



First Capital
FC Research
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Strategy Report 2017

Dec 2016

SRI LANKA

Uncertainty provides volatility; Hope in 2H2017

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Track Record

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Section 1.0

Withdrawal of Jul 2016 Recommendation

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	Date	Recommendation	Accuracy
Recommendation 1	Jan 2015 - Dec 2015	1Yr T-Bill to rise 200bps (8.0%) over 12 Months	Mostly Correct
Recommendation 2	Nov 2015 - Feb 2016	1Yr T-Bill to rise 100bps (8.0%) over 4 months	Correct
Recommendation 3	Nov 2015 - Dec 2016	1Yr T-Bill to rise 300bps (10.0%) over 14 months	Correct
Recommendation 4***	Jul 2016 - Dec 2016	1Yr T-Bill to decline 150bps (9.0%) over 6 months	Mostly Incorrect



Rates moving up

Rates reverse to move down

****FC Research should have withdrawn the recommendation in Oct 2016 when a sudden drop in foreign reserves and liquidity shortage occurred amidst heavy selling pressure. Now we withdraw it.*

Secondary Market rate movement significantly different to Auction rates

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Recommendation	Target and Target Date	Secondary Market (bps)			
		Auction	1 Yr	5 Yr	10 Yr
Recommendation 1 In Jan 2015	Dec 2015 +200bps	+111bps	+135bps	+280bps	+260bps
Recommendation 2 In Nov 2015	Feb 2016 +100bps	+156bps	+180bps	+255bps	+280bps
Recommendation 3 In Nov 2015	Jul 2016 +300bps	+360bps	+355bps	+280bps	+295bps
Recommendation 4 In Jul 2016	Dec 2016 -150bps	-29bps	-25bps	+30bps	+55bps

Reasons for failure in achieving latest targets

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- Expectations remained on par until Oct 2016

From Oct 2016

- Government reports released beyond Oct 2016 illustrated sharp depletion in the reserves. Aug to Nov 2016 **Official reserves down by USD 950 Mn**
- Sudden Liquidity Shortages were created in the money supply in **Sep, Nov and Dec 2016**
- **Sudden tax change proposals** in the budget for capital market investments debt and equity

Reform conditions during 2H2016 still not completed...

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Conditions for positivity still waits to be fulfilled (Not completed only in progress):

- Full implementation of RAMIS system to increase revenue
- Debt to Equity conversion on Chinese high debt projects
- Restructuring and partial sale of Sri Lankan Airlines
- Anything equivalent to above, to increase Tax to GDP ratio and lower debt payments

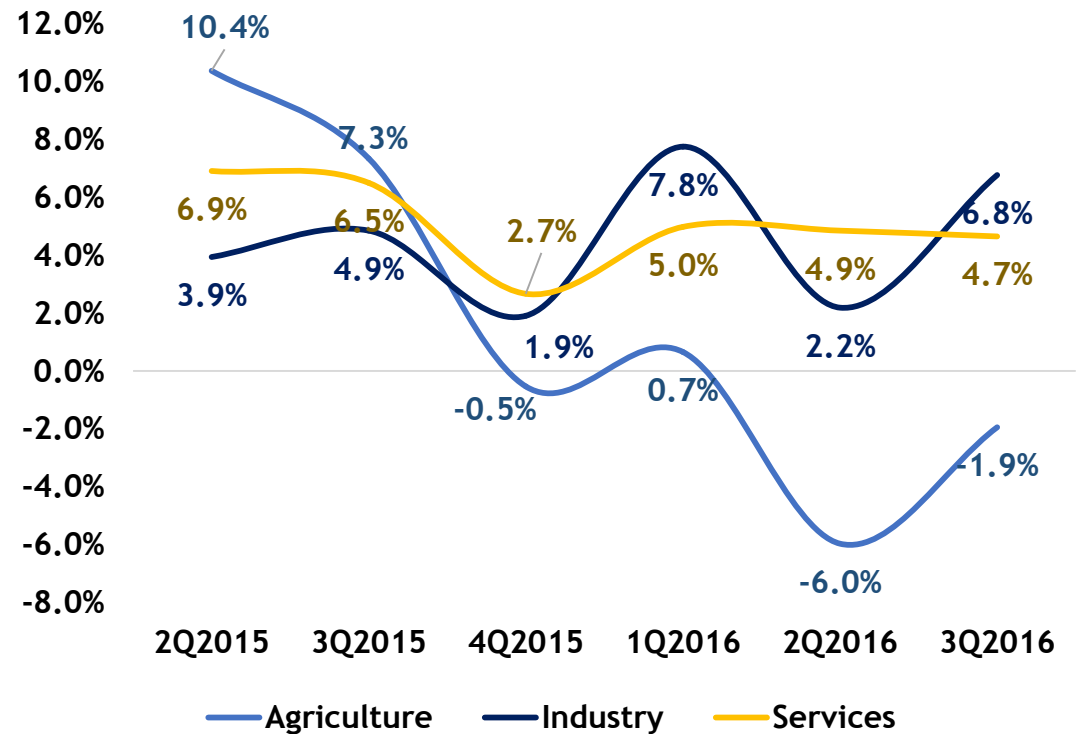
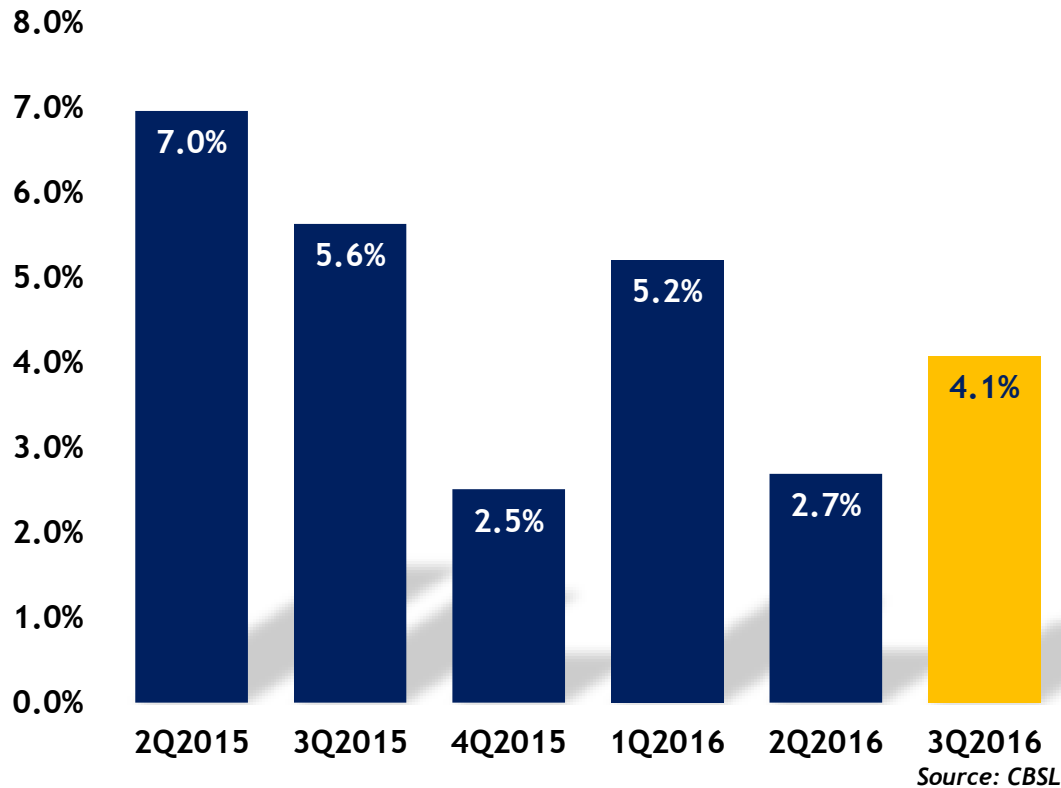
GDP Growth Outlook 2017

