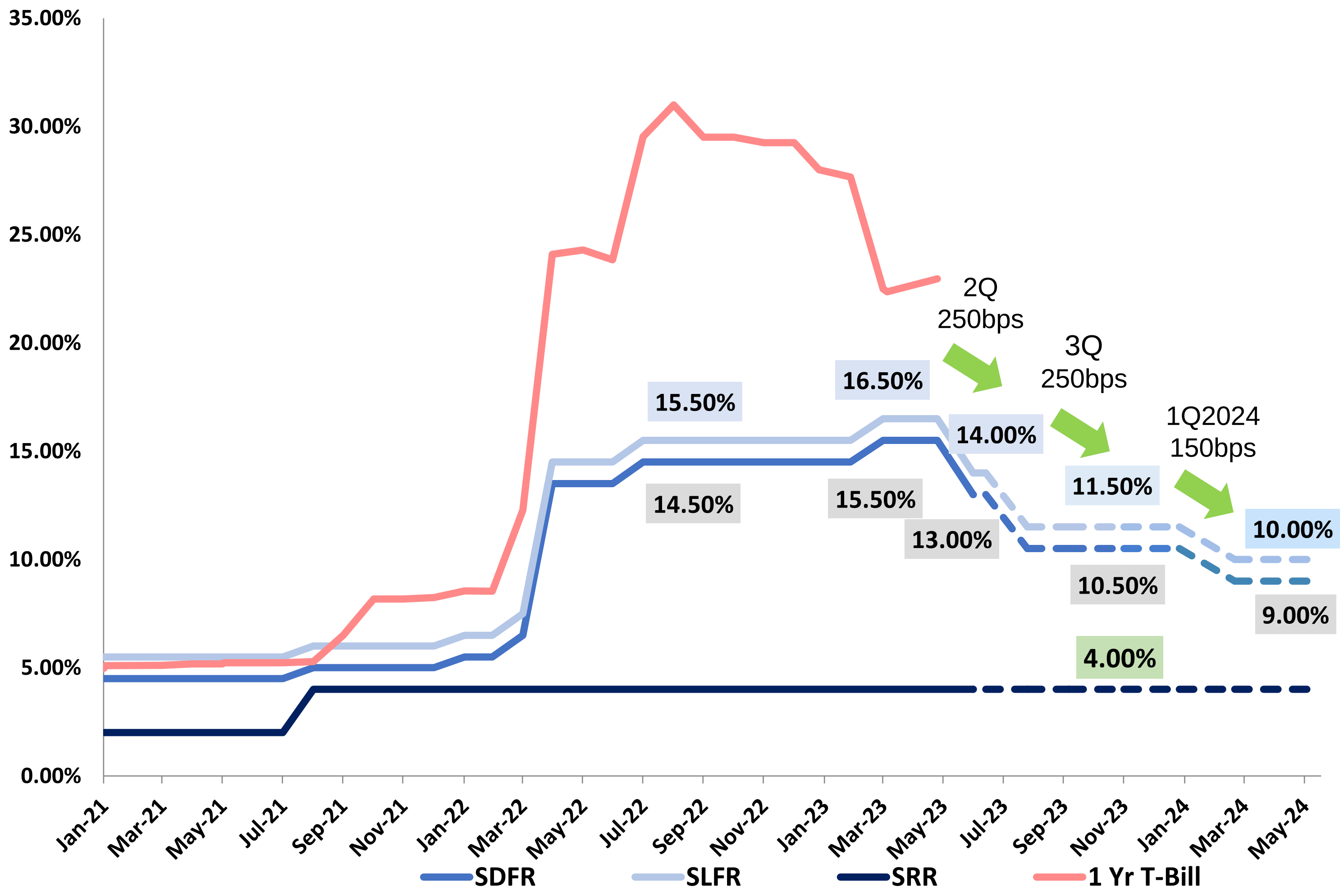
Further improvement is expected in 3Q2023, where the FI Health is expected to cross towards the Low-Risk territory leading the way for a further decline in interest rates.



