



First Capital
A Janashakthi Group Company

EQUITY STRATEGY

First Capital Research | 22 JULY 2024

“Equities ready for lift-off”

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WHY BUY NOW?



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First Capital Research remains **BULLISH** on equities despite the continuous uncertainties centered around the elections and the delay in external debt restructuring. We continue to believe that the catalysts for stronger returns out way the risk, as we advise investors to remain fully invested as the below catalysts are expected to re-rate the market to our target ASPI range of 13,500.



Rapid recovery in earnings which posted a growth of 32.3%YoY in 2H2023. The positive movement in earnings continued during 1Q2024 (+38.3%YoY) and FCR expects earnings to continue grow in 2024E (+42.0%YoY) and 2025E (+16.0%YoY).



Completion of external debt restructuring in Jul-24. Sri Lanka marked the completion of external debt restructuring and awaits the nod from the IMF, and a possible foreign currency credit rating upgrade.



Continuous improvement in key economic indicators and timely passing of key reforms.



Cheap valuation of CSE (trading at a BV of 1.0x cf. a regional peer average of 1.4x).



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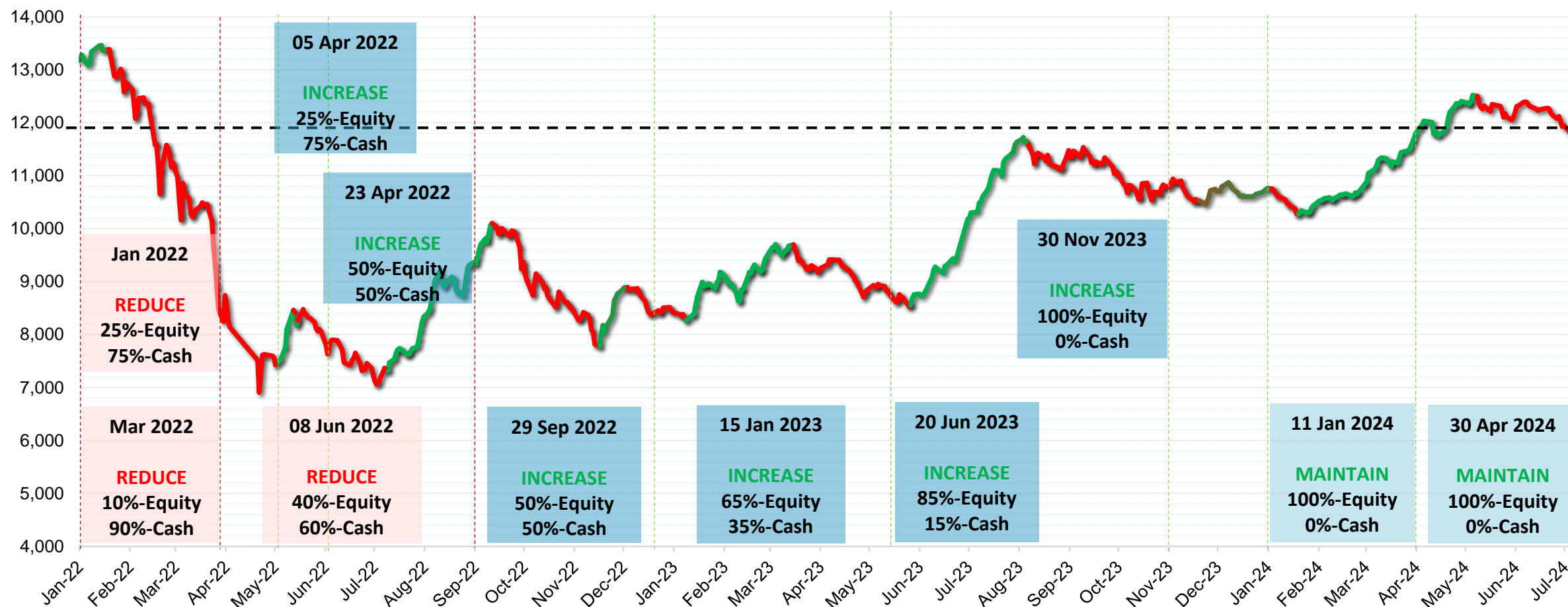
1.0 Performance of the CSE

Recap 30 Apr 2024



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First Capital *Maintains* Equity Exposure at 100% and Cash at 0%

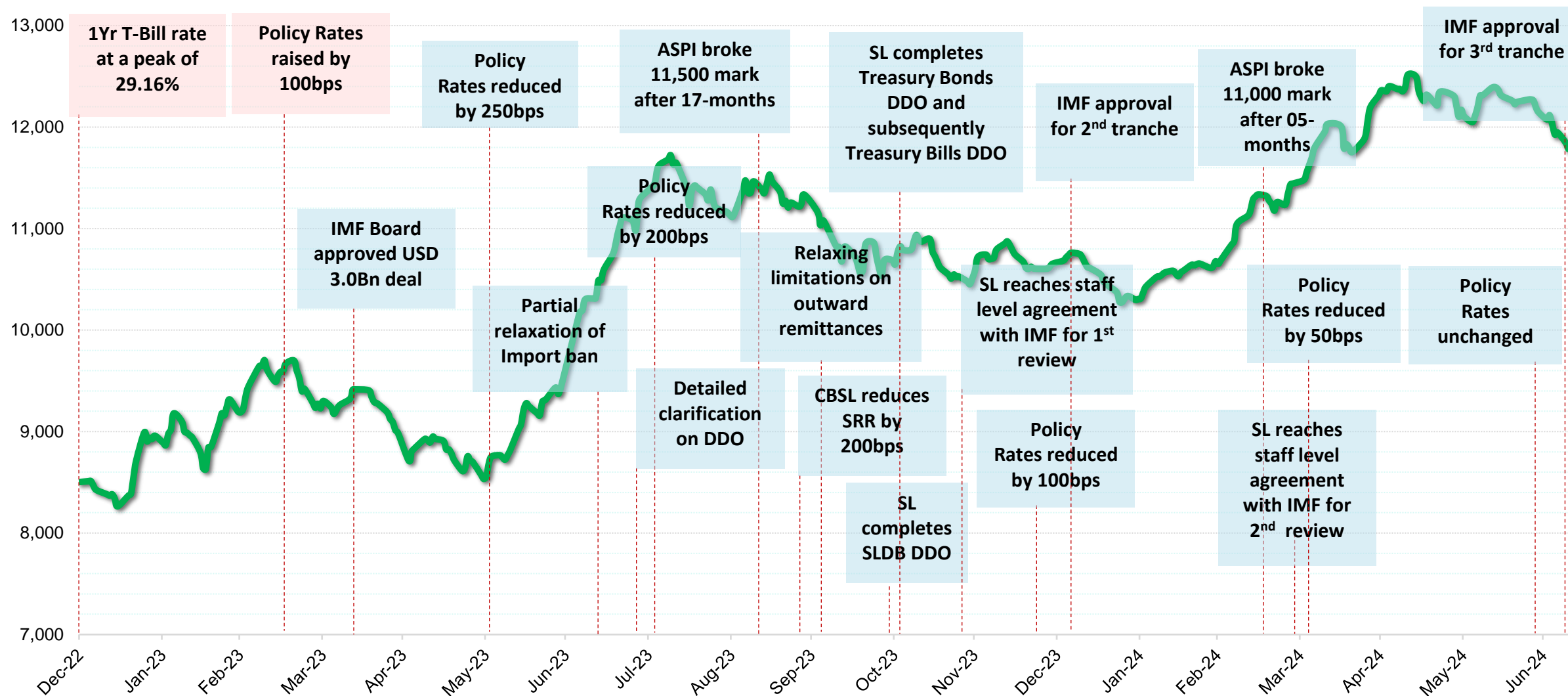


Source :CSE & First Capital Research

ASPI performance and key highlights



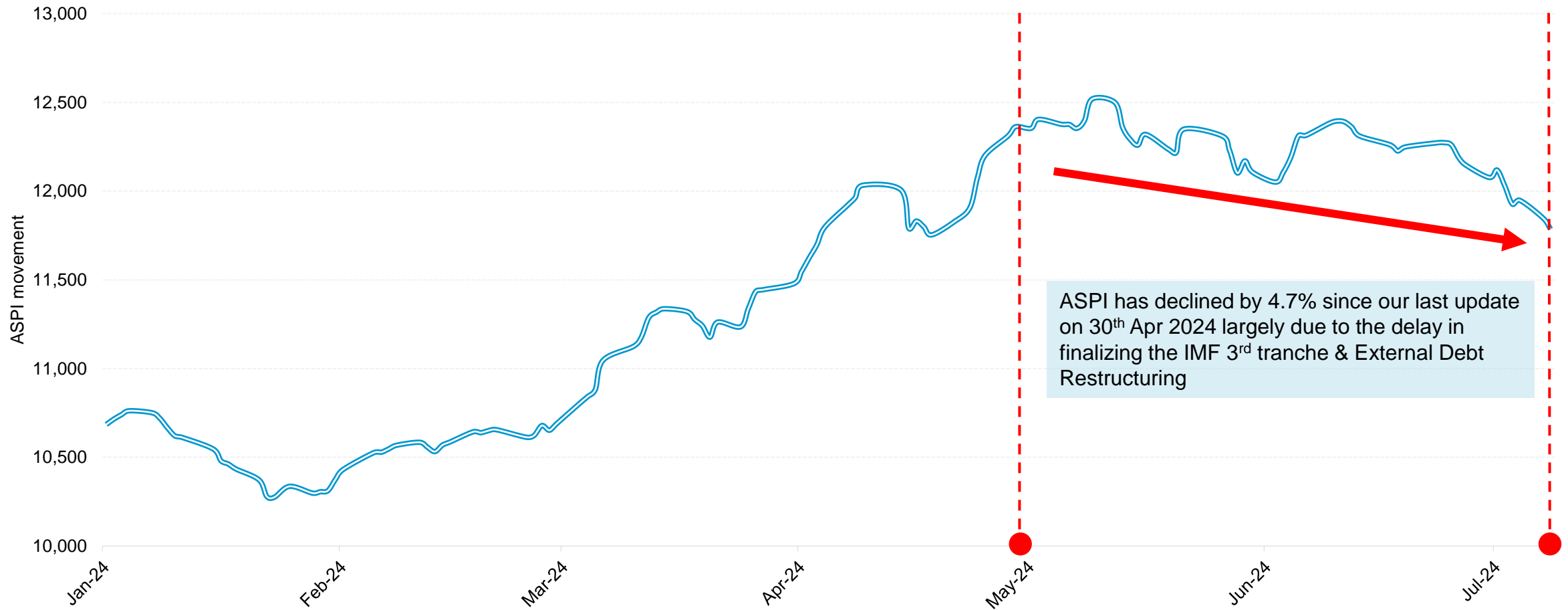
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Source :CSE & First Capital Research

Recap: ASPI movement Jan-24 to Jul-24

Having set a target of 13,500 for ASPI for 2024, the market moved up inline with our expectations during the Jan-May 2024 period gaining 17.5%. However, significant delay in the IMF 3rd tranche amidst the extensive time taken for external debt restructuring negotiations, created an uncertain environment causing ASPI to dip 4.7% between May 10th – July 9th period.