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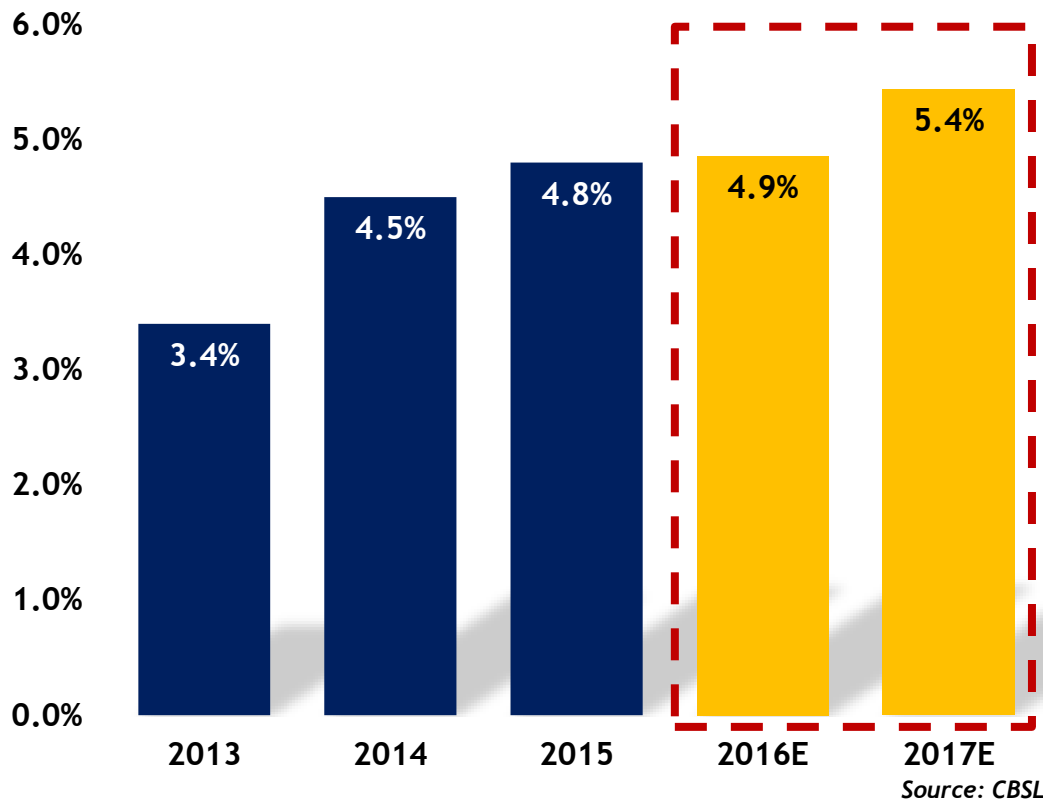
Section 2.0

Quarter GDP figures show signs of improvement in the Industry segment....

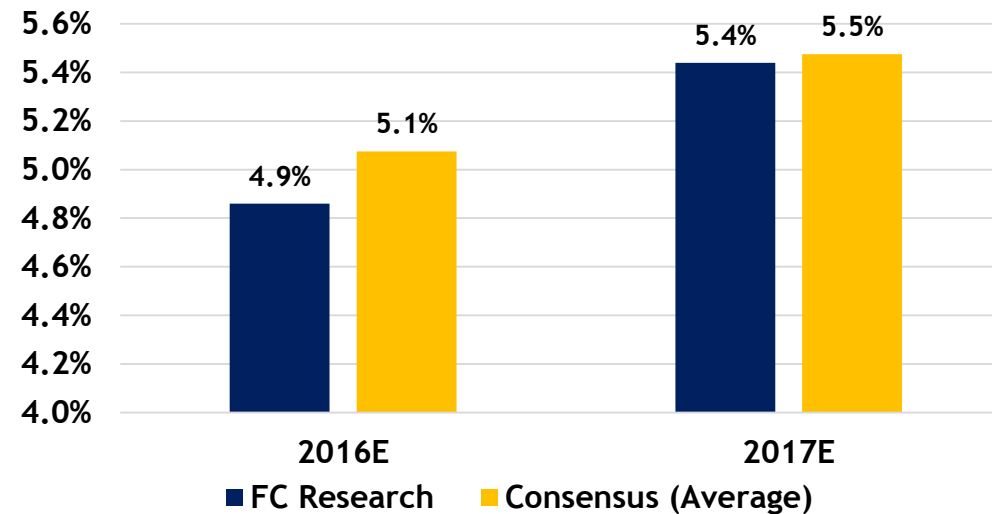
Stable growth in services sector



FC Research expects GDP Growth to slowly improve



SL GDP Growth Forecasts	2015	2016E	2017E
CBSL	4.8%	5.5%	6.3%
World Bank		5.3%	5.3%
IMF		4.5%	4.8%
ADB		5.0%	5.5%
Consensus (Average)		5.1%	5.5%



Factors to Consider for 2017 Outlook

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Section 3.0

Factors to make decisions

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- Political Factors
 - Elections
 - Other areas required to face voters
- Economic Factors
 - Foreign Reserves
 - Inflation
 - Liquidity
 - Credit Growth
 - Government Borrowings Requirement
- External Factors
 - Trump Factor
 - Global Growth

Political Uncertainty Clouds 1H2017

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Section 4.0

Some critical votings to take place, possibly in 1H2017...leads to **POLITICAL UNCERTAINTY**

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- Local Government Elections