Source: First Capital Research

Probabilities weigh higher for continued downtrend in policy rates

400 bps rate cut over the next 12months



Source: First Capital Research

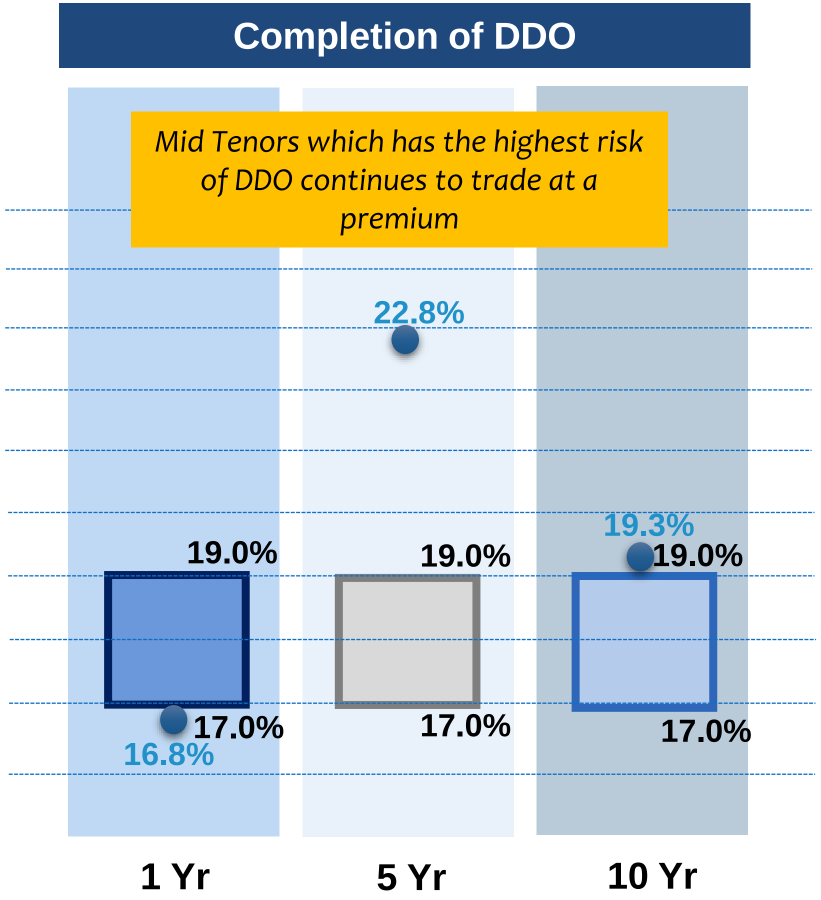
Post IMF, following the stabilization of the economy and the accelerated improvement in the economic indicators, CBSL has adopted an aggressive path for reduction in interest rates by announcing a 250bps rate cut in Jun-23.

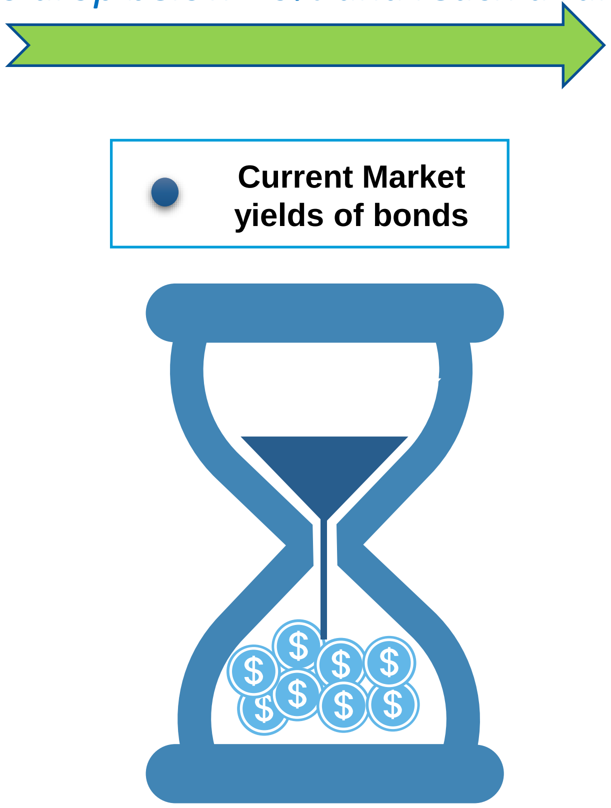
A further Rate cut is a strong probability towards 3Q2023. We target about two rate cuts amounting to a cumulative dip of about 500bps of which 250bps has already been given in 2Q while a further 250bps is likely in the 3Q.

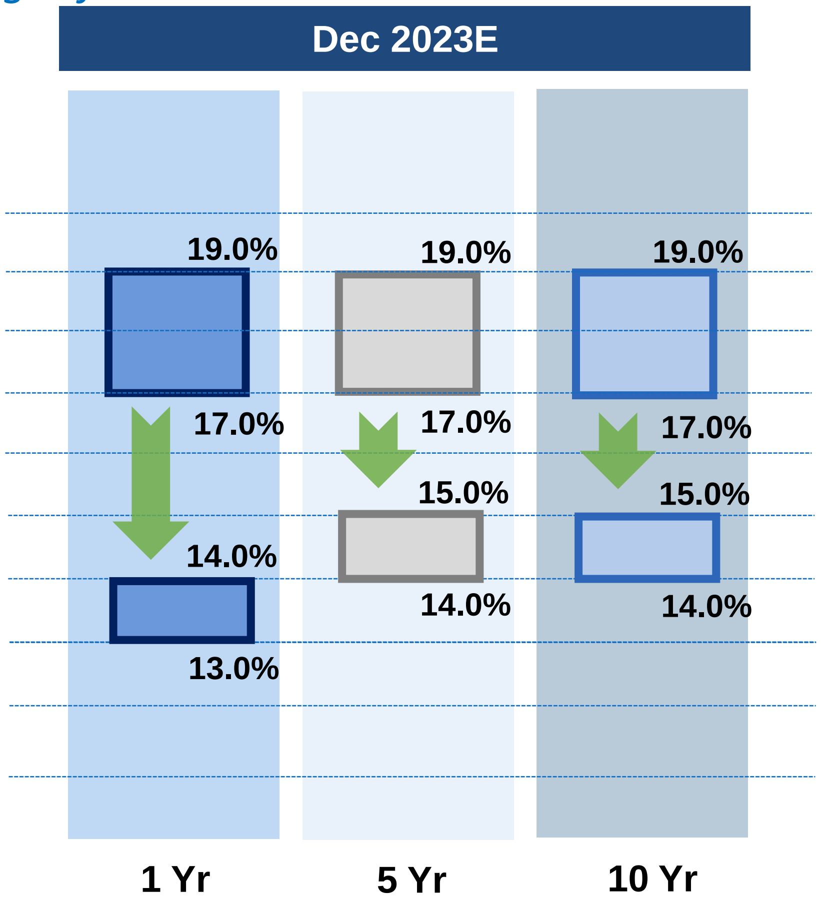
A further 150bps is likely in 1H2024 supported by the decline in inflation.