Source :CSE & First Capital Research

CSE showing signs of recovery

- ❑ Since our last update in Apr-24, ASPI moved largely sideways and recorded a marginal dip of 4.7%. The decline in ASPI during the period, was contributed largely by the delay in IMF 3rd tranche. The finalization of the negotiations with bilateral lenders and ISB holders were a major cause for the uncertainty created. Further uncertainty related to the election was also a supportive factor for the lull period in the market.
- ❑ Despite the marginal drop in ASPI, listed corporate earnings illustrated a significant recovery and recorded a growth 38.3%YoY to LKR 118.5Bn in 1Q2024.
- ❑ Return on alternative investments have declined steadily following the accelerated decline in the rates fixed income instruments as AWDR dipped below 9.0% to 8.38% while AWFDR dips to 10.39%.
- ❑ SL has now reached a deal with external creditors which may create a certain level of clarity for the investors while the completion of the process may showcase strong buying interest among local and foreign investors.





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2.0 Key drivers for equity



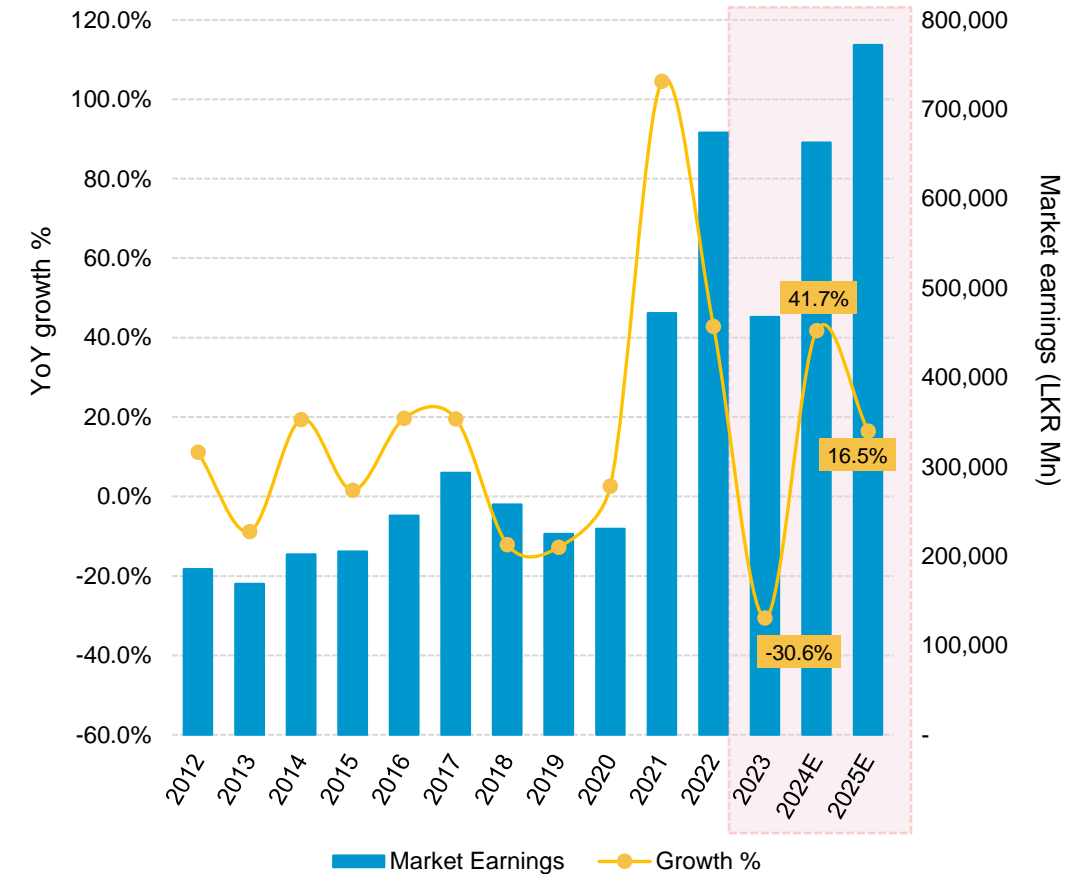
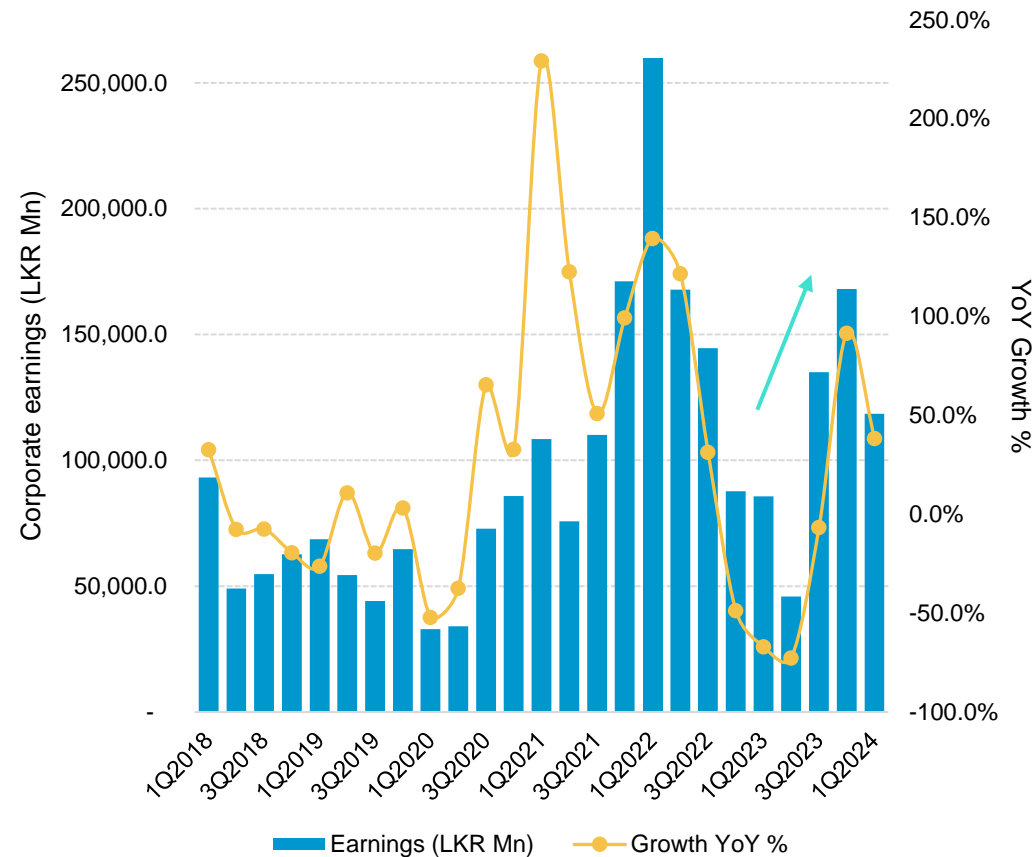
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2.1 Corporate profitability to boost prospects

Listed corporate profitability growth continue to remain strong...

“Listed corporate earnings, which bottomed out in 3Q2023 amidst shortages and higher interest rates, recovered and displayed significant growth during past three quarters”

“FCR expects market earnings to grow by 41.7%YoY in 2024E, whilst 2025E earnings is expected grow by 16.5%YoY”



Source : CSE, Annual Reports & First Capital Research

...aided by easing inflation that boost real wages...

