

FC Fixed Income Recommendation

JUNE 2017

**ANALYST CERTIFICATIONS AND REQUIRED
DISCLOSURES BEGIN ON PAGE 17**



First Capital
FC Research
Dimantha Mathew
Head of Research

Re-cap [Dec 2016]: Time Period vs Risk Score

	3 Months Outlook Feb-Apr	3-6 Months Outlook Apr-Jul	6-9 Months Outlook Jul-Oct	9-12 Months Outlook Oct-Dec
Risk Score Estimate	<50	50-75	75-100	50-75
Rise in Rates by +1%	High	Medium	Remote	Medium
Leverage	Reduce to 9.0x-12.0x	Slow Increase 12.0x-15.0x	Significantly Increase 15.0x or More	Slow Decrease 12.0x-15.0x
Utilization of Leverage	Limited to 40% or less	Limited to 60% or less	Limited to 80% or less	Limited to 60% or less

1.0 Economic Health Score

Jun 2017 Economic Health Score

Primary Criteria	-	36	+12	-	48
Secondary Criteria	-	14	+00	-	14

Economic Risk Score (Jun 2017) - 62

- (As against 50 in May 2017 & 44 in Feb 2017)
-

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Surge by USD 1.8Bn	04/15	+08	12/15
Liquidity	No significant change; Constant change towards small short/excess	07/15		07/15
Inflation	Dipped to 6.0%; FC Research expectation was 6.3%	11/15	+02	13/15
Foreign Buying	Increased by LKR16.7 Bn over the last 4 weeks; Foreign holdings reach 4.6%	02/10		02/10
Credit	March 2017 credit remains high; But we believe it may be one off	08/10		08/10
CBSL Holdings	CBSL Holdings decline by LKR 60Bn to LKR 208 Bn	04/10	+02	06/10
Primary Criteria		-	36 + 12	= 48

Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No Change	05/05		05/05
External Environment	No Change	04/05		04/05
BoT & BoP	Negative Balance of Payments position continues to be an issue	01/05		01/05
Political Risk	No Change	03/05		03/05
Other (New Taxes)	New IRA has not been gazetted as yet	01/05		01/05

Secondary Criteria - 14 + 0 = 14

2.0 Recommendation

Expectations for July 2017

PRIORITY CRITERIA

Foreign Reserves - 12/15		
Liquidity - 07/15		
Inflation - 13/15		
Foreign Buying - 02/10	+02	
Credit - 08/10		
CBSL Holdings - 06/10	+01	

Total - 48/75 +03

SECONDARY CRITERIA



Rating Outlook	- 05/05	
External Environment	- 04/05	
BoT & BoP	- 01/05	
Political Risk	- 03/05	+01
Other (New Taxes)	- 01/05	+04

Total - 14/25 +05

Total 62 + (3+5) = 70

Change in Probabilities

AS AT DEC 2016

Jan - Jul 2017	Probability	May 2017	Jun 2017
Interest Rates to be volatile within 150-200bps strip until uncertainty ends	65%	 70%	 85%
Macro Economic Conditions further worsens, upper band targets of the bonds will break	35%	30%	15%

Reasons for Expected July 2017 Health Score

Further improvement in the Economic Health Score is possible due to:

- Acceleration in foreign buying
- Completion of passing of the New Inland Revenue Act
- Further reduction in CBSL Holdings via Funds received from Dollar buying by CBSL and possible net inflows into Debt or equity capital markets

Recommendation

Fixed Income Portfolio Recommendation

- Further increase portfolio exposure: BUY
- Increase capacity Utilization to 70% from 60%
- Possibility of Bonds touching the bottom bands of FC Research across the yield curve
- Need to watch out for the passing of the Inland Revenue Act
- Need to heavily target the possible July Bond Auction & Bill Auctions over the next few weeks

Sequence of Events

Feb 2017 – Risk was high had a utilization of less than 40%.