Bond yields to continue downtrend in 2023 to reach 13%-15%

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% and reach a range of 13%-15%.

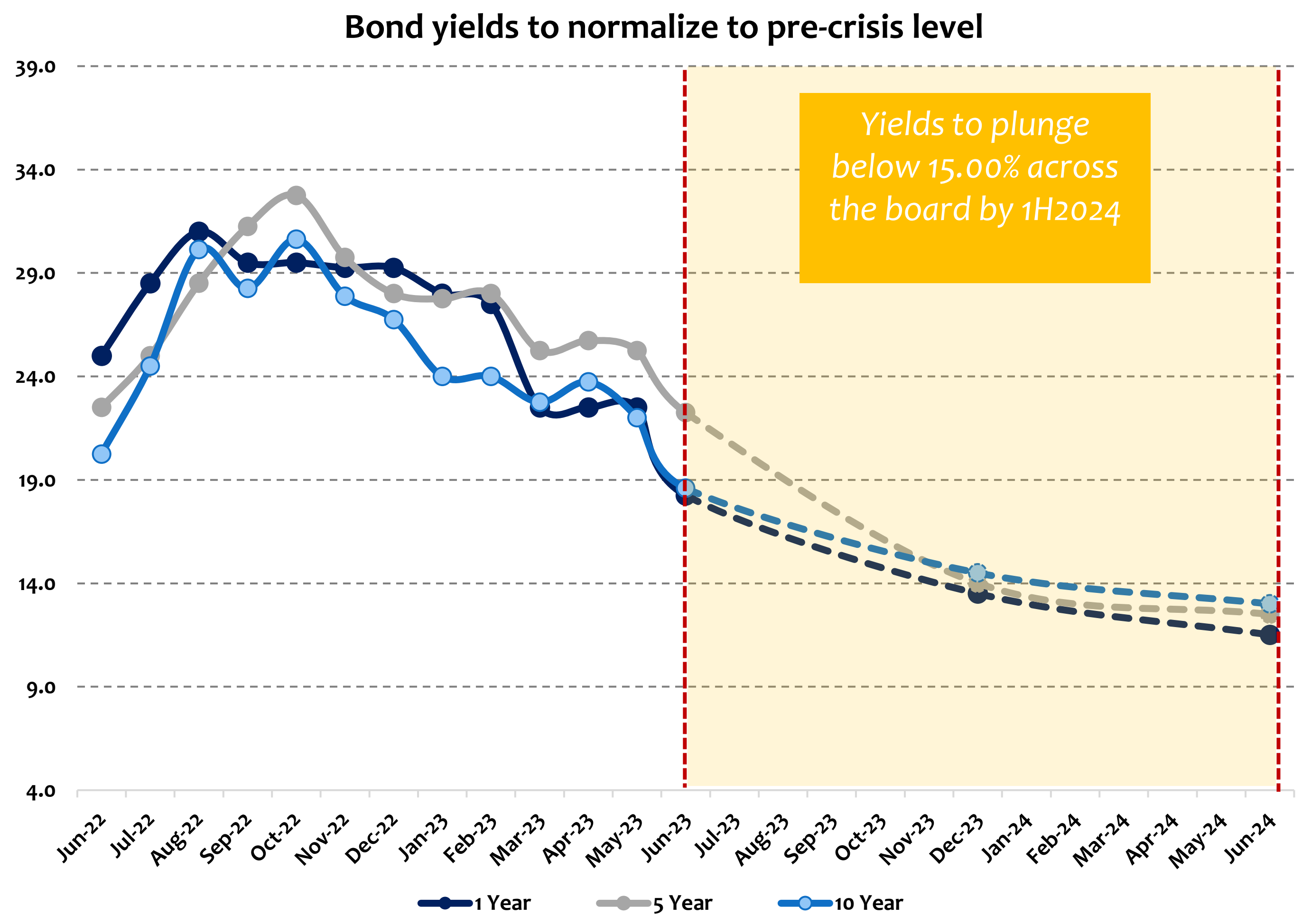




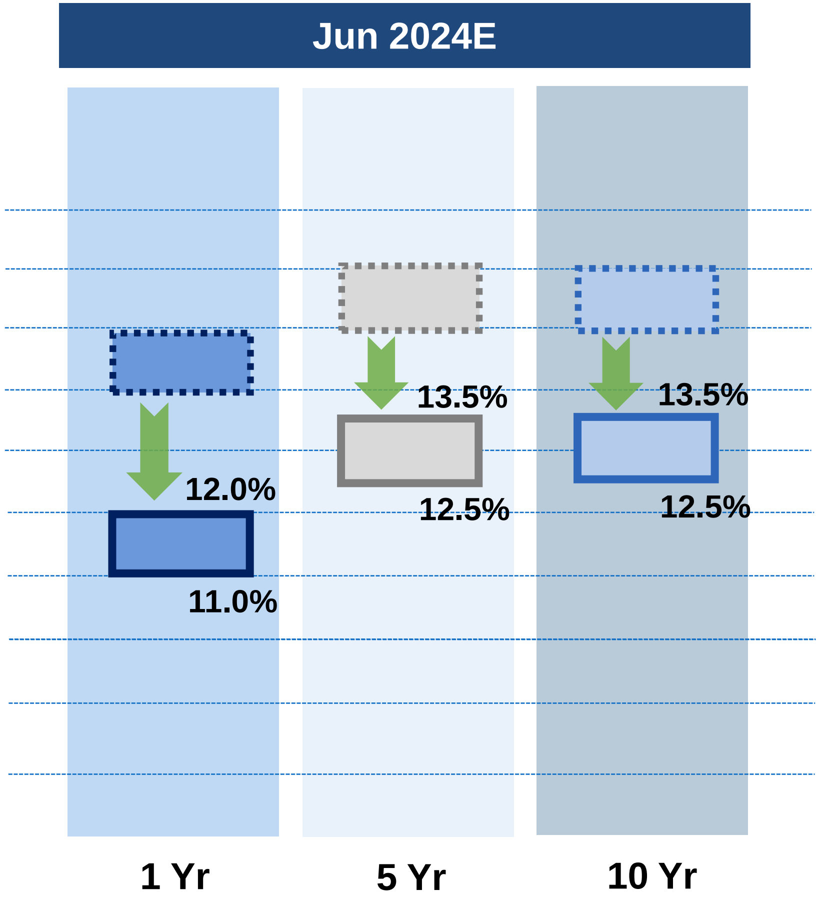


Source: First Capital Research

Bond Yields in 1H2024 is expected further drop to a range 11%-13.5%



Source: First Capital Research



Time to be cautious

First Capital Research believes it's time to partly book profits

Recommendation Change:
Downgrade to **Hold** from **Buy**

DDO draws closer; Premiums decline: With the massive decline in G-Sec yields, the significant premium that was previously available on yield curve is no longer available. The extreme short term (1Yr) and the long tenors (10Yr) have already reached our post DDO target while 5Yr only has about a 400bps spread to fall into the target range of 17%-19% of First Capital.