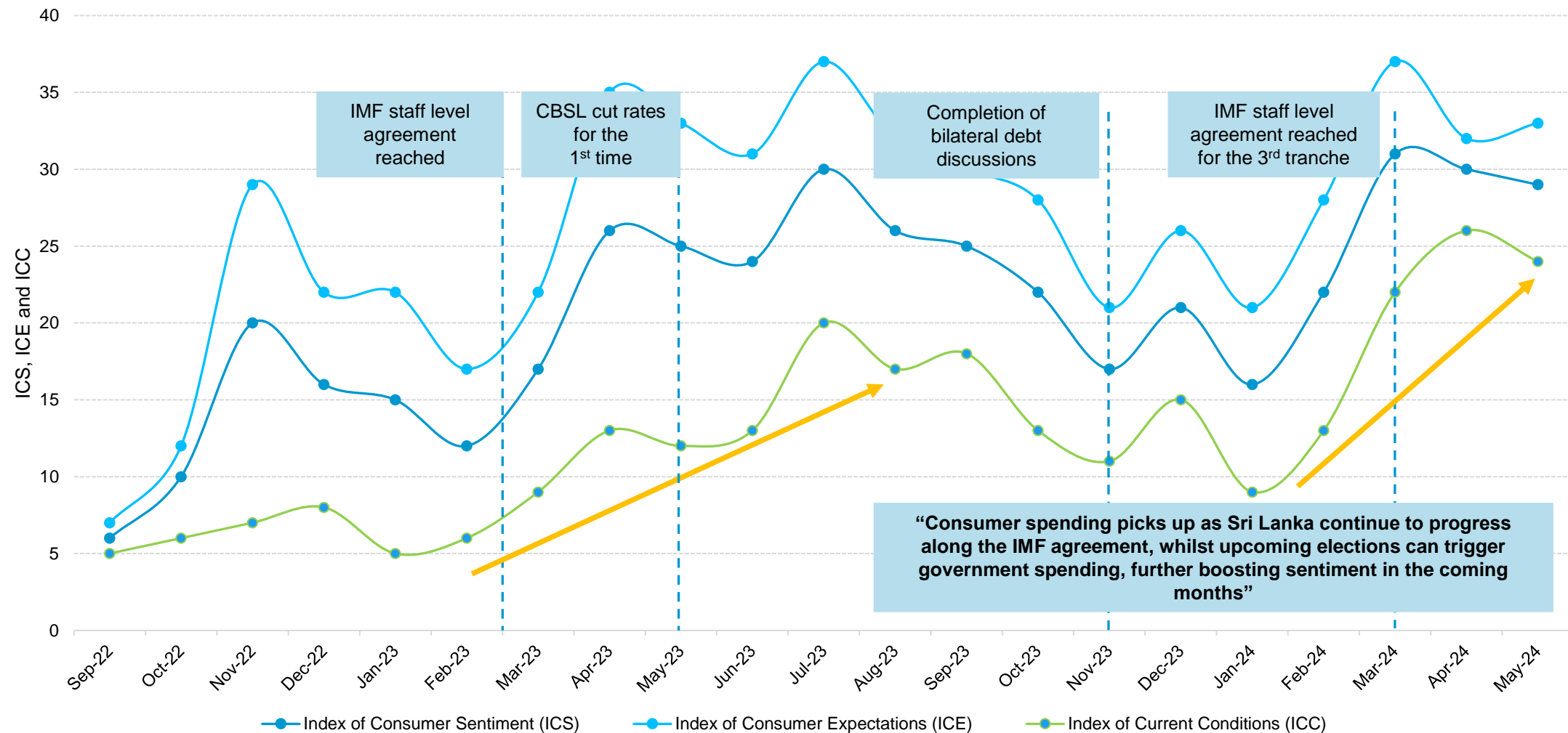


Source : CBSL/Monthly Indicators

...and improving consumer confidence



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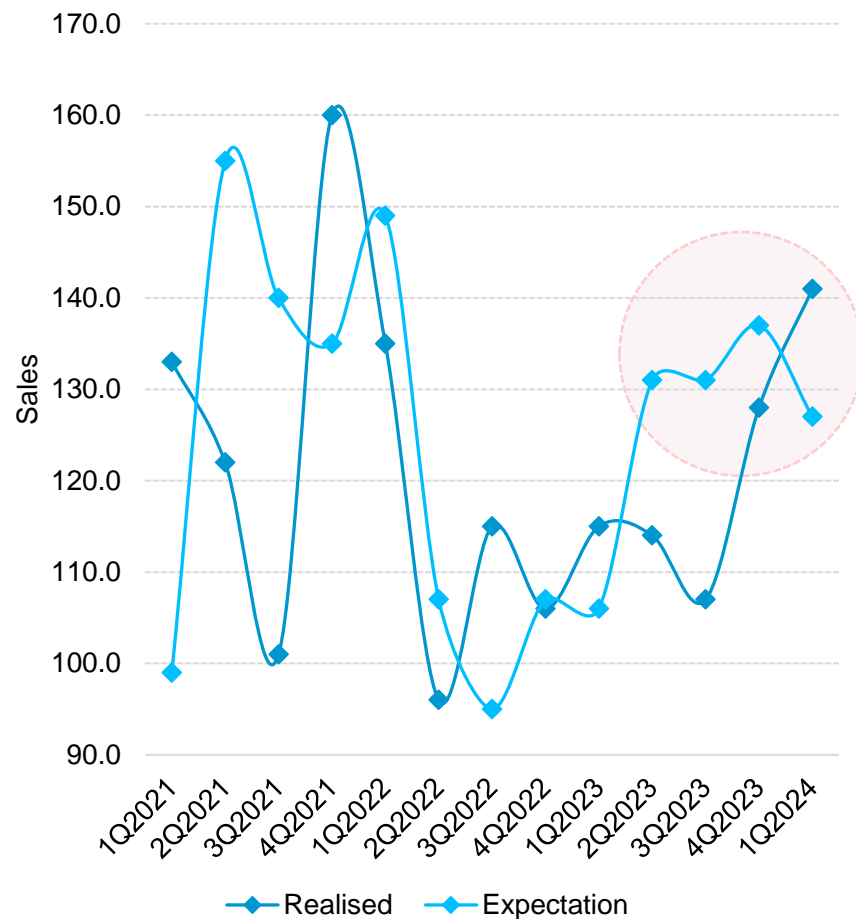
Source : IHP & First Capital Research

Business activity continues to improve...



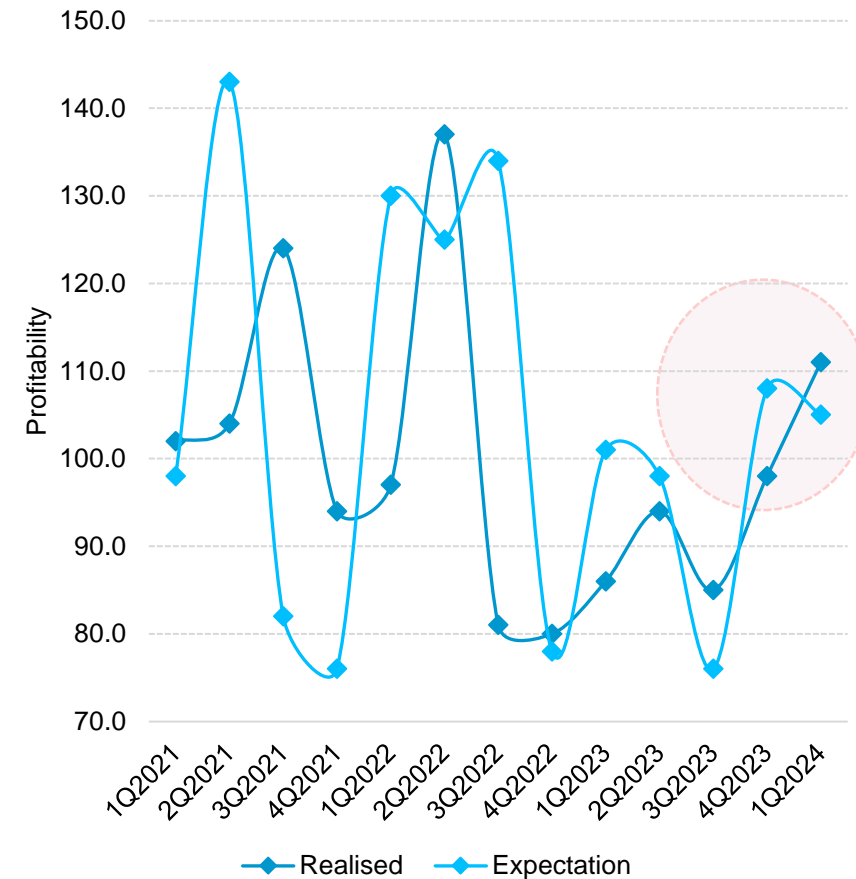
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Sales grew above expectations....



“Despite the improvement in sales (crossing the neutral threshold in 4Q2022), business profitability climbed above the neutral threshold for the 1st time in 1Q2024 (since 3Q2022)”

...whilst profitability climbed above the neutral threshold surpassing expectations

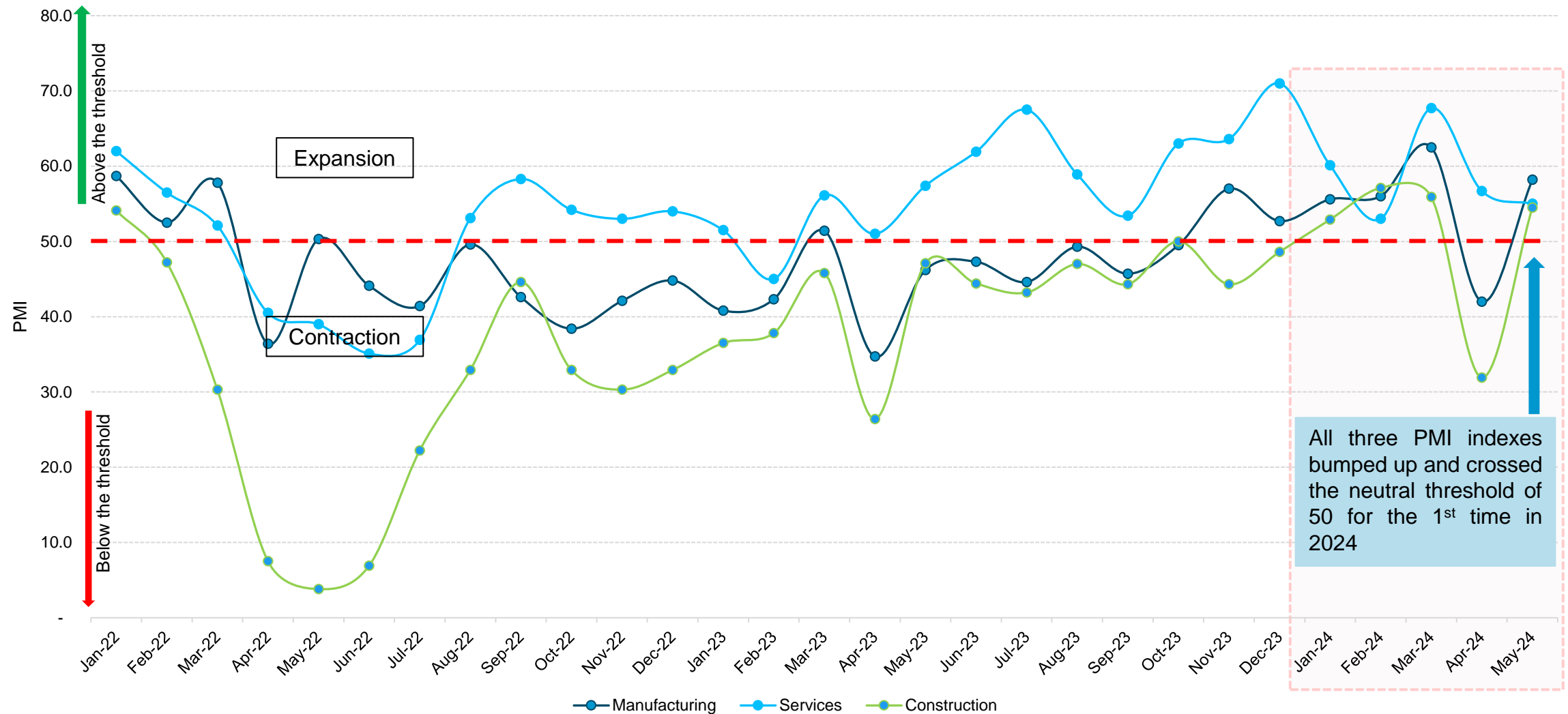


Source : CBSL, Annual Reports & First Capital Research

...as purchasing managers index rise above the neutral threshold...