Mar 2017 – Risk reduced signs of positivity. BUY; Portfolio increased to 50%

Apr 2017 – Signs of further outflows but risk score increases so HOLD or SELL a portion to represent future risk

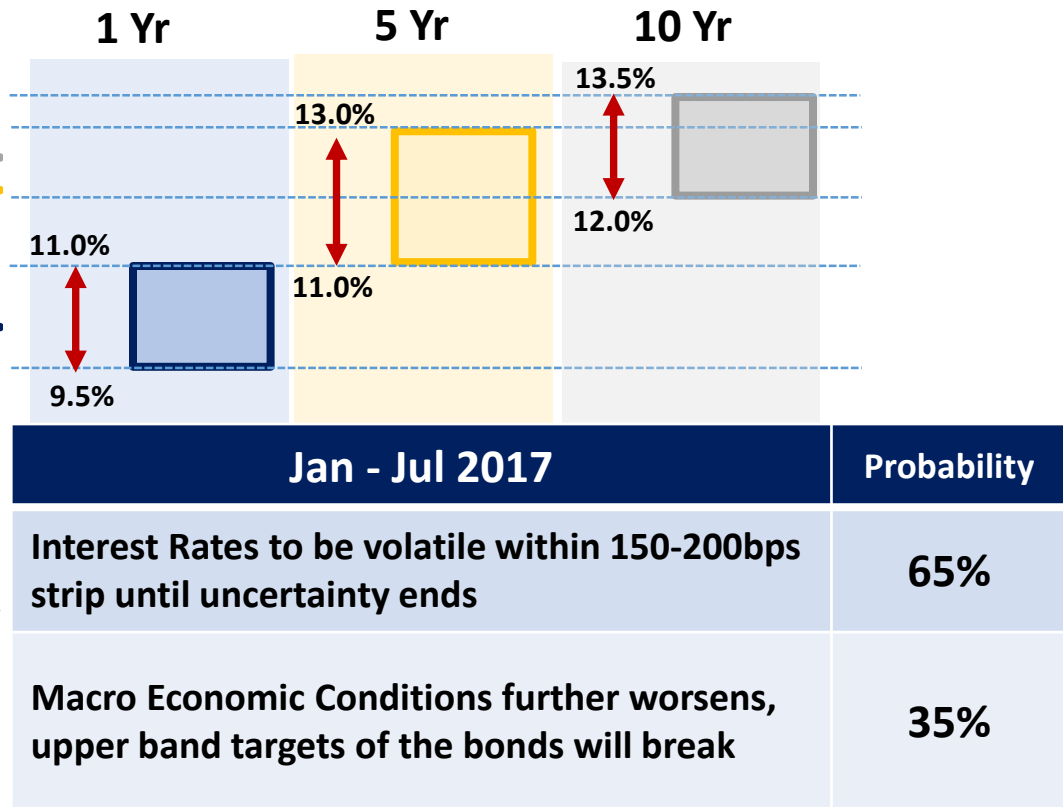
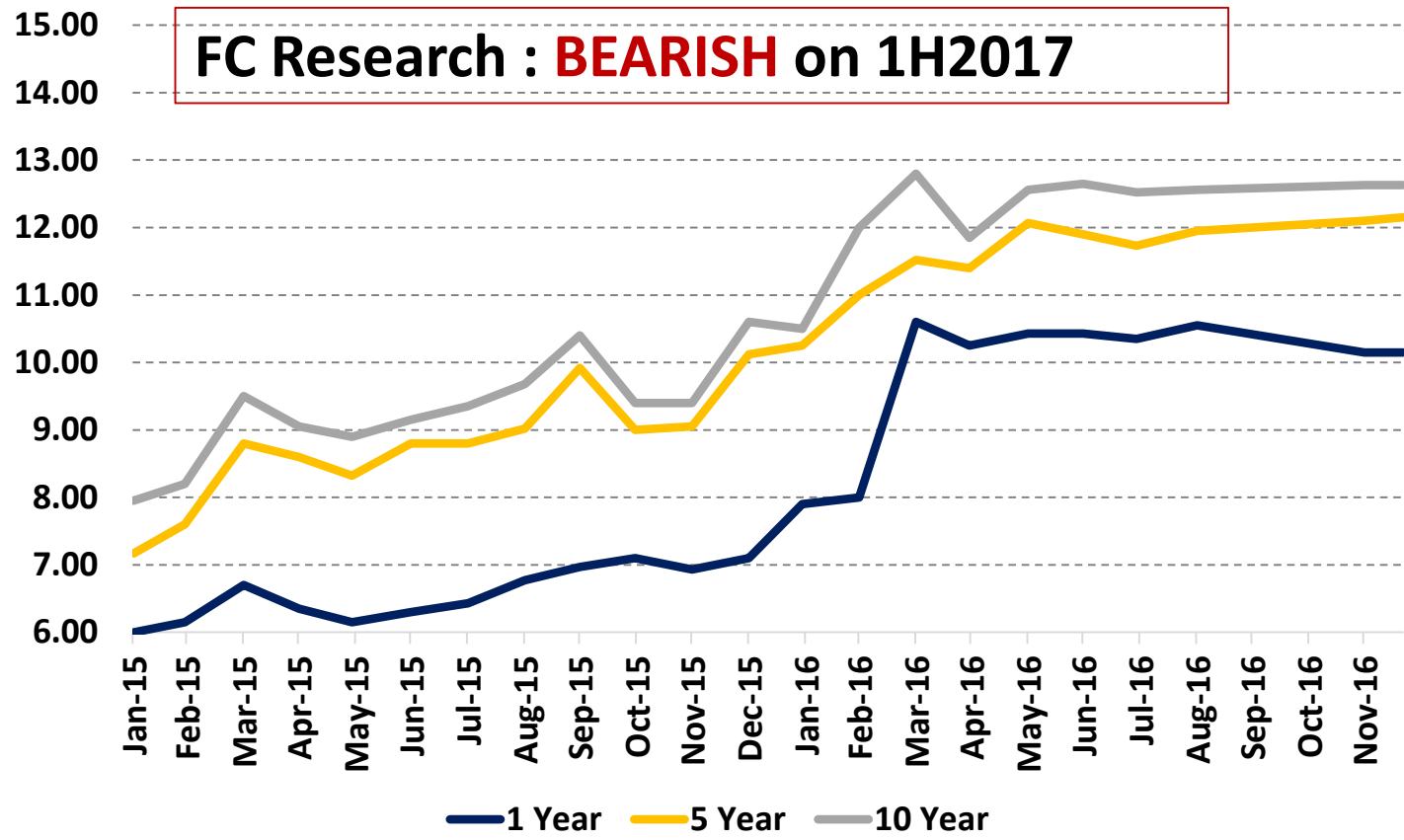
Early May 2017 – Comments on delay in Sovereign Bond; Hold portfolio and switch to Bills or shorter term securities.