Book profits & reduce exposure: There is a lot of uncertainties surrounding DDO and its application. As the premiums attached to the bonds have significantly reduced and in some cases completely eliminated, we would like to advice investors adopt a **wait and see approach** on their portfolios. We would like to further advice to book profits on part of the bondholding specifically on the long end of the portfolio.

Ability to BUY post DDO: Multiple risks are associated with DDOs. It could be in the form of extension of maturity, coupon cut or principal haircut. It can be applicable for specific investors or even specific bonds. 2024 and 2025 bonds have the highest restructuring risk considering the IMF gross financing needs criteria. Post DDO Govt is likely to re-enter the market to raise debt via bond auctions. ***Considering the uncertainty, possible volatility in yields and new bond auctions post DDO, it is advisable for investors to create some buying capacity to take advantage of the volatility in rates post DDO.***

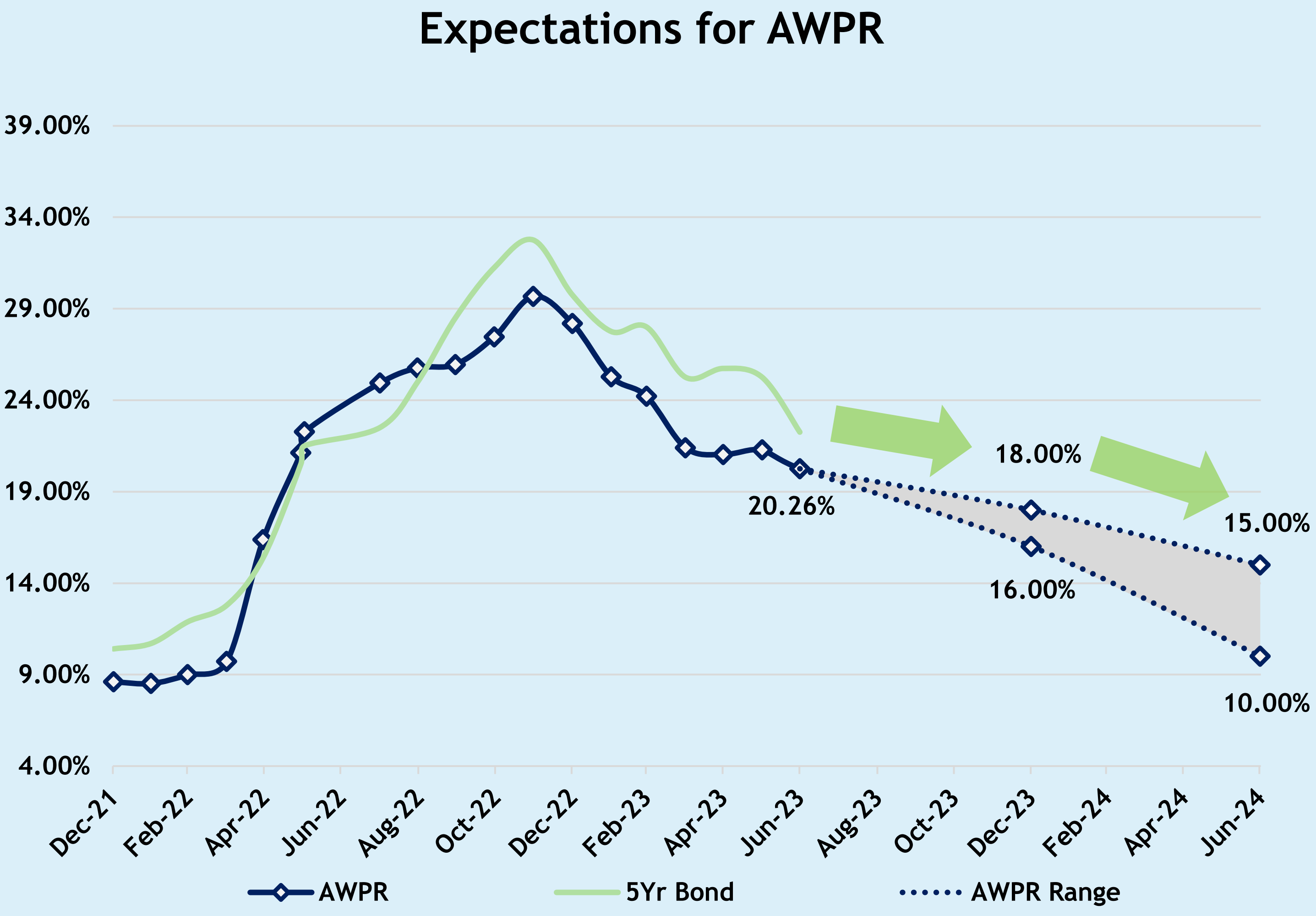
First Capital Research View on Banking Rates Jul’23-Jun’24

