



First Capital
First Capital Research

“BID HIGHER FOR AUCTIONS”

First Capital Fixed Income Recommendation – 11th Mar 19

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BID HIGHER FOR AUCTIONS

Successful issuance of USD 2.4Bn sovereign bonds to support reserves - Sri Lanka successfully raised USD 2.4Bn by conducting an International Sovereign Bond (ISB) offering tenors of 5 and 10 year. In the 5 Year Bond category USD 1.0Bn was raised at 6.85% (up by 110bps by from 2018) and USD 1.4Bn was raised via the 10-year bond category at 7.85% (up by 110bps from 2018). In 2018, USD 1.25Bn of 5 year sovereign bonds were issued at 5.75% and USD 1.25Bn of 10 year was issued at 6.75%. Following the issuance we expect the foreign reserves to show significant improvement reaching above USD 7.5Bn in Mar 2019.

IMF Agreement & Budget - Following negotiations Sri Lanka also reached a staff level agreement with the IMF completing the 5th review, while agreeing to recommence the agreement and extend the agreement by a further 1 year period upto June 2020. Following the staff level agreement IMF would submit the reached agreement to its Board for approval prior to release of 5th tranche of the IMF EFF facility. We estimate the tranche to be USD 125Mn while it is likely to be released by May 2019. Budget for 2019 was presented on the 5th March 2019. The Government unexpectedly continued to take forward the fiscal consolidation measures despite it being an election year which is a further positive for the IMF agreement.

Reserves and Liquidity may improve - Over the 3 months under review (19th Dec – 8th Mar) yields have recorded a steep downward shift (Slide 7) stemming on the expectations of the renewed IMF agreement and the planned USD 2Bn Sovereign Bond. The mid – long tenors have broken our lower bands and trades at unattractive levels. However, short tenors remain attractive continuing to remain closer to our upper bands. So far CBSL secured only 50% of the total USD commitment for this year. We expect the balance commitments to be met via a combination of SLDBs, SWAPs and bilateral loans providing the ability to maintain reserves above USD 7.0Bn during Mar-Sep 2019 despite the USD 500Mn payment (maturing ISB) on 7th Apr .

Bid Higher for Upcoming Auction – Amidst the unattractive nature of the mid-long tenor maturities we expect yields to be upward trending in the absence of liquidity and maturities in the market. In the upcoming bond auction we expect 5-Year and 10-Years weighted average rate to be c.11.0% and c.11.5% as we expect lesser demand specifically on the 10 year maturity (Refer Slide 3). If bidding for the auction, we propose investors to bid 20-50bps above the expected weighted average rate on a staggered basis. Currently we recommend investors to significantly increase exposure into short tenor maturities. However, on the long run investors should be mindful of a further uptick in yields by 25-30bps.

Comparison with Previous Issues and Expectations

In Dec 2018 and Jan 2019, CBSL has issued relatively small bond issues, LKR 25Bn each, while stronger bid / offer ratios were received for the longer tenors which were trading attractive rates.

The Bond auctions offered on 12th Mar 2019, the 5Yr has an offer of LKR 30Bn while the 10Yr has an offer of LKR 40Bn. In the current context of a liquidity deficit and the lack of a corresponding maturity, we expect lower bids for the 10Yr, which poses unattractive secondary market yields as well. However, 5Yr may receive a reasonable level of bids considering it's smaller issue size and the fact that the Bond trades in the border line of our lower band. (Refer Slide 5 for FC Research Bands).

We expect a weighted average yield of 11.0% for the 5Yr Bond issue (2024 maturity) broadly in-line with the current secondary market yields.