May 2017 – Successful Bond issue; Signs of Future Risk reducing; Increase from 50% to 60% but slow increase as mid term bond rates are too low

Jun 2017 – Concrete signs of future risk reducing; Increase capacity utilization to 70% from 60%; Possibility of overall yield curve touching bottom bands over next 2 months; But watchout for Inland Revenue Act

3.0 Recap of Dec 2016 Economic Wrap

Interest Rates to be volatile within 150-200bps strip until uncertainty ends (Target: 7 months)



Pressure on interest rates to ease off over the 2H2017 (Target: 12 months)

No Bond Maturities beyond Jul 2017

No SLDB Maturities beyond 1st Aug 2017

No elections unless 1H2017 elections and referendums are delayed

Low Government Borrowing Requirement and low Private Sector Credit Growth may improve money supply and liquidity in the system

FC Research : BULLISH on 2H2017

BY END 2017	Probability
Interest Rates to decline and hit the lower bands (1 Yr – 9.5%, 5 Yr – 11.0%, 10 Yr – 12.0%)	65%
Macro Economic Conditions further worsens in 1H2017, end 2017 rates will remain same as current rates (1 Yr – 10.0%, 5 Yr – 12.0%, 10 Yr – 12.6%)	35%

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC. based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the correctness, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or its principal, their respective Directors, or Employees may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

Research Disclosure

NOTICE TO US INVESTORS

This report was prepared, approved, published and distributed by First Capital Equities (Pvt) Ltd, company located outside of the United States (a “non-US Group Company”). This report is distributed in the U.S. by LXM LLP USA, a U.S. registered broker dealer, on behalf of First Capital Equities (Pvt) Ltd only to major U.S. institutional investors (as defined in Rule 15a-6 under the U.S. Securities Exchange Act of 1934 (the “Exchange Act”)) pursuant to the exemption in Rule 15a-6 and any transaction effected by a U.S. customer in the securities described in this report must be effected through LXM LLP USA.

Neither the report nor any analyst who prepared or approved the report is subject to U.S. legal requirements or the Financial Industry Regulatory Authority, Inc. (“FINRA”) or other regulatory requirements pertaining to research reports or research analysts. No non-US Group Company is registered as a broker-dealer under the Exchange Act or is a member of the Financial Industry Regulatory Authority, Inc. or any other U.S. self-regulatory organization.

NOTICE TO US INVESTORS

Contd...

Analyst Certification. Each of the analysts identified in this report certifies, with respect to the companies or securities that the individual analyses, that (1) the views expressed in this report reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this report. Please bear in mind that (i) First Capital Equities (Pvt) Ltd is the employer of the research analyst(s) responsible for the content of this report and (ii) research analysts preparing this report are resident outside the United States and are not associated persons of any US regulated broker-dealer and that therefore the analyst(s) is/are not subject to supervision by a US broker-dealer, and are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with US rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

NOTICE TO US INVESTORS

Contd...

Important US Regulatory Disclosures on Subject Companies. This material was produced by Analysis First Capital Equities (Pvt) Ltd solely for information purposes and for the use of the recipient. It is not to be reproduced under any circumstances and is not to be copied or made available to any person other than the recipient. It is distributed in the United States of America by LXM LLP USA and elsewhere in the world by First Capital Equities (Pvt) Ltd or an authorized affiliate of First Capital Equities (Pvt) Ltd. This document does not constitute an offer of, or an invitation by or on behalf of First Capital Equities (Pvt) Ltd or its affiliates or any other company to any person, to buy or sell any security. The information contained herein has been obtained from published information and other sources, which First Capital Equities (Pvt) Ltd or its Affiliates consider to be reliable. None of First Capital Equities (Pvt) Ltd accepts any liability or responsibility whatsoever for the accuracy or completeness of any such information.

NOTICE TO US INVESTORS

Contd...

All estimates, expressions of opinion and other subjective judgments contained herein are made as of the date of this document. Emerging securities markets may be subject to risks significantly higher than more established markets. In particular, the political and economic environment, company practices and market prices and volumes may be subject to significant variations. The ability to assess such risks may also be limited due to significantly lower information quantity and quality. By accepting this document, you agree to be bound by all the foregoing provisions.

NOTICE TO US INVESTORS

Contd...

LXM LLP USA assumes responsibility for the research reports content in regards to research distributed in the U.S. LXM LLP USA or its affiliates has not managed or co-managed a public offering of securities for the subject company in the past 12 months, has not received compensation for investment banking services from the subject company in the past 12 months, does not expect to receive and does not intend to seek compensation for investment banking services from the subject company in the next 3 months. LXM LLP USA has never owned any class of equity securities of the subject company. There are not any other actual, material conflicts of interest of LXM LLP USA at the time of the publication of this research report. As of the publication of this report LXM LLP USA, does not make a market in the subject securities.

CONTACT US



First Capital

Dimantha Mathew +94 11 2639 853

Amanda Lokugamage +94 11 2639 868

Atchuthan Srirangan +94 11 2639 863

Michelle Weerasinghe +94 11 2639 866

Hansinee Beddage +94 11 2639 864