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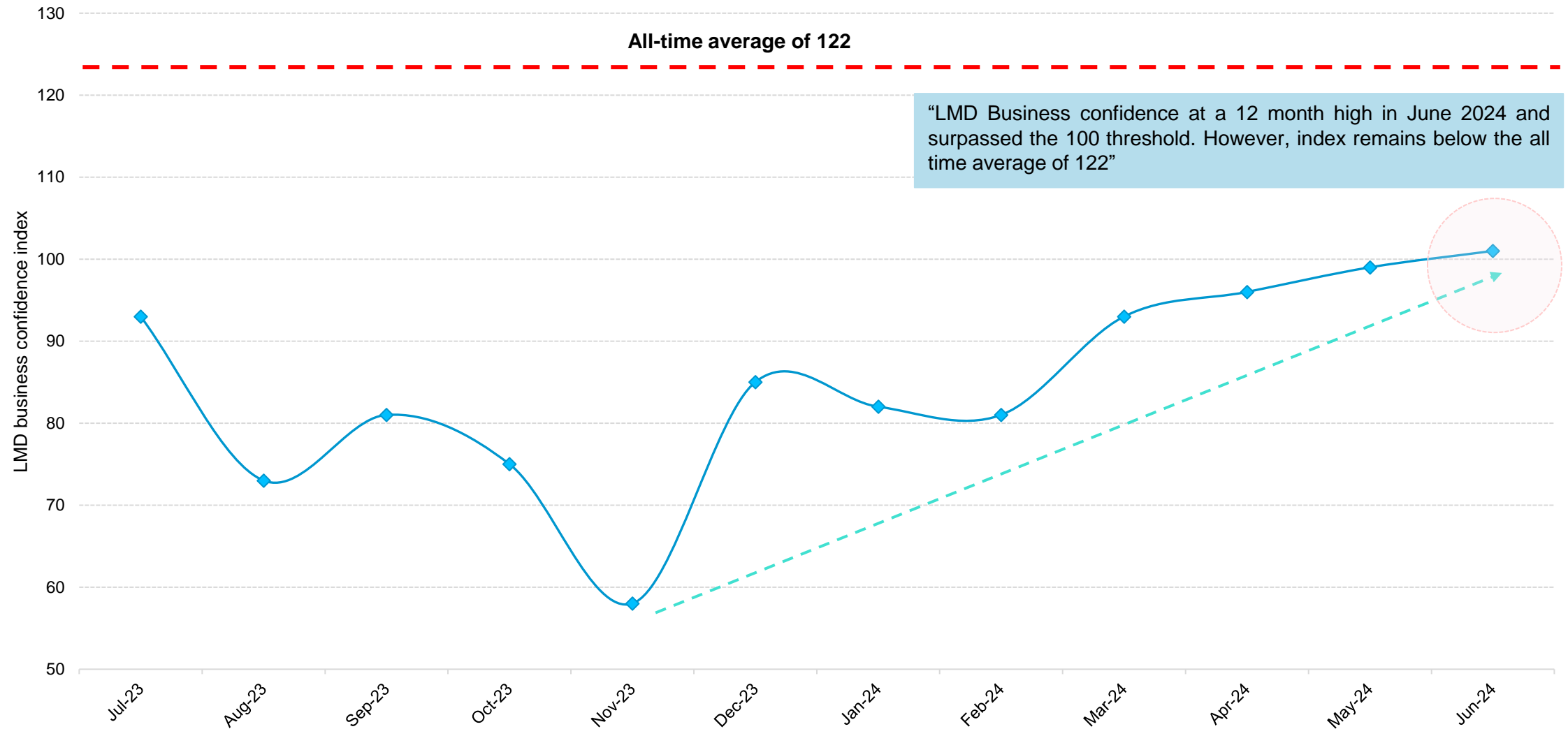


Source : CBSL/Monthly Indicators

...elevating business confidence to an upward trajectory



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Source :LMD & First Capital Research



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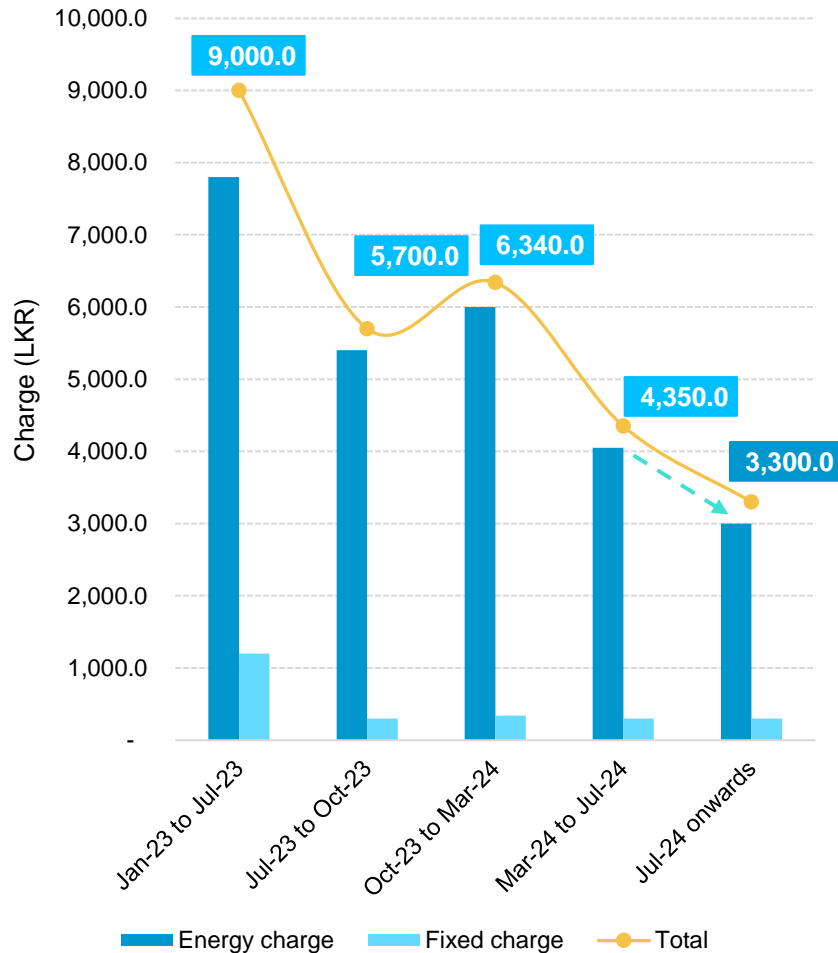
2.2 Reduction in operating expenses to boost business margins

Plunge in electricity prices...



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Industrial/hotel electricity charge for <300kWh



Example 01: A business which will use 300kWhs in Aug-24

↓ **24.1%** cost saving
 Energy charge (LKR/kWh) 10.0
 Fixed charge 300.0

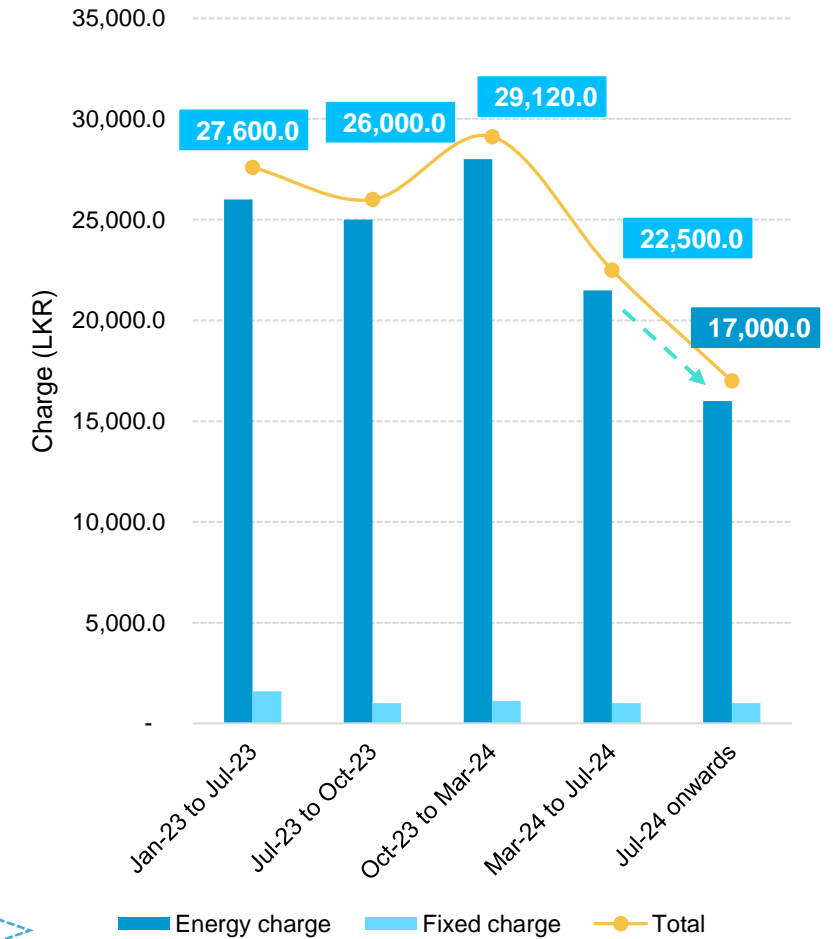


"this reduction in the electricity tariff will further reduce the corporate operating expenses from 15th Jul-24 onwards"