In relation to the 10Yr Bond (2029 maturity) we expect a weighted average yield of 11.5%, 20-30bps above secondary market yields (touching First Capital Research target lower bands referred in Slide 5)

| Issue Date | Period to Maturity | Amount Offered (LKR Mn) | Bids Received (LKR Mn) | Bid/Offer Ratio | Amount Accepted (LKR Mn) | Weighted Average Yield Rate % | Secondary Market Rate % |
|------------|--------------------|-------------------------|------------------------|-----------------|--------------------------|-------------------------------|-------------------------|
| 31-Jan-19 | 2Y 6M | 25,000 | 67,982 | 2.72 | 25,000 | 10.85% | 10.95% |
| | 7Y 11M | 25,000 | 102,291 | 4.09 | 25,000 | 11.30% | 11.28% |
| 13-Dec-18 | 3Y | 25,000 | 69,515 | 2.78 | 25,000 | 11.88% | 11.80% |
| | 7Y 8M | 25,000 | 76,250 | 3.05 | 25,000 | 12.23% | 11.95% |
| 13-Nov-18 | 8Y 7M | 50,000 | 100,570 | 2.01 | 50,000 | 12.16% | 11.65% |
| | 10Y 6M | 48,000 | 103,545 | 2.16 | 48,000 | 12.23% | 11.75% |
| 13-Oct-18 | 4Y 9M | 20,000 | 48,625 | 2.43 | 20,000 | 11.69% | 11.70% |
| | 14Y 3M | 20,000 | 55,049 | 2.75 | 20,000 | 11.90% | 11.88% |

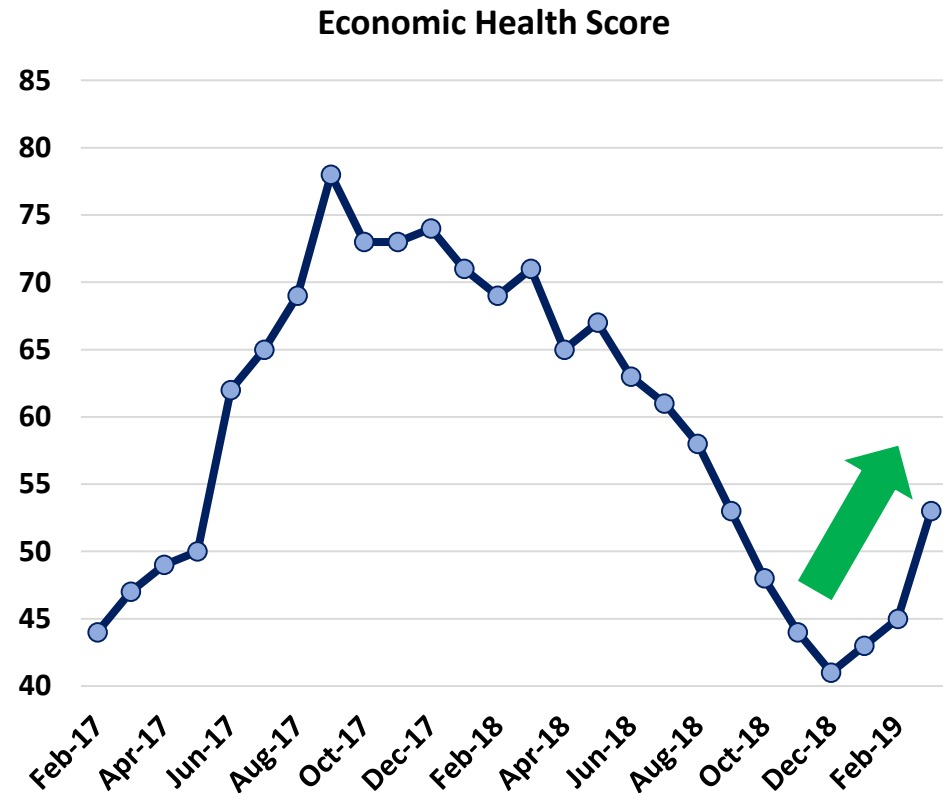
Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Increase overall portfolio to 55% from 50%.**

- Increase Carrying Portfolio to 45% from 35%.
- Reduce Trading Portfolio to 10% from 15%.

We recommend to add 2020, 2021, 2022 maturities to the carrying portfolio while further reducing trading portfolio by cutting mid and long tenors.