Section 6.2

AWPR to dip to 10%-15% over the next 12 months

With the steep drop in Bond yields, AWPR has followed a similar suit with an accelerated pace ahead of our expectations. The lag effect has significantly reduced with AWPR moving in line with the yields decline or sometimes even ahead of it.

We expect AWPR to further decline towards 16.0%-18.0% by Dec-23 and further dip to 10.0%-15.0% by Jun-24.



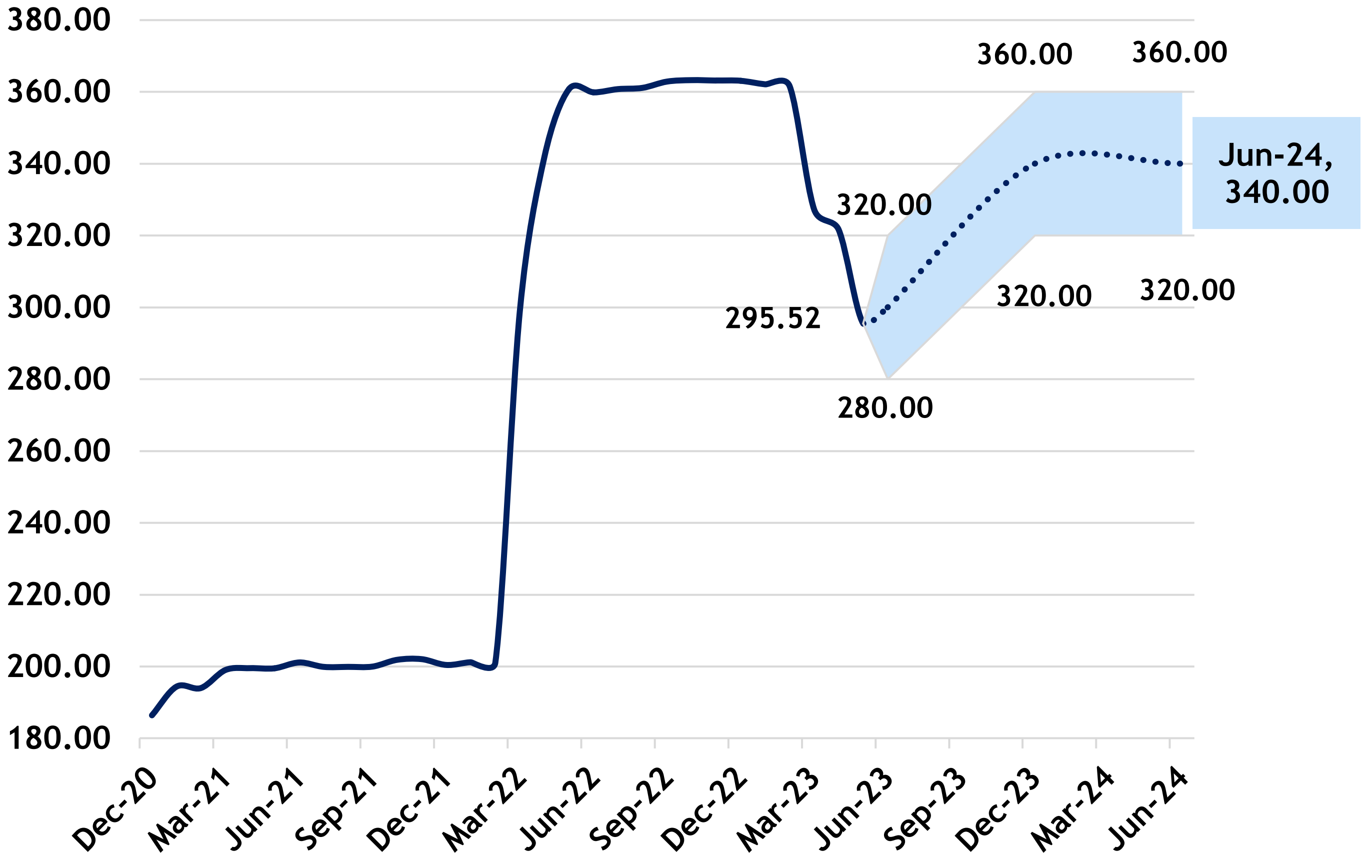
Source: CBSL, First Capital Research

First Capital Research View on Exchange Rates Jul’23-Jun’24

Section 6.3

Exchange Rate outlook upgraded to LKR 320.0-360.0

USD/LKR is expected to gradually depreciate in 2H2023 & 1H2024 amidst trade relaxation, hovering within a range of LKR 320.0-360.0 over the next 12 months (Jun-24)



Source: CBSL, First Capital Research

Following the approval of the IMF loan in Mar-23, foreign inflows into government securities and dollar to rupee conversions by locals were beyond FCR's expectations, particularly the local conversions which strengthened the LKR.