Example 02: A business which will use 1000kWhs in Aug-24

Energy charge (LKR/kWh) 16.0
 Fixed charge 1000.0
 ↓ **24.4%** cost saving

Industrial/hotel electricity charge >300kWh



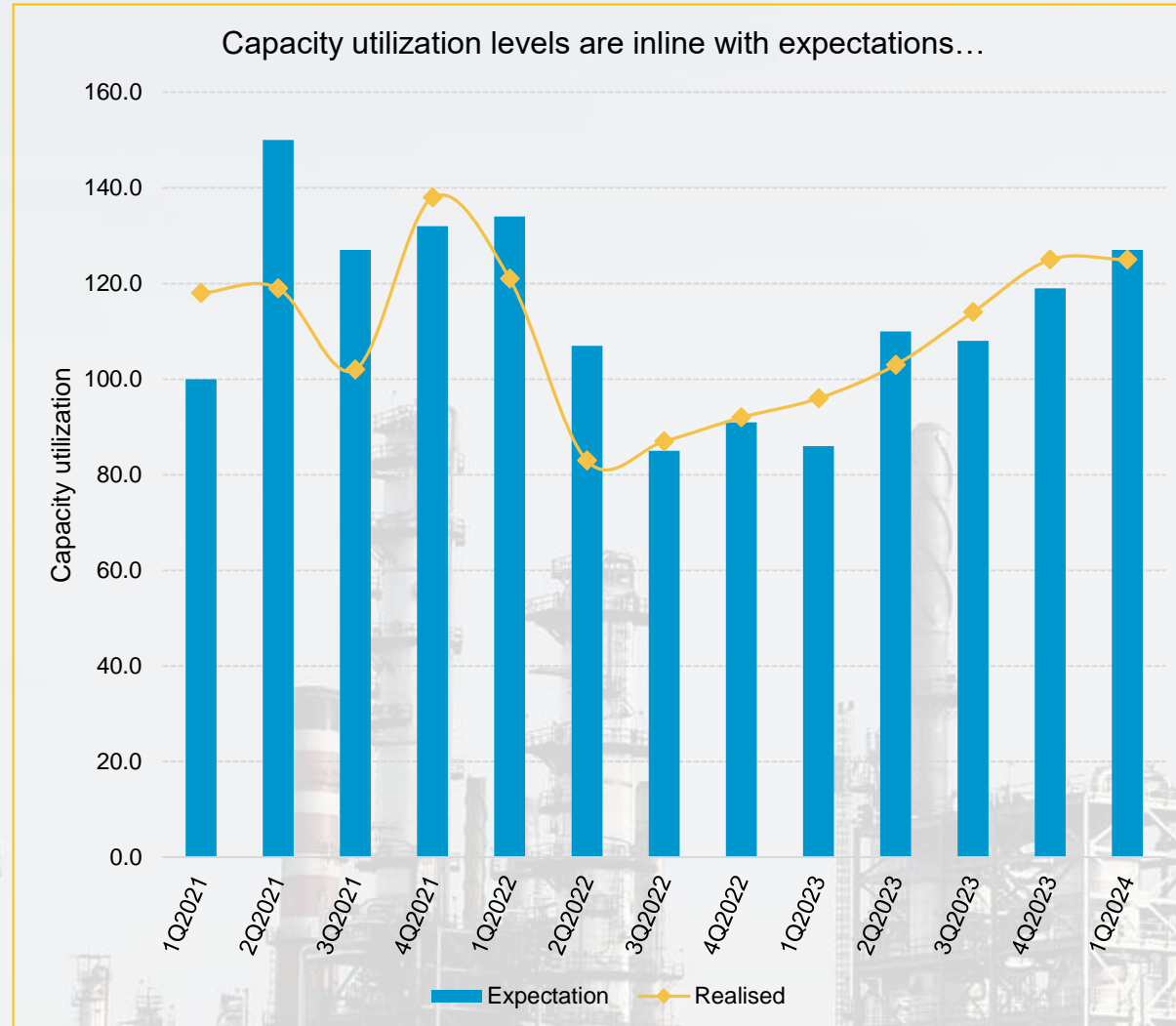
**From Aug-22 to Jul-23, hotel sector chargers have been different from industrial chargers; whereas from Jul-23 onwards chargers are same

Source: PUCSL, CEB, Economynext & First Capital Research

...improved capacity utilization...



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Source : CBSL, Annual Reports & First Capital Research

“

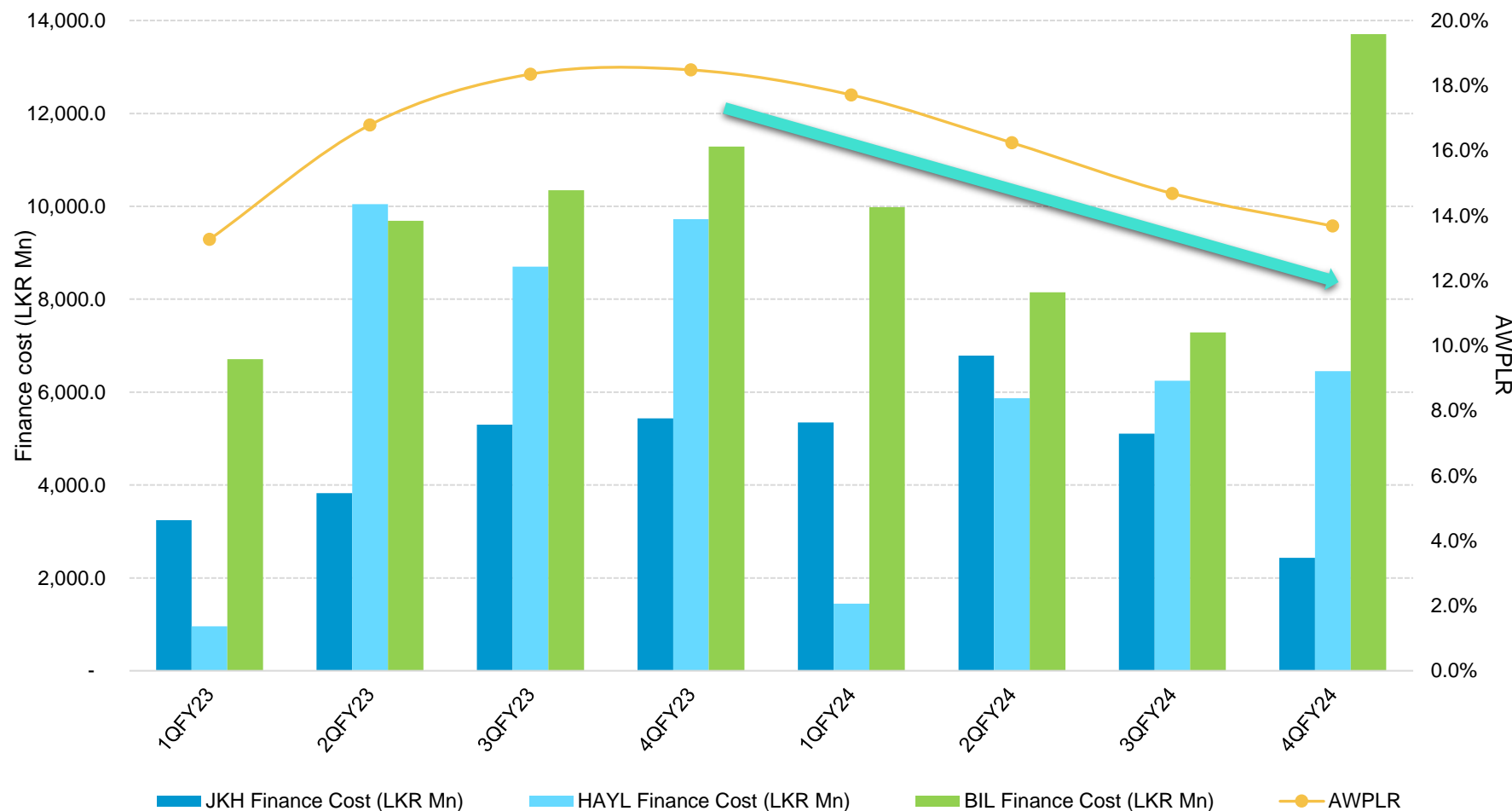
The decline of inflation from the peak seen in Sep-22 and continuous recovery in key economic indicators, led towards the recovery in capacity utilization outperforming expectations. The improvement in utilization accelerated since the initial growth in GDP in 3Q2023.

”

...and lower finance cost...



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Finance expenses of the listed corporates continue to edge down amidst the decline in interest rates.

We expect pressure from debt service payments on corporate profitability to ease, as net lending rates adjust down inline with the CBSL lending rates.

Source: CSE, Annual Reports & First Capital Research

“ ...is
expected
boost
productivity
and
business
margins
across
most
business
segments
”



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2.3 Uncertainties may clear out

Investor sentiment is likely to improve as uncertainty clears on debt restructuring...

				Coupon Rate		
Insturment Type	Bond Installments	Notional amount at exchange date (US\$m)	Notional at end 2027 (US\$m)	Up to 2027 (cash)	2028-2032 (cash)	2033 onwards (cash)
Past Due Interest 1,678						
Plain Vanilla #1	2024	291	n.a.	4.00%	n.a.	n.a
	2025	336	n.a.	4.00%	n.a	n.a
	2026	336	n.a.	4.00%	n.a.	n.a.
	2027	336	n.a.	4.00%	n.a.	n.a.
	2028	380	n.a.	4.00%	n.a.	n.a.
New bonds instalments 9,036						
MLB #1	2029	650	650	3.50%	3.75%	-
	2030	650	650	3.50%	3.75%	-
MLB # 2	2031	900	900	3.75%	4.00%	-
	2032	900	900	3.75%	4.00%	-
	2033	750	750	3.75%	4.00%	8.75%
Plain Vanilla #2	2034	800	800	4.00%	5.50%	9.25%
	2035	800	800	4.00%	5.50%	9.25%
MLB #3	2036	1,195	1,195	4.00%	4.25%	9.50%
MLB #4	2037	1,196	1,196	4.00%	4.25%	9.75%
	2038	1,196	1,196	4.00%	4.25%	9.75%

- Accrual start date on 31 March 2024, with first coupon payments due on 30 September 2024 and principal instalments due in March of the relevant year
- 28% haircut on the nominal amount of existing bonds
- 11% haircut on PDIs (calculated as of end March 2024)
- Consent fee representing c.1.8% of original principal claim (excl. PDIs, US\$ 225m) to be paid upfront

Key evolutions of the MLB structure

- Adjustment of 2024 payouts (consent fee, PDI, first half coupon)
- Reduction of MLB upper bound
- Calibration of GDP thresholds
- Introduction of a control variable

Having completed domestic debt restructuring in Sep-23 and bilateral debt restructuring in Dec-23, Sri Lanka initiated commercial creditor discussions in Apr-24 and achieved a timely completion in Jul-24.

The completion of debt restructuring paves way for Sri Lanka to come out of its default status and reinstate confidence amongst foreign investors.

Moreover, this also lifts the overhanging uncertainty regarding the equity investments and expected to increase participation in the financial markets in the coming months.