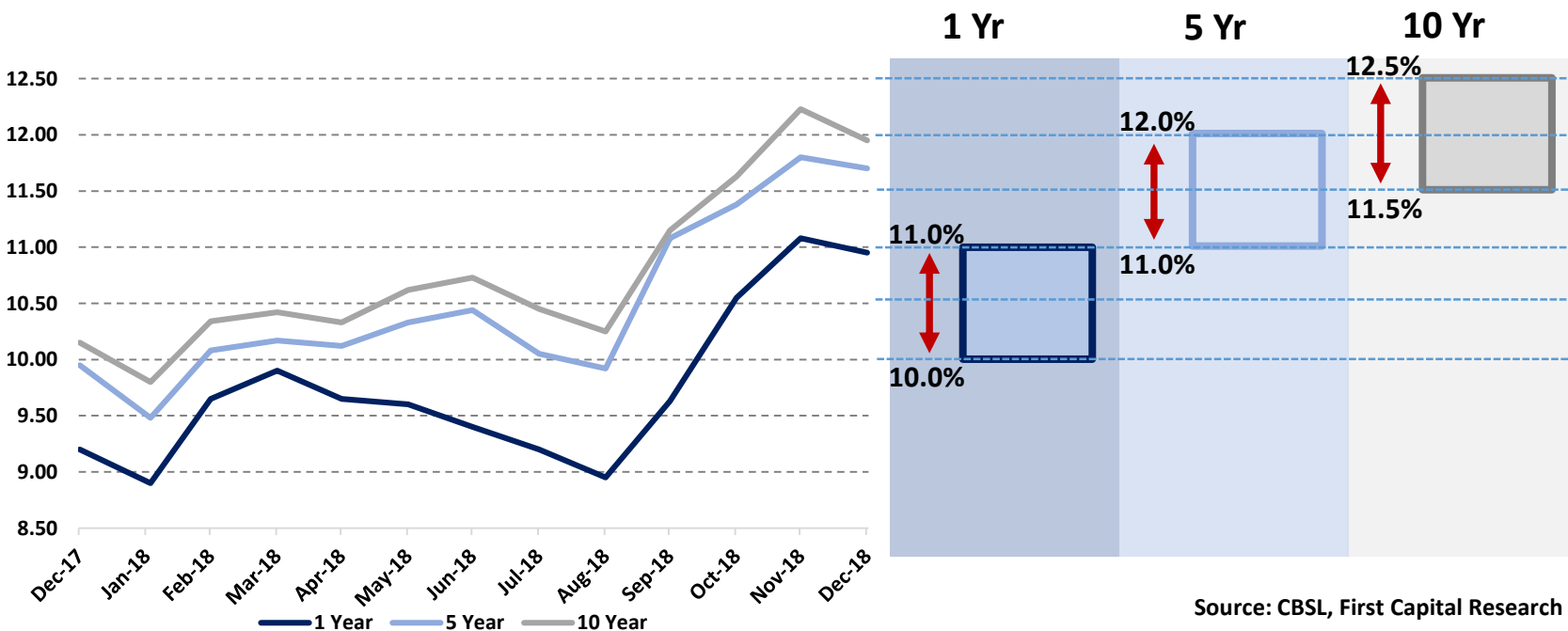
Bond Rates to peak in 1Q2019 and gradually ease (12 months)

Expectations: Moderately Bullish beyond 1Q2019

Policy Rate Expectation

On a base case First Capital Research expects 2 rate cuts of 25bps each during 2019 as overnight CBSL standing lending facility rate which stands at 9.0%, we believe is too high for accelerated economic activity.

| Jan 2019 – Dec 2019 | Probability | Impact |
|--|-------------|-----------------------------|
| Bond Rates to peak in 1Q2019 and gradually ease to the bottom bands | 75% | Moderately Bullish / Stable |
| Political deadlock or Economic turmoil (adverse impact to foreign income or foreign debt) may result in the breaking the upper bands | 25% | Bearish |



Source: CBSL, First Capital Research

2019 Outlook - Base Case (75% Probability)

With the heavy debt payments and liquidity shortage, we expect bond yields to touch the upper bands of the yields curve during 1Q. The heavy risk associated with lower reserve position by end Jan 2019 following payment of the USD 1Bn Sovereign Bond and other debt payments would be the primary cause for the yields to move towards the upper bands. Though the fund flow towards EM is positive now, there is a cap of 5% for foreign holdings in Sri Lanka.