- *“Elections to the local authorities would be held before March 31”, Subject Minister Faiszer Musthapha said - DailyMirror*
- *“President Maithripala Sirisena informed the leaders of his United People's Freedom Alliance (UPFA) yesterday that the local government elections would be conducted early next year”, Fisheries Minister Mahinda Amaraweera - DailyMirror*
- *“Elections Commission will start compilation and updating of details about staff members to be recruited to poll related duties in the future” Commission’s Chairman Mahinda Deshapriya said - DailyMirror*

- Possible Referendum

- *“Steering Committee decided on Monday, to have a debate on the new constitutional proposals in Parliament on January 9, 10 and 11” - DailyMirror*
- *“Once the debate on the six sub-committee reports is over in the first week of January 2017, we will present the report of the Steering Committee to the Assembly. Later, the real debate on the nature of the Constitution will initiate. It has to go to Parliament, be passed by two-thirds, and then finally a referendum” - Ranil Wickramasinghe - DailyMirror*

Economic Outlook for 1H2017 Weak: Uncertain

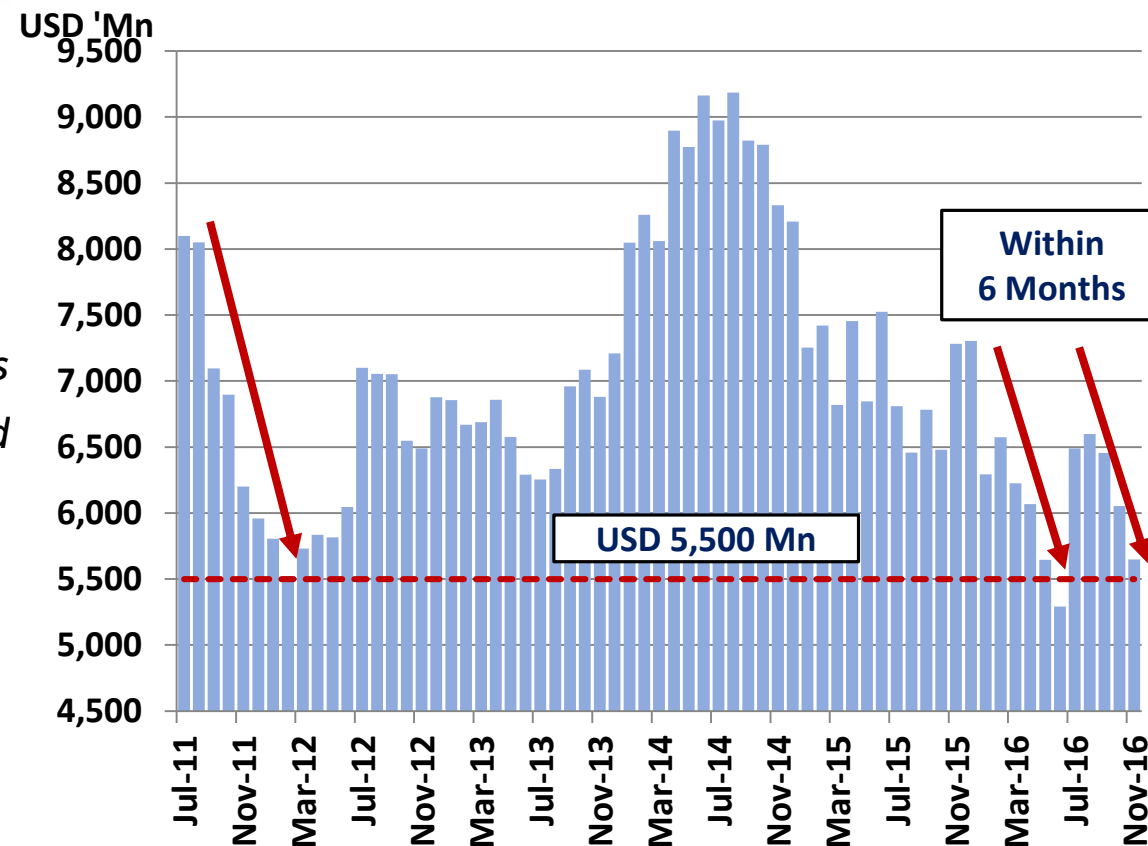
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Section 5.0

Foreign Reserves dangerously low

- Every time Sri Lanka's Reserves record significant declines and also reach closer to USD 5,500 Mn the country tends to go towards a balance of payments crisis
- **Second significant decline** in reserves within a space of 6 months
- On average Sri Lanka spends around USD 1,500 Mn for a month of imports and as a result require about **USD 6,000 Mn for 4 months** of imports

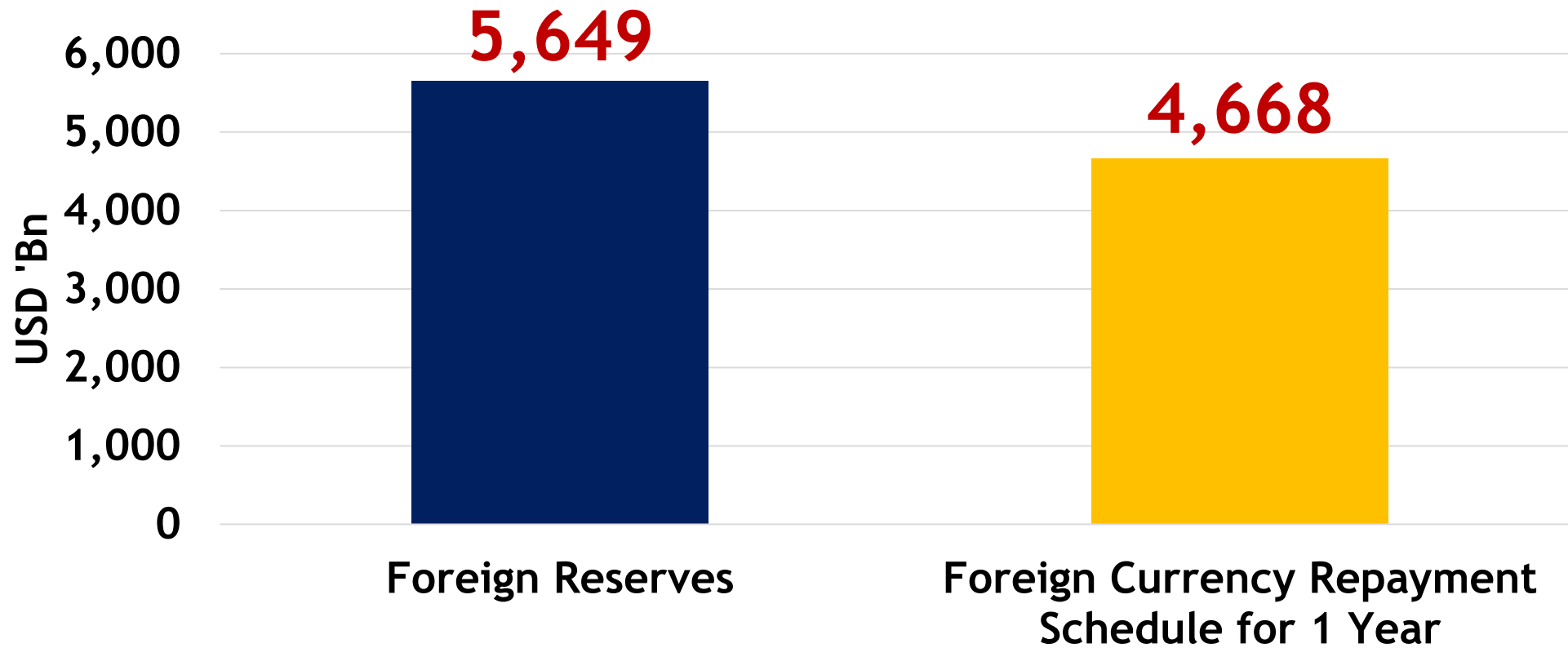
As a result Sri Lanka's Foreign Reserves are dangerously low at the moment



