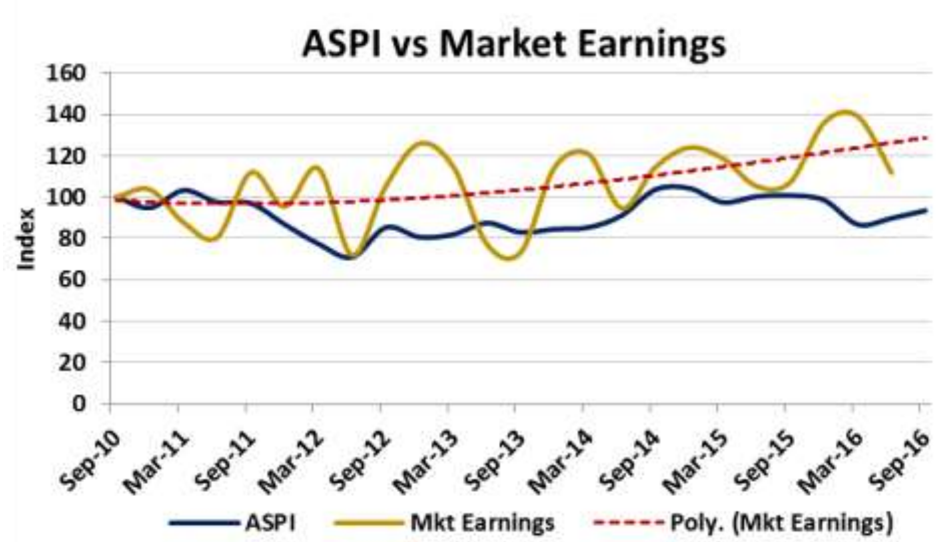
Earnings & Market Returns Forecast

Results Update – June 2016 Quarter

1.0 Market Earnings slowdown to continue; Market Returns to be bullish in the medium term…



Source: FC Research Estimates

Dim Earnings to continue in 3Q2016: Slow earnings growth [as expected] was witnessed during 2Q2016 quarter primarily affected by the monetary tightening while banking providing cushion for earnings. We maintain our expectation that the slow earnings effect is likely to continue for 3Q2016 as well with the exception of the construction and building material segment and banking. We maintain our overall market earnings growth targets for **Dec 2016E / Mar 2017E to be at 4%-5%YoY** and also maintain our expectation for market earnings to accelerate from 2H2017E onwards, resulting in earnings for **Dec 2017E / Mar 2018E to grow by 11%-12%YoY.**

Market Returns bullish only in the mid-term and conditionally on the longer term: We maintain our view on the market returns outlook, despite earnings outlook remaining dull, we are bullish on equity market returns due to attractive overall valuations and likely decline in interest rates reducing expected returns on the equity market. **We expect market returns to be positive and strong during the Medium Term**. With the Government together with the IMF programme targeting some major Fiscal Reforms and Government Institutional reforms which may have major positive effect on the economy. As a result on a conditional term we remain **bullish on market return over the long term [1 year and beyond]** provided reforms are successful. If reforms fail to be implemented, IMF programme would also fail.

2.0 Our previous forecasts on earnings

Our "Results Update March 2015 Report" forecast for future earnings was as follows:

Monetary tightening, rupee depreciation and rise in interest rates to negatively affect market earnings; Market Returns bullish in the mid-term and conditionally on the longer term: A slowdown in market earnings during the 2Q-3Q2016 is possible amidst the likely slowdown in consumer demand resulting from the current monetary tightening and the depreciation of the rupee. However, banking sector is likely to provide stability with higher margins while construction and building material companies may continue to show strong performance with the Government's infrastructure drive. As a result we believe overall market earnings growth for **Dec 2016E / Mar 2017E to be at 4%-5%YoY**. We also expect Market earnings to accelerate from 2H2017E onwards resulting in earnings for **Dec 2017E / Mar 2018E grow by 11%-12%YoY.** Following a negative 1H2016 in terms of market returns despite earnings outlook remaining dull, we are bullish on equity market returns due to the market decline resulting in attractive overall valuations and likely decline in interest rates reducing expected returns on the equity market. **We expect market returns to be positive and strong during the Medium Term**. Government's targets for fiscal and institutional reforms together with the IMF programme may bring positive effects on the economy. As a result on a conditional term we remain **bullish on market return over the long term [1 year and beyond]** provided reforms are successful. If reforms fail to be implemented IMF programme would also fail.