With foreign inflows & debt inflows towards 2Q, rise in economic activity amidst upcoming elections and low debt payments after 7th April, liquidity is likely to improve and ease yields beyond 1Q2019 towards the lower bands.

1.0 Previous Recommendation

Recap of 19th Dec 2018 Recommendation

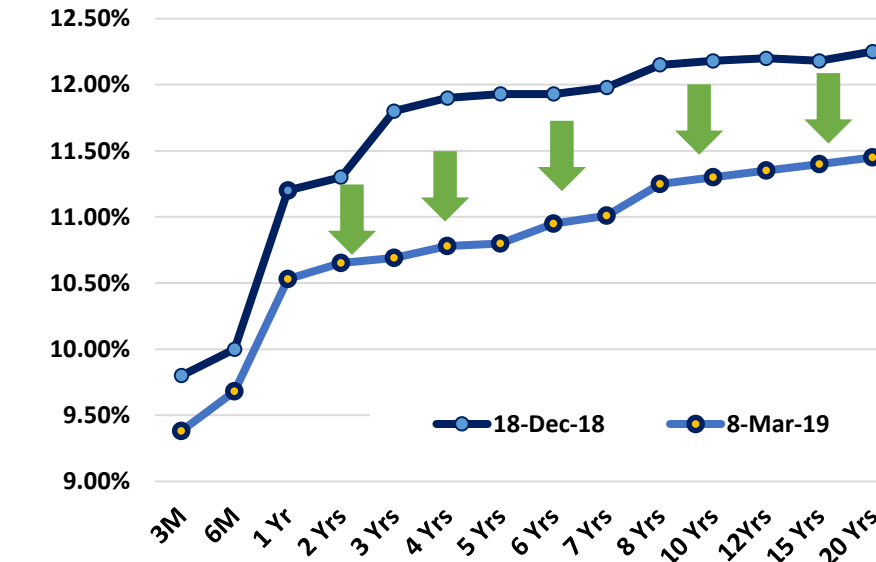
19th Dec Recommendations and Yield curve movement afterwards

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Increase portfolio to 50% from 30%**

- Increase Trading Portfolio to 15% from 5%.
- Carrying Portfolio to be maintained at 35%.

Yields of short-mid tenors 3Y, 4Y and 5Y have fallen into a buy range while 7Y and 8Y have also registered attractive price levels to initiate accumulation



Yield Movement

- Following our previous report on 19th Dec 2018, yields registered 65-113bps downward movement in 2Yr to 20Yr.
- Overall yield curve shifted downwards amidst some foreign selling pressure in the mid to long tenors.
- Heavy foreign outflow of LKR 13.7Bn was observed over the last 2 months.

| Interest Rate Change (bps) | | | |
|----------------------------|-----------|----------|--------------|
| Tenure | 18-Dec-18 | 8-Mar-19 | Change (bps) |
| 3M | 9.80% | 9.38% | -42 |
| 6M | 10.00% | 9.68% | -32 |
| 1 Yr | 11.20% | 10.53% | -67 |
| 2 Yrs | 11.30% | 10.65% | -65 |
| 3 Yrs | 11.80% | 10.69% | -111 |
| 4 Yrs | 11.90% | 10.78% | -112 |
| 5 Yrs | 11.93% | 10.80% | -113 |
| 6 Yrs | 11.93% | 10.95% | -98 |
| 7 Yrs | 11.98% | 11.01% | -97 |
| 8 Yrs | 12.15% | 11.25% | -90 |
| 10 Yrs | 12.18% | 11.30% | -88 |
| 12 Yrs | 12.20% | 11.35% | -85 |
| 15 Yrs | 12.18% | 11.40% | -78 |
| 20 Yrs | 12.25% | 11.45% | -80 |