Source: CBSL

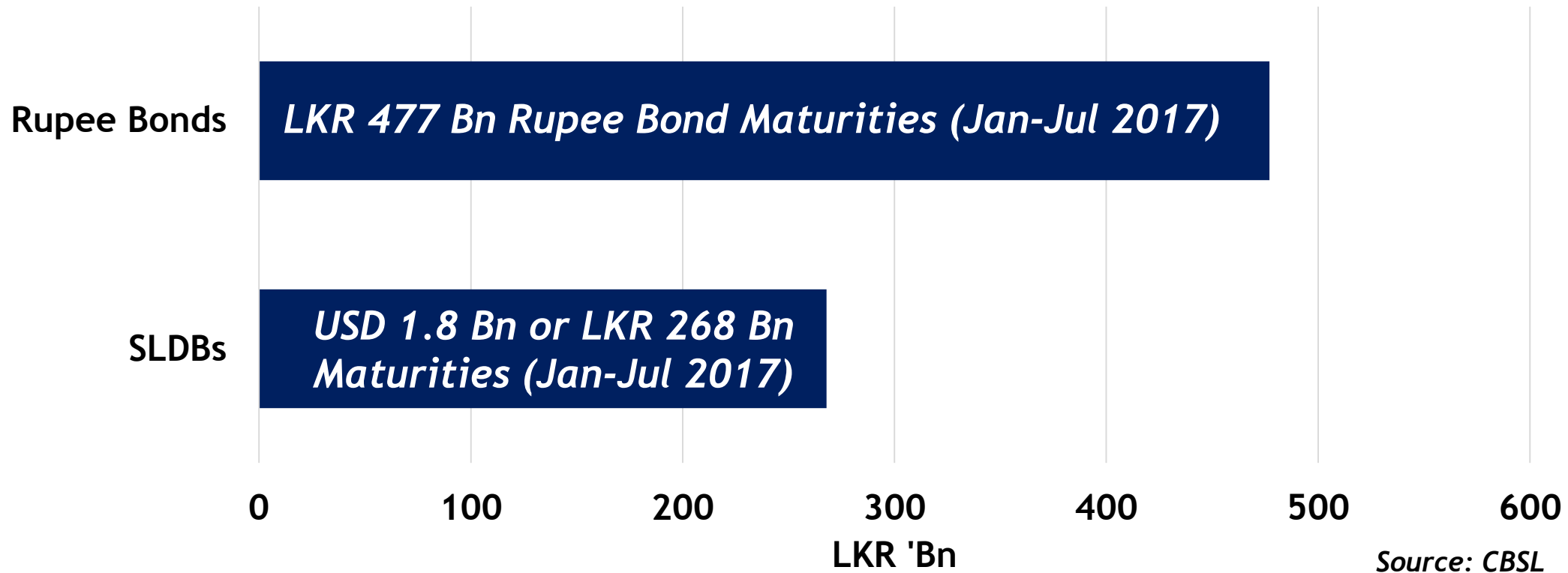
Foreign Currency Payments are as high as Reserves