...whilst uncertainty regarding elections may also ease



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- ❑ **Three elections on the cards:** Sri Lanka is expected to undergo a crucial 12 months, as the nation prepares for three elections, including Presidential, Parliament and local government. Moreover, upcoming elections also brings a certain amount of uncertainty to equities, as investors continue to weigh risks of future policy impact on listed corporates.
- ❑ **Awaits announcement:** Colombo Stock Exchange witnessed a greater level of volatility during the past weeks, as investors awaited official announcement for Presidential election dates.
- ❑ **Possible dates:** Election commission on 20th July announced that the Presidential election is expected to be held on 21st September 2024.
- ❑ **Announcement may clear uncertainty:** The announcement of dates is expected to clear the lingering uncertainty regarding election dates and offer investors clear direction on the upcoming key events to the Sri Lankan economy.



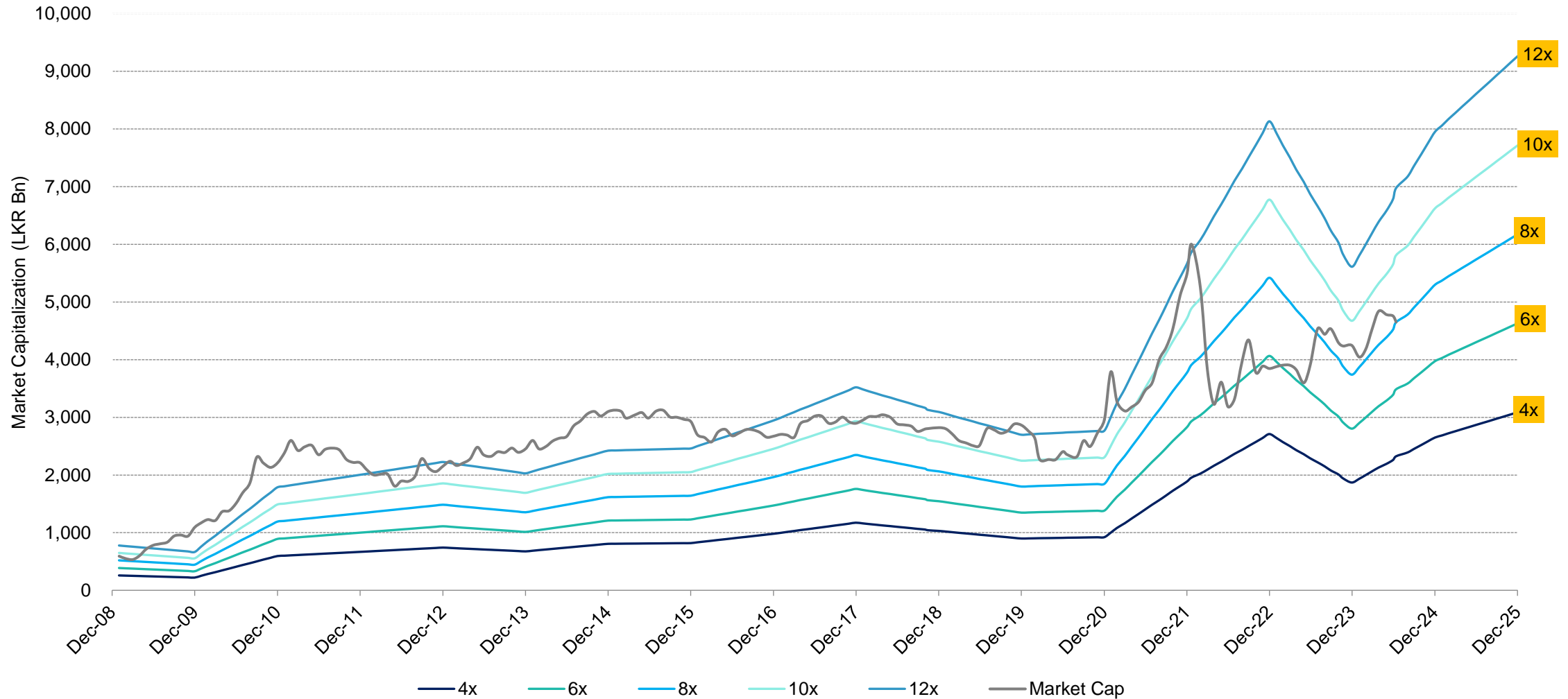
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3.0 FCR recommendations

ASPI trades at a discount of 21.0% to the historical PER of 12.0x...

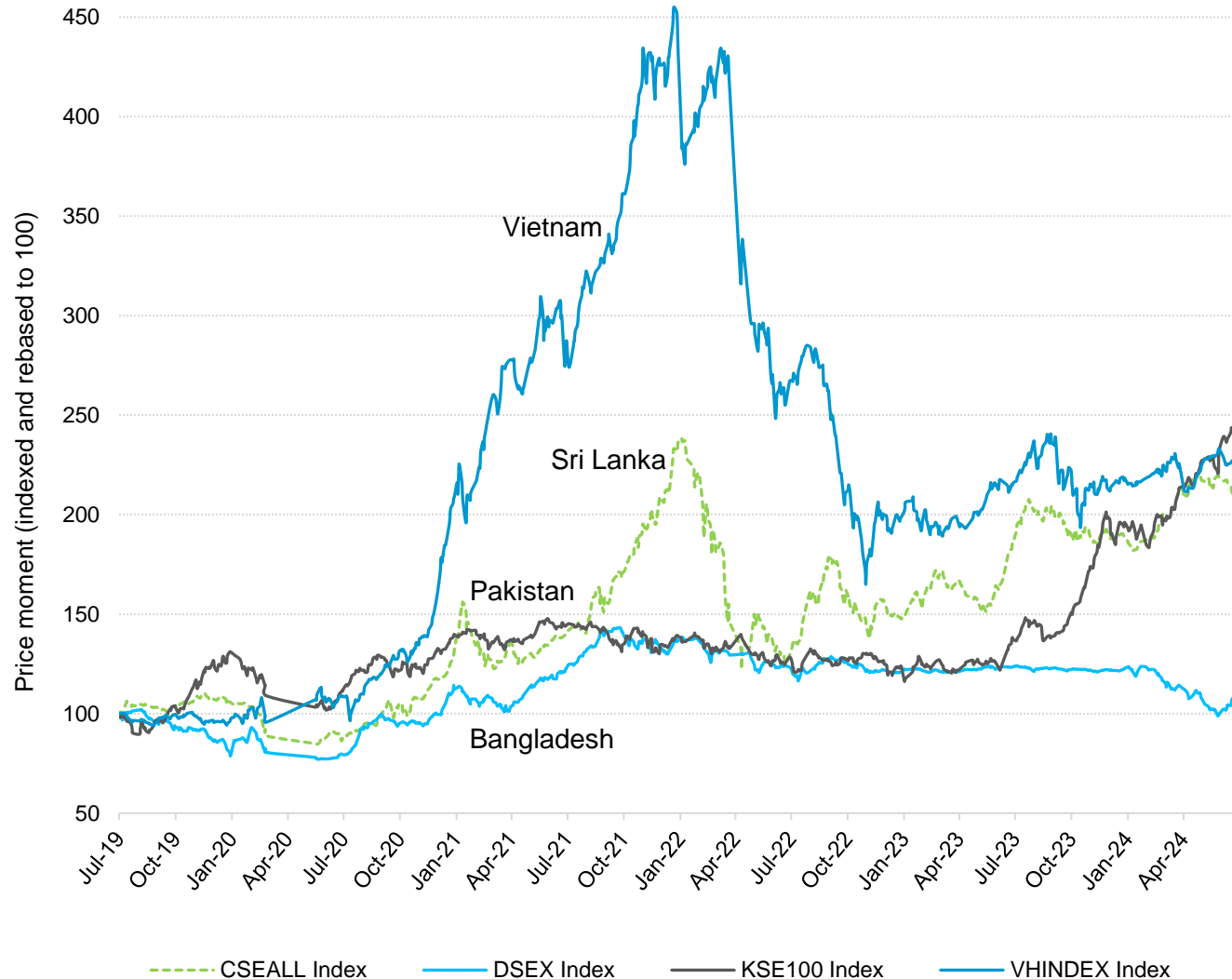






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Source: First Capital Research Estimates