However, going forward currency appreciation is likely to be limited as the government plans to gradually ease import restrictions which could potentially exert a downward pressure on the currency, especially considering the ongoing recovery in GDP growth.

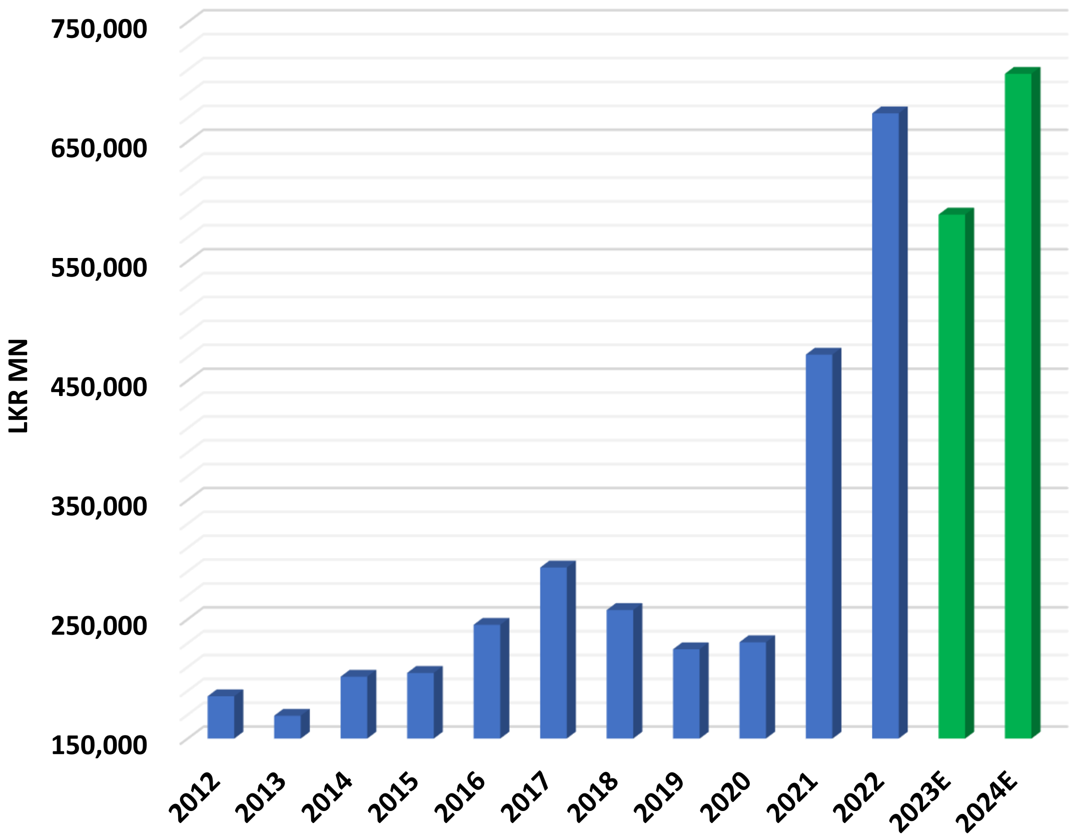
The exchange rate is expected to gradually depreciate towards 2H2023 to a range of LKR 320.0-360.0 for Dec-23 while the target for Jun-24 also remains the same at LKR 320.0-360.0.