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Source: CBSL

Domestic Debt Maturities are also High in 1H2017



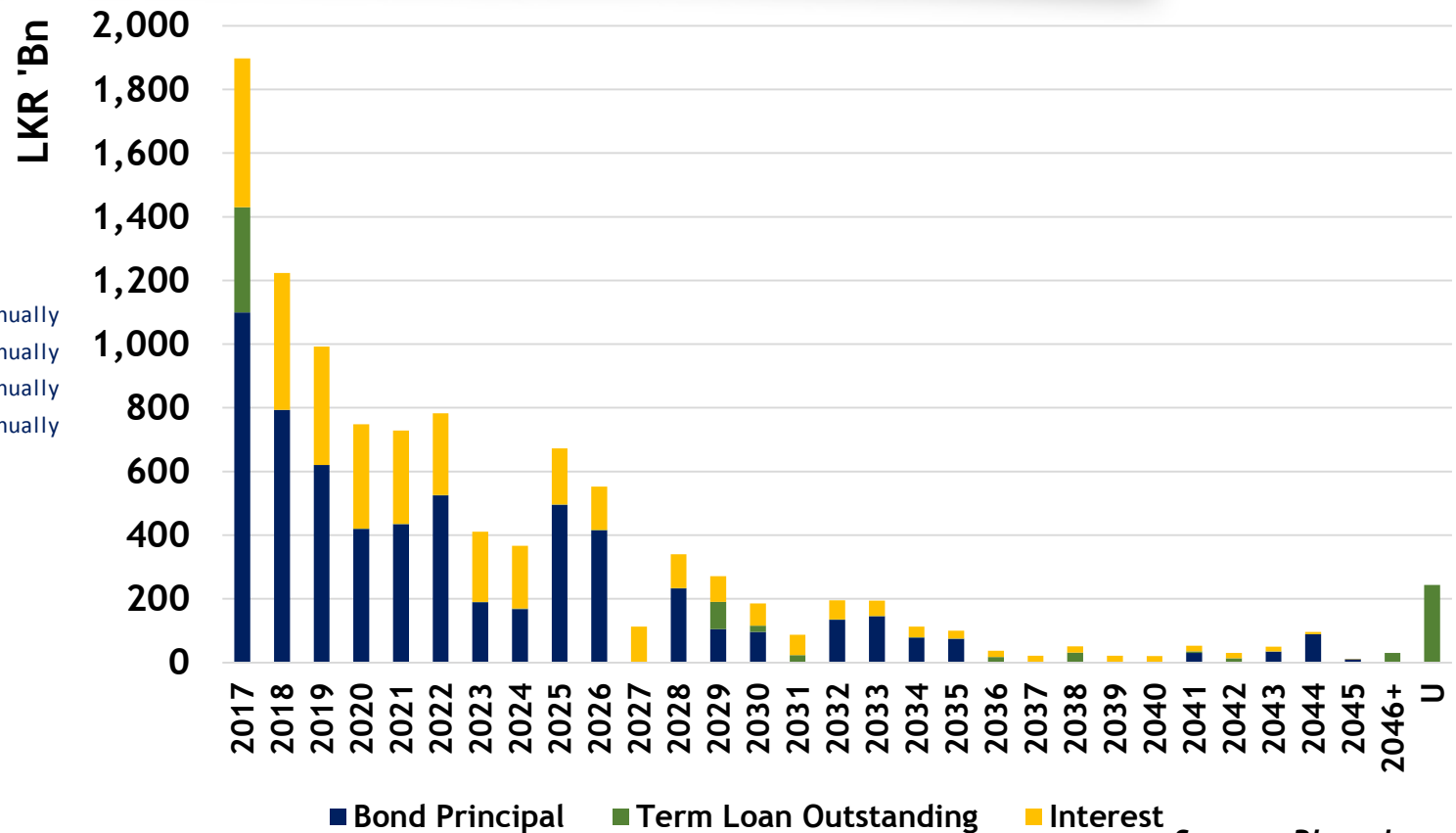
Sri Lanka Overall Debt Payments

Sri Lanka's Current Debt Payments are as follows:

Date	Bond Principal* (LKR 'Bn)	Term Loan Outstanding (LKR 'Bn)	Interest (LKR 'Bn)
2017	1,099.84	330.15	467.39
2018	793.81	0.00	429.83
2019	620.84	0.00	371.80
2020	420.17	0.54	327.25
2021	434.25	1.07	292.90

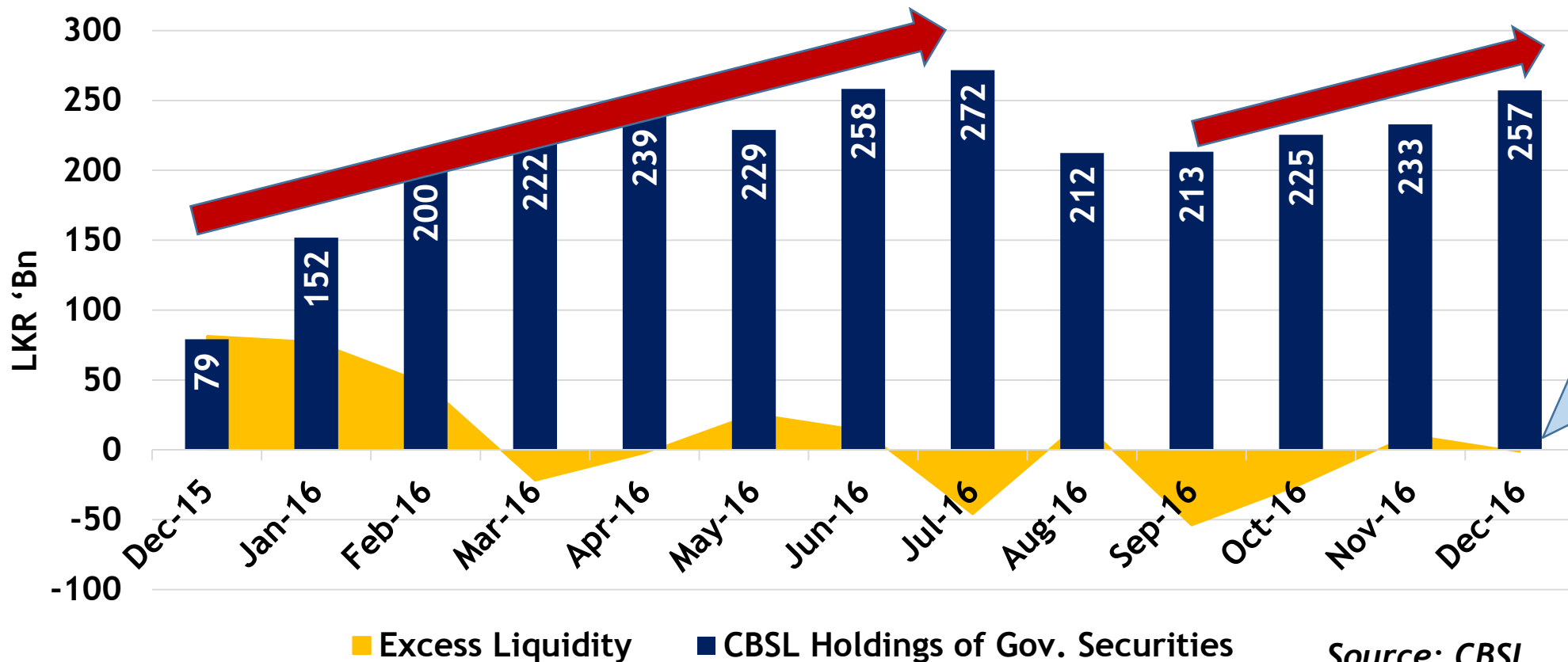
*Includes Bills, Bonds, SLDBs and Sovereign Bonds

We expect Sri Lanka's Debt to GDP to reach 76% by 2016E and further increase to closer to 80% by 2018E provided *no large scale equity investments take place within the year*