...whilst CSE continue to trade at a discount compared to regional peers



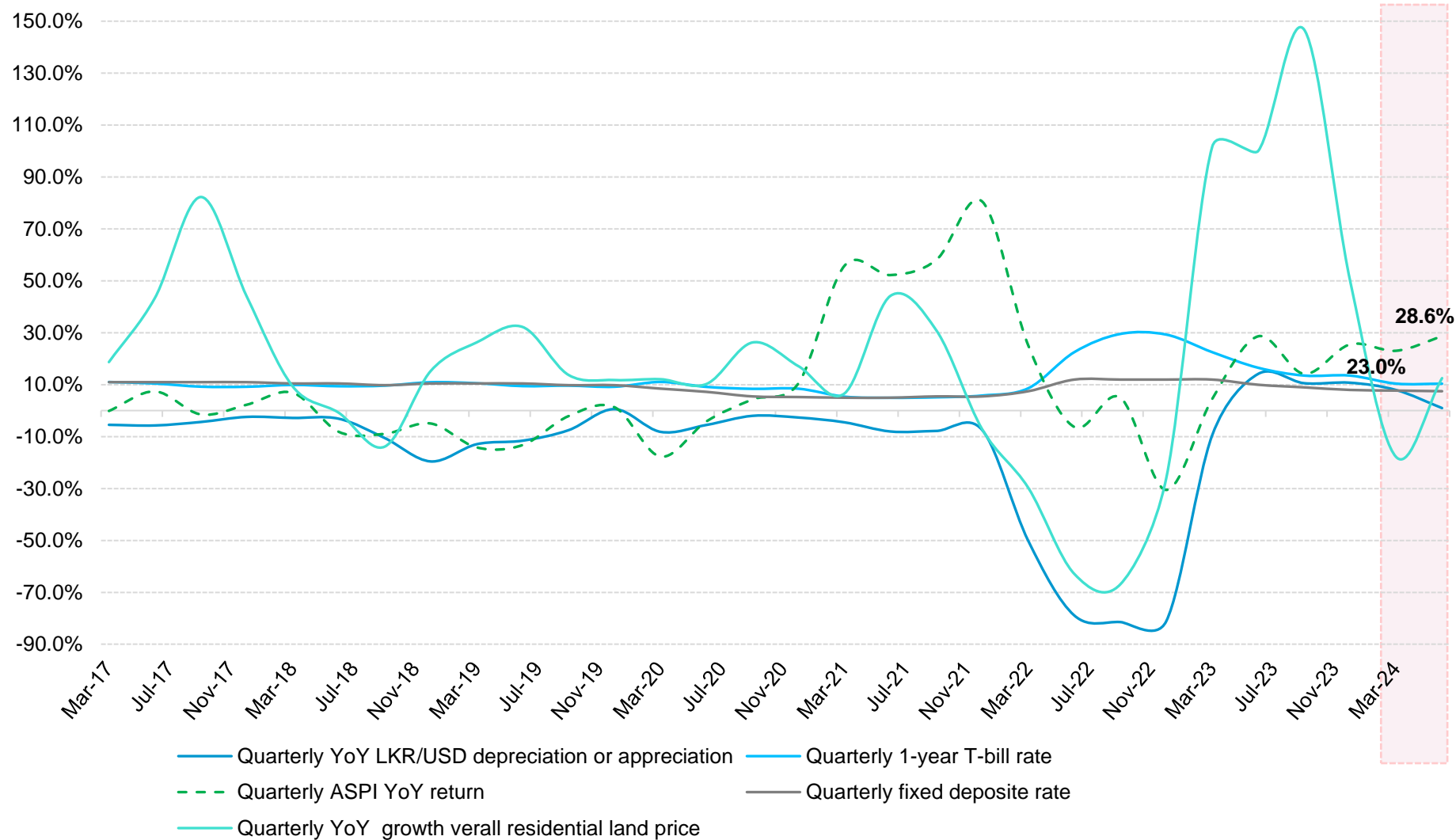
Stock Exchange	Bloomberg Ticker	Last Close	Market Capitalization (USD Bn)	P/E	PBV
 CSE COLOMBO STOCK EXCHANGE Creating Wealth and Value (Colombo Stock Exchange)	CSEALL	11,879	15.5	9.6x	1.0x
 (Dhaka Stock Exchange)	DSEX	5,483	56.5	14.4x	N/A
 (Pakistan Stock Exchange)	KSE100	81,156	9.2	5.8x	1.5x
 HANOI STOCK EXCHANGE SỞ GIAO DỊCH CHỨNG KHOÁN HÀ NỘI (Vietnam Hanoi Stock Exchange Equity Index)	VHINDEX	245	6.5	20.4x	1.3x

**Data as at 16th-Jul-24

"CSE remains the cheapest amongst peers in terms of book value whilst PE trades slightly above (mainly due to depressed earnings seen during 1H2023) yet expected to re-rate following positive expectation of earnings in the next 12 months (FCR expects listed corporate earnings to grow by c. 42% and c.16% in 2024E and 2025E, respectively.)"

Source: Bloomberg & First Capital Research

Limited returns on alternative investments to further lighten up the mood



“Despite having a limited range of alternative investments, equities continue to offer the highest yields. The ASPI recorded a 28.6% YoY return for the quarter ending Jun-24, up from 23.0% YoY in quarter ending Mar-24.

Source: Sri Lanka Property Web, CBSL, CSE & First Capital Research

Market to re-rate with the completion of External Debt Restructuring (EDR)

*First Capital Research maintains stance on **BUYING***

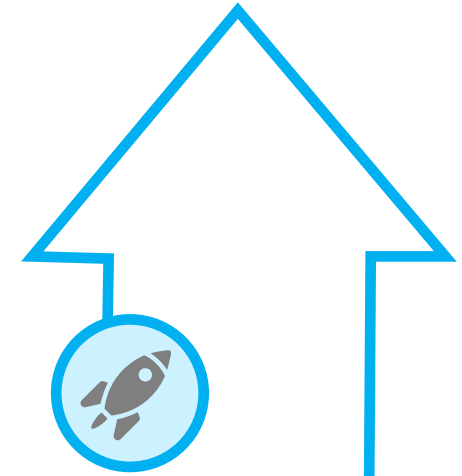
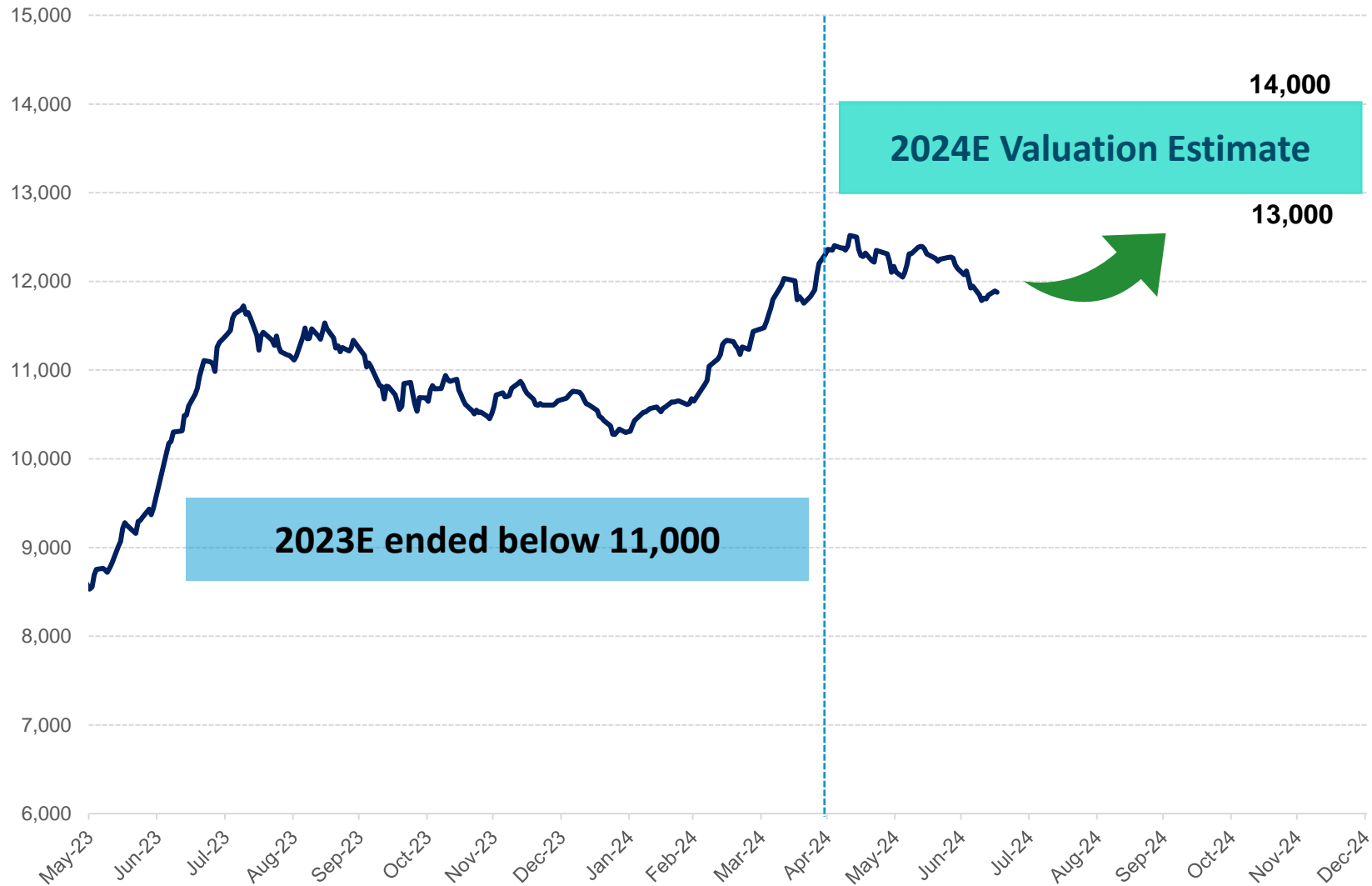
- ❑ **Earnings of listed corporates to accelerate:** Earnings of listed corporates for 1Q2024 grew 56% YoY with GDP growth also spiking by 5.3% displaying strong signs of economic recovery. We expect GDP growth and corporate earnings may further strengthen towards the 2H2024 amidst lower interest rates and increase in liquidity in the system. First Capital Research expects corporate earnings to grow by 39% for 2024E while growing 16% for 2025E.
- ❑ **EDR Uncertainty continue to ease:** With the completion of external debt restructuring in Jul-24, Sri Lanka cleared the hurdle of debt restructuring and awaits the final approval from the IMF. The lifting of uncertainty is expected to boost confidence within the investors and a possible rating upgrade from the current Restricted Default status is also expected to act as a confidence booster for both local and foreign investors.
- ❑ **CSE trades amongst the cheapest in the region:** With corporate earnings on the recovery, PER of ASPI has fallen below 10x, offering a discount of c. 20.0% to the historical average and 25.5% discount to the regional peer PER of 12.6x.
- ❑ **Market to re-rate towards election:** Investor attention is likely move towards elections as elections get announced next week. In line with the past, elections itself creates a lot of business activity and Government spending in the economy which may again support growth and corporate earnings. Further announcement of the elections also may gradually clear doubts relating to the elections as we move towards it. Further, with the doubts clearing supported by the completion of EDR and the related country rating upgrade may have a significant bearing towards re-rating the market towards our ASPI target of 13,500.