2.0 Economic Health Score

Mar 2019 Economic Health Score

Health score to improve

| | | | | | |
|--------------------|---|----|------|---|----|
| Primary Criteria | - | 41 | + 05 | - | 46 |
| Secondary Criteria | - | 04 | + 04 | - | 08 |

Economic Health Score (Mar 2019) - 54

- [As against 45 in Feb 2019 & 71 Mar 2018 (1 Year ago)]

Changes to Health Score – Priority Criteria

| Criteria | Update | Current Score | Add / Deduct Score | New Score |
|------------------|---|---------------|--------------------|-----------|
| Foreign Reserves | Feb 2019 reserves reduced to USD 6.0Bn from USD 6.1Bn in Jan 2019 and CBSL net purchasing USD 29.0Mn from the market. Issuance of USD 2.4Bn Sovereign Bond boost reserve to above USD 7.5Bn end of March. | 07/15 | +03 | 10/15 |
| Liquidity | Liquidity level was heavily volatile with CBSL conducting few reverse repo auctions while the SRR cut released liquidity into market. | 06/15 | +02 | 08/15 |
| Inflation | CCPI in Feb at 4.0%, lower than First Capital Research expectation of 4.1%; | 10/15 | | 10/15 |
| Foreign Buying | Net outflow LKR 951.0Mn over the last 4 weeks; Foreign holding reaches 3.06%. | 05/10 | | 05/10 |
| Credit | Credit growth remains under control. | 07/10 | | 07/10 |
| CBSL Holdings | CBSL Holdings remained above LKR 160.0Bn. | 06/10 | | 06/10 |

Primary Criteria - 41 + 05 = 46

Changes to Health Score – Secondary Criteria

| Criteria | Update | Current Score | Add / Deduct Score | New Score |
|----------------------|--|---------------|--------------------|-----------|
| Rating Outlook | No major changes. | 02/05 | | 02/05 |
| External Environment | Rupee remains steady over the last 2 months. | 00/05 | +01 | 01/05 |
| BoT & BoP | Deficit in the trade account slowed down with reduction in imports in Nov 2018. | 02/05 | | 02/05 |
| Political Risk | Political stability reinstated to some degree and amid the prospect one or more election in 2019 | 00/05 | +01 | 01/05 |
| Investor Confidence | BCI recorded a notable increase of 14 points to reach 115 in Feb – compared to 101 in Jan | 00/05 | +02 | 02/05 |

Secondary Criteria - 04 +04 = 08

Sequence of Events

19th June 2018 - Maintain overall portfolio to 50%. Carry portfolio to be maintain to 40%. Trading portfolio to be maintained to 10%.

26th Jul 2018 - **Reduce** overall portfolio to 40% from previous 50%. Cut Trading portfolio to 0% from 10%. Carry portfolio to be maintained at 40%.

23rd Aug 2018 - **Reduce** overall portfolio to 30% from previous 40%. Cut Carrying portfolio to 30% from 40%. Trading portfolio to be maintained at 0%.

19th Sep 2018 - **Increase portfolio to 50% from 30%**. Increase Trading Portfolio to 20% from 0%. Carrying Portfolio to be maintained at 30%.

12th Oct 2018 - **Increase portfolio to 60% from 50%**. Increase Carrying Portfolio to 35% from 30% and Trading Portfolio to 25% from 20%.

9th Nov 2018 - **Reduce** overall portfolio to 40% from previous 60%. Cut Trading portfolio to 5% from 25%. Carrying portfolio to be maintained at 35%.

19th Dec 2018 - **Increase portfolio to 50% from 40%**. Increase Trading Portfolio to 15% from 5%. Carrying Portfolio to be maintained at 35%.

11th Mar 2019 - **Increase overall portfolio to 55% from 50%**. Increase Carrying Portfolio to 45% from 35%. Reduce Trading Portfolio to 10% from 15%.

Disclaimer

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