Our "Results Update December 2015 Report" forecast for future earnings was as follows:

Monetary tightening hinders earnings forecast: The accelerated monetary tightening and the surge in interest rates are likely to affect consumer demand negatively resulting in a steep slowdown in earnings growth from March 2016 quarter onwards. A further depreciation in the rupee is likely to illustrate more forex losses similar to the Dec 2015 quarter. In addition to the earnings downgrade in the previous quarter we would like to further downgrade our Earnings forecast for **Dec 2015 /Mar 2016E to 7%-9%YoY** from the previous 9%-11%. Amidst slow economic conditions we continue to maintain our earnings forecast for **Dec 2016E / Mar 2017E at 4%-5%YoY**. Rising interest rates by almost 300 basis points over the past 3 months have significantly increased the expected return in the more risky equity market resulting in investors moving into fixed income. Amidst the sharp fall in the equity market during the Mar 2016 quarter **we expect market returns be flat (zero)** amidst the volatile economic condition over the **medium term [April-Sep 2016]**. However, we remain **bullish on market return over the long term [1 year and beyond]**.

Our "Results Update September 2015 Report" forecast for future earnings was as follows:

Rupee depreciation and Interest rate rise to gradually slowdown consumer demand; Market returns may struggle over the Medium Term: We expect consumer demand to remain high though on a marginal decelerating trend during 1H2016 amidst higher disposable income among consumers. The rupee depreciation and rising interest rate environment may affect the economy predominantly during the 2H2016 while the effect will be partially felt during the latter part of 2Q2016 as well. Amidst significant forex losses wiping out the high growth rates produced via consumer demand, we would like to downgrade our Earnings forecast to **Dec 2015E /Mar 2016E at 9%-11%YoY** from the previous 11%-13%. With the slowdown in economic conditions we continue to maintain our earnings forecast for **Dec 2016E / Mar 2017E at 4%-5%YoY**. In terms of market returns we expect a volatile period during the short term due to strong earnings and rise in interest rates. However, with earnings expected to slow down over the **medium term 1 year period** and continued rise in interest rates, **we expect market returns to be negative**.

3.0 Strong performance in Banking sector and declining crude oil prices driving growth

Jun Quarter earnings up by 8%YoY: June quarter earnings grew 8%YoY to LKR 49.7Bn, despite a decline of 20%QoQ. The growth was primarily driven by healthy performance in Banking, Finance and Insurance sector (+23%YoY) and Power and Energy sector (+166%YoY) with higher interest rates spreads and lower crude oil prices while growth being partially offset by the dips Diversified Holdings sector (-20%YoY) and Beverage Food and Tobacco sector (-11%YoY) both of which are directly attributable to issues faced in the Carsons Group.

Interest rates and low crude oil prices boosted earnings: Banking, Finance & Insurance sector continued to remain the largest contributor to earnings by achieving earnings of LKR 22.9Bn (+23% YoY). The earnings growth is primarily driven by the increase in interest rates driving up the bank's spread with loan book re-pricing faster than its deposits. Larger Banks led by HNB (+41%YoY), SAMP (+54%YoY) and COMB (+23%YoY) posted attractive earnings growth who collectively represented c.40% of the sector earnings. LIOC who represented 82% of the Power and Energy sector earnings posted attractive earnings growth to LKR 2.0Bn (+1068%YoY) availed by the decline in crude oil prices. Crude oil prices in the world market decline by c.22% YoY. Power and energy sector represented 5% of the total earnings.

Low palm oil prices and adverse weather partially offset growth: The growth posted by Banking, Finance and Insurance and Power and Energy sectors was partially offset by lower earnings in Diversified Holdings and Beverage, Food and Tobacco sectors. Diversified sector recorded earnings of LKR 4.6Bn (-20%YoY) which represented 9% of the total earnings. The decline in earnings is primarily caused by CARS who posted a loss of LKR 667Mn (-207%YoY) as a result of the low palm oil prices and adverse effects from LION. Further, Beverage, Food and Tobacco sector posted earnings of LKR 7.6Bn (-11%YoY) which represented 15% of earnings. The earnings saw a decline mainly due to LION who posted losses of LKR 477Mn (-182%YoY) traceable to adverse weather conditions resulting in a factory closure.