Source: Bloomberg

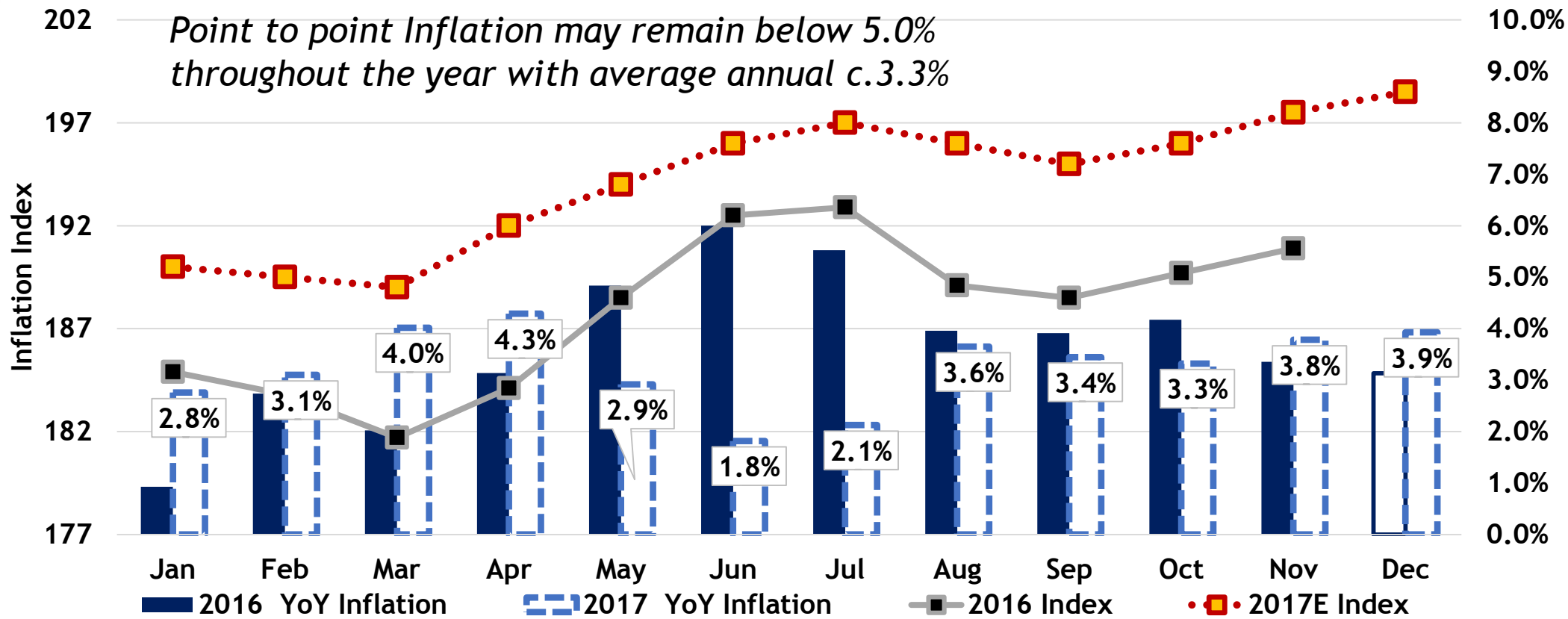
Though continuous money shortage may have resolved in short term printed money remains high, negatively suggesting money shortage in the 1H 2017 as well...



Resolving money shortage issue may be temporary as CBSL Holdings remains high

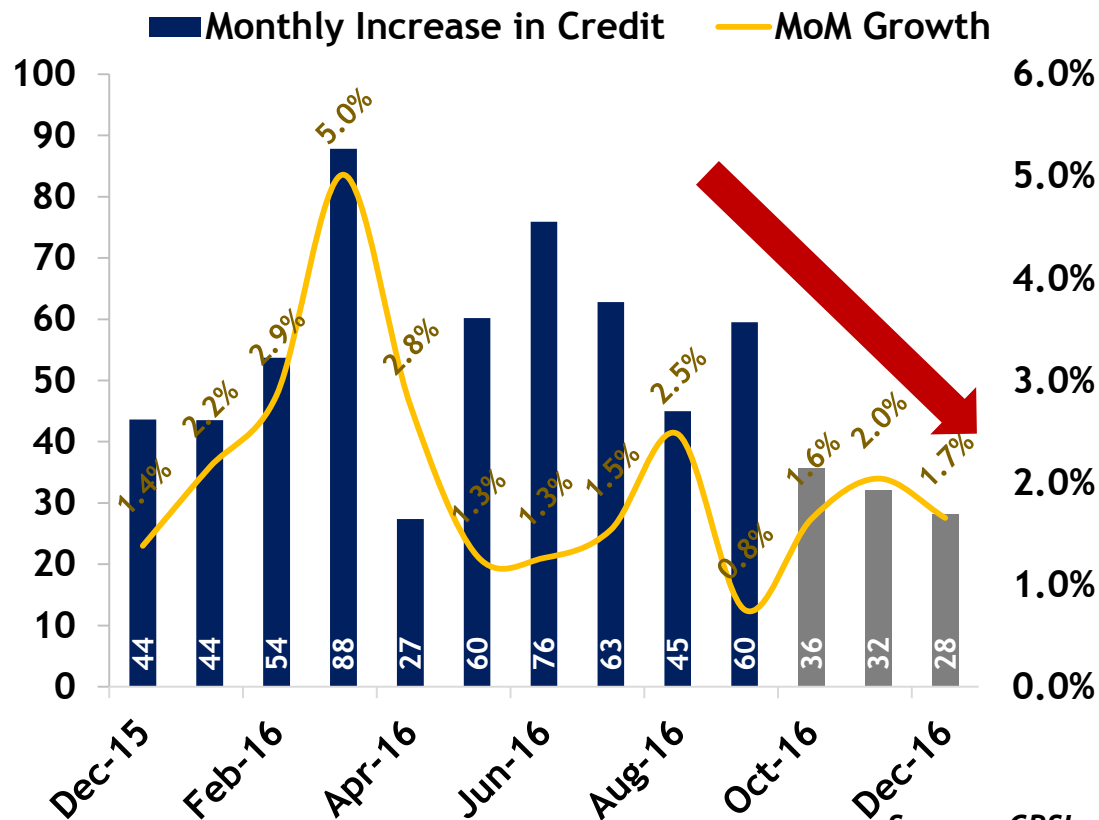
Source: CBSL

Inflation index to spike despite YoY growth remaining low due to high base effect in 2016