First Capital Research View on Equity Market Jul’23-Jun’24

Section 6.4

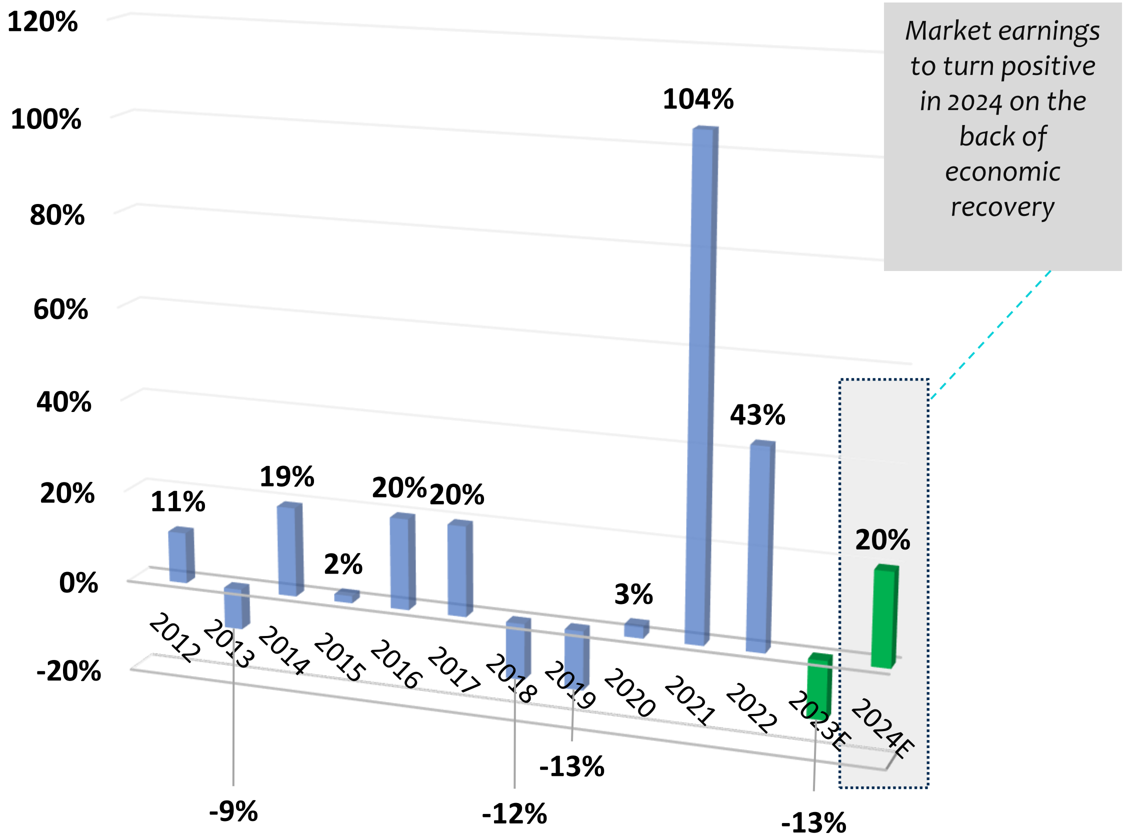
Market earnings to recover with the economy by 2024...

Market Earnings surpass LKR 700Bn



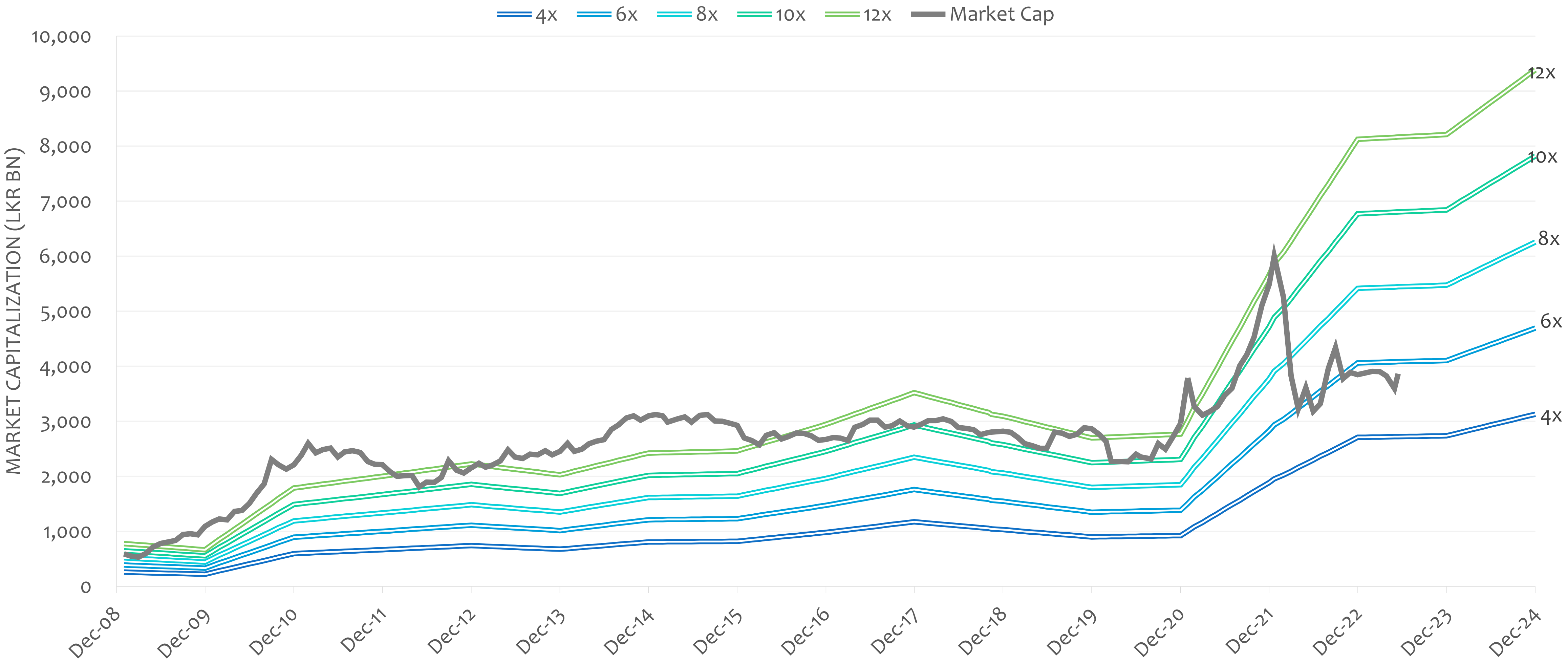
Source: CSE, First Capital Research

Market Earnings growth may touch 20%



Source: CSE, First Capital Research

…with ASPI trading below 6.0x PER



Source: First Capital Research Estimates

“COLLECT! Buy into the Portfolio”