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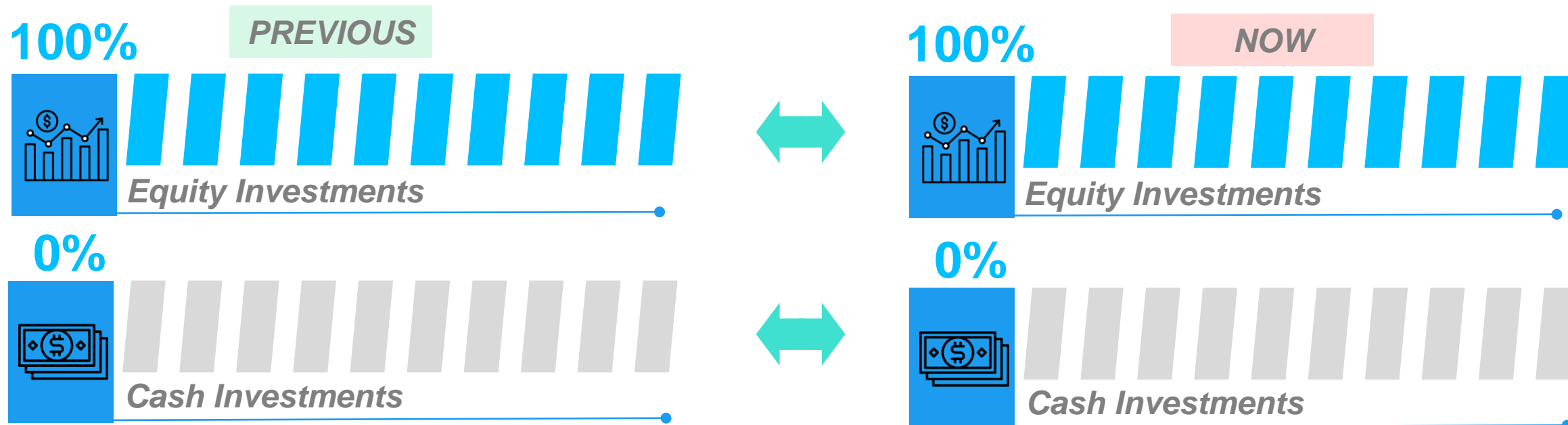
ASPI Dec-24 target maintained at 13,500



First Capital maintains ASPI 2024E fair value range of **13,000-14,000** owing to the anticipated moderate recovery in earnings on the back of tax revisions, declining interest rates and improving domestic and global economic conditions.

First Capital *Maintains* Equity Exposure to 100% retaining cash to 0%

Recommendation for Funds allocated for purely Equity investments



- ❑ With the completion of preliminary agreements with external creditors, together with the easing uncertainty regarding upcoming presidential election dates, we expect ASPI to re-rate towards the 13,500 mark, as improvement in listed corporate profitability and improvement in investor participation may further aid towards index achieving the set target for 2024E.
- ❑ Out of the funds **purely allocated for equity** we have been advising on investing in the equity market, emphasizing the potential for substantial upside. However, it's crucial to note that all investments carry inherent risks, and we encourage regular reviews of portfolio in light of evolving market conditions and individual circumstances.

**First Capital Research assumes that investors have separately allocated funds for equities, and our recommendation is to fully utilize 100% of the allocated funds for equity investments.*



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4.0 Key risks for consideration

ALL EYES ON PRESIDENTIAL ELECTIONS

Sri Lanka is expected to face its first election since announcing default on external obligations in Apr-22, which was followed by shortages of essentials and protests around the country.

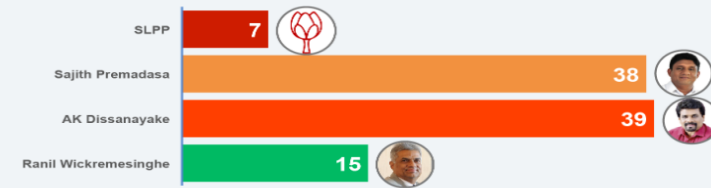
The upcoming presidential election is expected to be crucial, as Sri Lanka plans to embark on the next chapter of economic growth, following the completion of debt restructuring and stabilizing key economic indicators.

With scales evenly balanced, and no clear winner in the election race, we expect political uncertainty leading to elections, to play a critical part in the next 3 months period.

POLITICS

Support for Sri Lanka president grew in May but remained far behind rivals: poll

PRESIDENTIAL ELECTION VOTING INTENTION, MAY 2024 (% ADULTS) If there was a Presidential Election today, who would you vote for?



Institute for Health Policy Sri Lanka Opinion Tracker Survey MRP
Estimates based on 17,751 interviews conducted from 1 Oct. 2021–24 Jun. 2024, including 503 interviews in May 2024. Estimates are derived using a MRP statistical model and are associated with a margin of error assessed as 1–4%. SLPP referred originally to "President Gotabaya Rajapaksa" but respondents are now asked about "Gotabaya Rajapaksa or a member of the SLPP".



Thursday July 4, 2024 1:12 pm

the SUNDAY TIMES

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News

Nominations for presidential election in mid-August, voting on September 21

View(s): 1648

By Damith Wickremasekara

Nominations for the presidential election are set to be accepted only in mid-August, not earlier, with the announcement of the exact date to be made in the coming week. Election Commission sources said yesterday.

Accordingly, the election is now expected to be held on September 21, instead of October 5 or 12, as earlier indicated. Constitutionally, after the announcement of the elections, nominations should be received within 16 to 21 days, and elections should be held within 28 to 42 days, thereby giving the Commission a maximum of 63 days to conduct the poll.

Political parties, election monitoring groups and civil society groups have stepped up their campaigns, calling on the Election Commission to announce the day of nominations as early as possible. The Commission, since last Wednesday (July 17), has been empowered to make an announcement about the day of the nominations.

Elections Commissioner General Saman Shri Ratnayake told the *Sunday Times* that political parties and other groups should refrain from demanding an early declaration of elections as it could be seen as an interference in the Commission's activities.

Election Commission Chairman R.M.A.L. Ratnayake told the *Sunday Times* that the nominations for the election would be called for "in the next few days", with the arrangements well underway for the conduct of the polls.

He said in the latest of a series of meetings with officials, he met with Treasury Secretary Mahinda Siriwardena and Treasury officials on Wednesday, where an assurance was given that the allocation of Rs 10 billion would be released in keeping with the requirements.

He said that it was pointed out at the meeting that expenses could be doubled compared to the previous presidential election.

Meanwhile, the Elections Commission has requested Police Chief Deshabandu Tennakoon to draw out a security plan for the nomination day and the campaign period leading up to the election. The Commission has also requested a plan regarding the deployment of police personnel and vehicles.



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Resumption of debt repayments to tighten reserves growth...



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USD Mn	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	Total Debt Service
GDP threshold #1 (avg. GDP 2025-2027: \$100bn)	724	740	726	713	1,177	1,548	1,494	1,733	1,653	1,526	1,334	1,260	1,812	1,672	1,530	19,640
GDP threshold #2 (avg. GDP 2025-2027: \$96bn)	724	740	726	713	1,015	1,393	1,353	1,607	1,544	1,526	1,334	1,260	1,812	1,672	1,530	18,947
GDP threshold #3 (avg. GDP 2025-2027: \$92bn)	724	740	726	713	875	1,199	1,169	1,414	1,369	1,424	1,303	1,299	1,678	1,548	1,417	17,527
IMF baseline (avg. GDP 2025-2027: \$88.6bn)	724	740	726	713	787	1,029	1,005	1,224	1,188	1,277	1,258	1,184	1,485	1,370	1,254	15,963
Below IMF baseline #1 (avg. GDP 2025-2027: \$86.7bn)	724	740	726	713	753	925	904	1,099	1,067	1,153	1,220	1,146	1,322	1,220	1,116	14,827
Below IMF baseline #2 (avg. GDP 2025-2027: \$84.7bn)	724.00	740.00	726.00	713.00	723.00	831.00	812	986	957	1,040	1,185	1,111	1,173	1,083	990	13,794

Sri Lanka finalized the deal with the private creditors in Jul-24 and marked the completion of debt restructuring. According to the preliminary agreement, Sri Lanka is expected to start servicing its debt on 30th September 2024.

Sri Lanka is expected to initially repay a total of USD 516.0Mn (USD 291.0Mn ISB debt + USD 225Mn) on 30th September 2024, and this is expected to tighten the rapid reserves growth witnessed post Apr-22 period.

...whilst IMF deal to keep Sri Lanka on float.



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With a history of inconsistent policies, Sri Lanka faced its worst economic crisis in 2022. However, since then, with the aid of IMF and with the passing of crucial reforms, Sri Lanka has got back on track with expectation of GDP growth between 2.0%-4.0% between 2024E-2025E period.
















However, the upcoming elections and past track record of Sri Lanka doesn't offer confidence of the outlook, yet we believe the circumstances have changed, given the sensitive position of the country. Therefore, despite the risk of potential change in government, we believe keeping up with the IMF program is crucial for SL and any deterrence of path from the agreement is expected to place devastating impact on country's future growth trajectory.



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5.0 First Capital Research top picks for FY25E and FY26E

FIRST CAPITAL 2025E/FY26E TOP RECOMMENDATIONS

	Stock	Stock Code	24-Jul-24	PE	PBV	DY	52-Week High	52-Week Low	Target Price 2025E/FY26E
	LKR								
	Commercial Bank PLC - Voting	COMB.N0000	100.75	4.9	0.6	0.0%	117.50	75.50	200.00
	Hatton National Bank PLC - Voting	HNB.N0000	196.00	4.9	0.5	0.0%	208.00	150.00	350.00
	Sampath Bank PLC	SAMP.N0000	77.80	4.9	0.6	4.4%	82.70	59.90	135.00
	Nations Trust Bank PLC	NTB.N0000	125.00	3.3	0.6	0.0%	135.75	75.00	200.00
	John Keells Holdings PLC	JKH.N0000	195.50	26.1	0.8	0.8%	218.00	150.00	300.00
	Teejay Lanka	TJL.N0000	39.50	25.5	0.9	1.9%	42.20	30.90	60.00
	Hayleys Fabric	MGT.N0000	46.00	7.5	1.9	5.1%	49.70	23.50	75.00
	Hayleys	HAYL.N0000	101.25	11.0	0.9	5.3%	97.90	63.50	180.00
	Ceylon Tobacco Company	CTC.N0000	1,241.50	8.2	18.2	14.3%	1,250.00	1,230.00	1,600.00
	Hemas Holdings	HHL.N0000	81.40	8.0	1.1	2.9%	91.00	66.50	115.00
	Ceylon Cold Stores	CCS.N0000	57.10	15.8	2.7	2.3%	67.50	40.40	100.00
	Aitken Spence Hotel	AHUN.N0000	64.00	18.9	1.0	0.0%	90.00	55.80	100.00
	John Keells Hotels	KHL.N0000	17.80	N/A	0.8	0.0%	24.70	17.20	30.00
	Hayleys Leisure	CONN.N0000	19.90	N/A	1.6	0.0%	28.00	19.50	37.00
	Asian Hotels & Properties PLC	AHPL.N0000	60.00	N/A	0.9	0.0%	75.00	35.40	80.00

*First Capital Research's top recommended stocks are chosen based on the potential return and the liquidity of the stocks



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Thank you!

*"SUCCESSFUL INVESTMENTS IS ABOUT
MANAGING RISKS"*

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