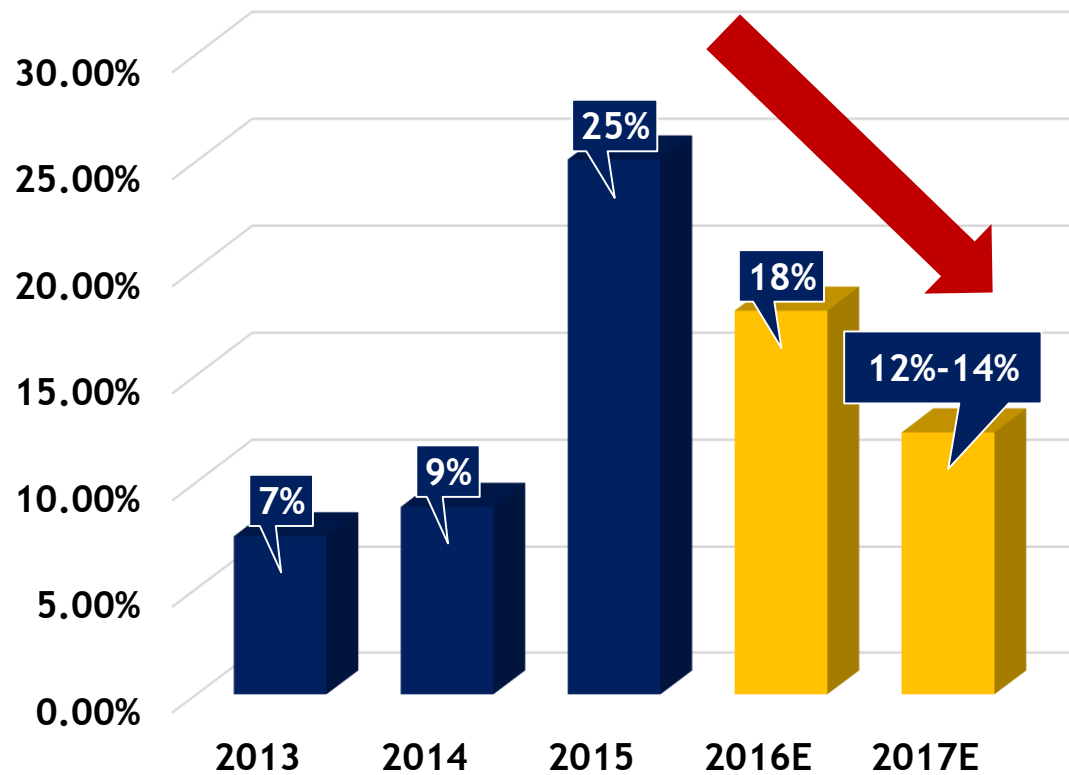


Source: Dept. Census and Statistics & FC Research

Private sector credit growth continue to slowdown dipping to 12-14% in 2017E



Source: CBSL



Source: CBSL

External Environment in Unknown Terrain

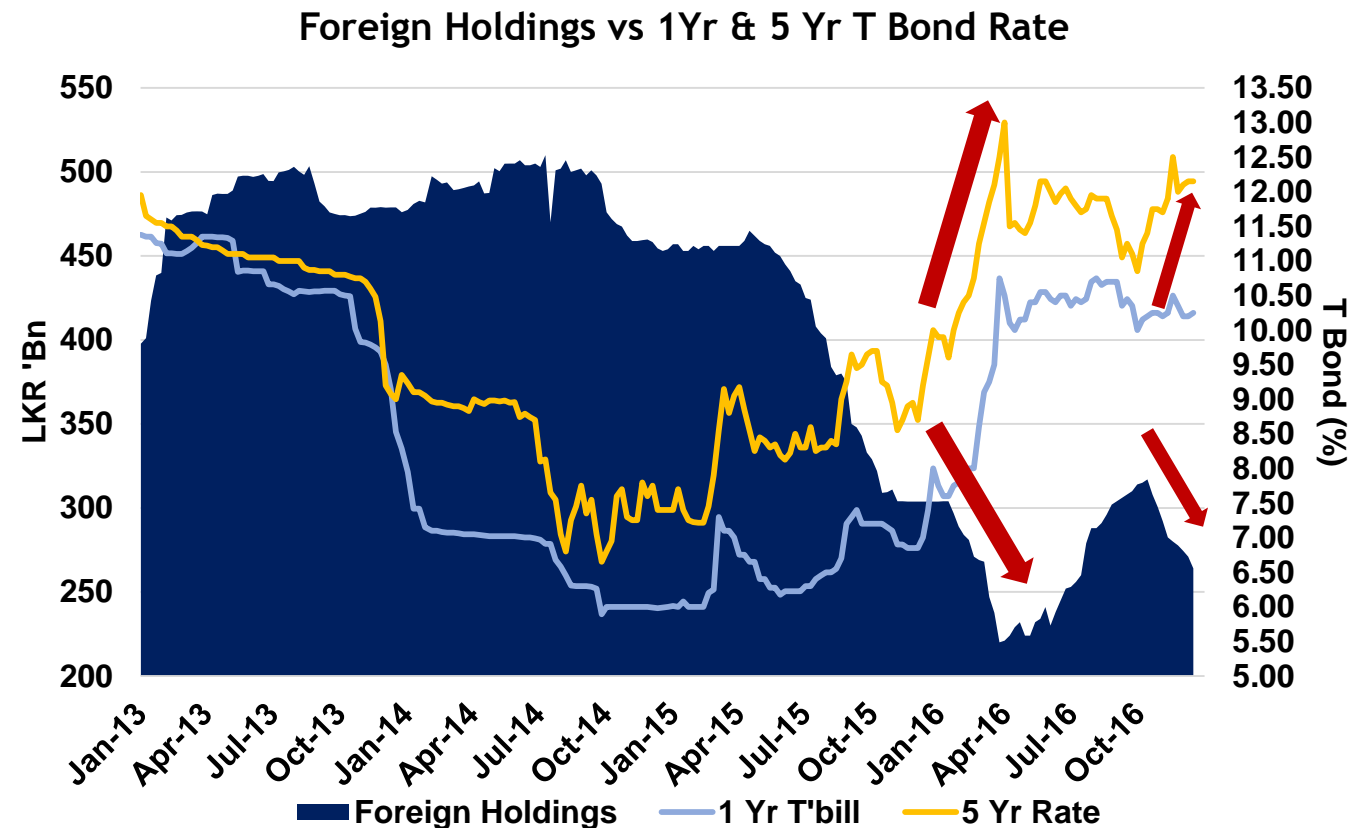
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Section 6.0

External Environment effect on Sri Lanka can go both ways positive and negative...

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- Trump Factor
 - Long term: There is difficulty in assessing how trump's appointment takes effect. There is direct attacks to China and Mexico which be beneficial for us. Then if US does well fund flows move towards US which is negative
 - Short term: Foreign outflows are continuing on a daily basis in all capital markets debt and equity
- Global Growth outlook slow but outlook for South Asia led by India Growth remains strong
- At the moment money is moving out of the emerging and frontier markets, but difficult to assess the medium term flow