Increase equity allocation as market potentially re-rates

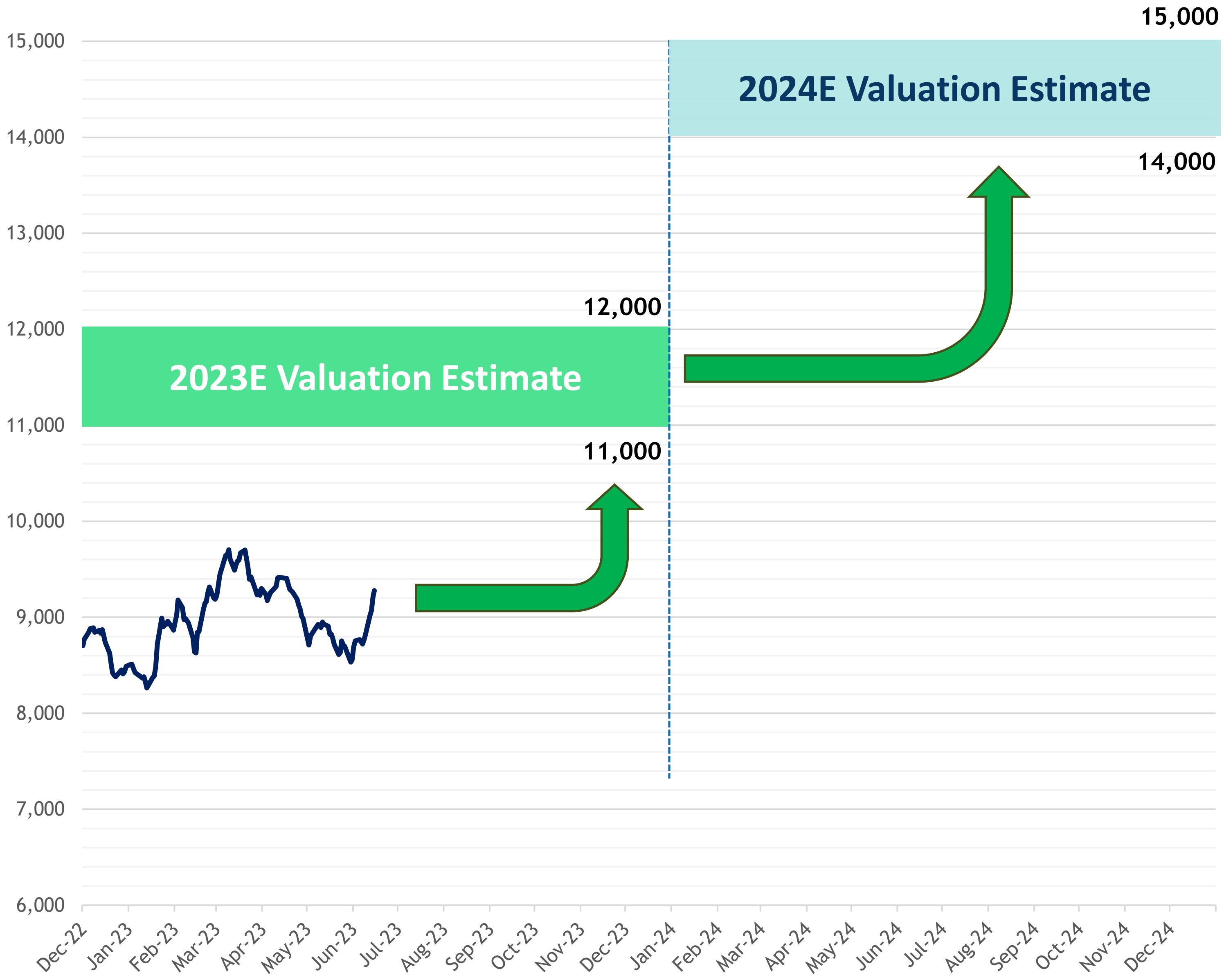
With visible signs of economic recovery aided by plunge in inflation and steep rate cuts, the ASPI have already re-rated upward from its historical lowest trading multiples (recovering to a PE of 5.6X in Jun-23 cf. 4.8X in Apr-23).

The recovery in the ASPI is expected to continue during 2H2023E, supported by further reduction of interest rates, successful completion of the debt sustainability negotiations and YoY recovery in GDP from 4Q2023E.

With the expectation of ASPI to re-rate to 12,000 by Dec-23, we advice to increase the equity allocation from 65% to 85%, whilst reducing the cash allocation from 35% to 15%.

ASPI to reach 12,000 by Dec 2023 & 15,000 by Dec 2024

First Capital maintains ASPI 2023E fair value range of *11,000-12,000* on the market re-rating while targeting *14,000-15,000* for 2024E on earnings recovery



Source: CSE, First Capital Research

First Capital *Upgrades* Equity Exposure to 85% reducing cash to 15%

PREVIOUS RECOMMENDATION

EQUITY

65%

CASH

35%

Equity exposure increased to 65% from 50%,
Cash exposure reduced to 35% from 50%.

RECENT RECOMMENDATION

EQUITY

85%

CASH

15%

Equity exposure increased to 85% from 65%,
Cash exposure reduced to 15% from 35%.

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"Successful investments is about managing risks"

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