Source: CBSL & FC Research

FC Research Interest Rate View for 2017

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Section 7.0

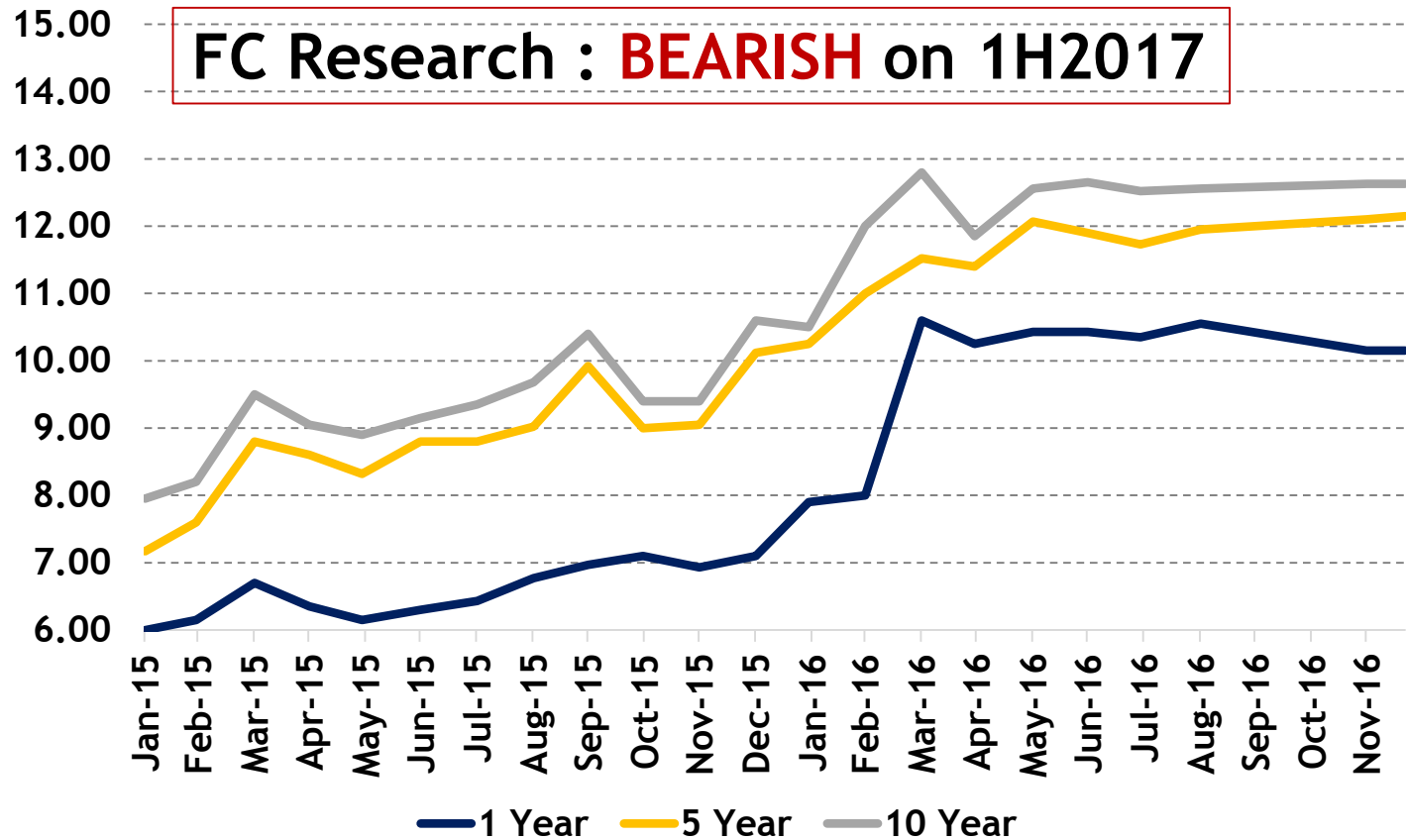
What do the indicators say for investments?

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- Political Outlook : **Negative**
 - ❑ Uncertainty created with elections and referendums results weak investor sentiment
- Economic Outlook : **Negative**
 - ❑ Risks created with Weak Foreign Reserves, High Foreign Debt payments, High bond maturities, shortage in money supply due to CBSL holdings of Government Securities outweighs positive factors of point to point inflation being under control and declining credit growth
- External Outlook: **Neutral**
 - ❑ Trump, global trading and fund flows can go either way in the medium term depending on Trump's performance and other country's (including China's) reaction to it

Overall Outlook : **Negative**

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



1 Yr	5 Yr	10 Yr	Probability
9.5% - 11.0%	11.0% - 13.0%	12.0% - 13.5%	65%
Interest Rates to be volatile within 150-200bps strip until uncertainty ends			65%
Macro Economic Conditions further worsens, upper band targets of the bonds will break			35%

Target Period: Jan - Jul 2017

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

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- 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%

FC Research Exchange Rate View for 2017

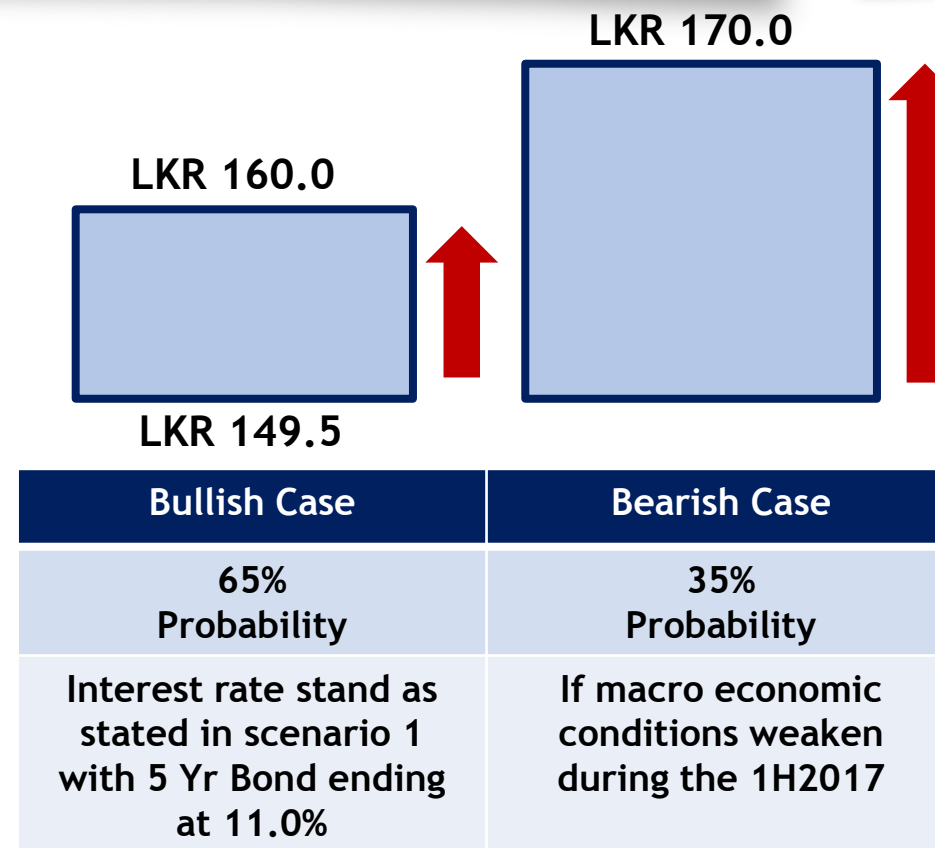
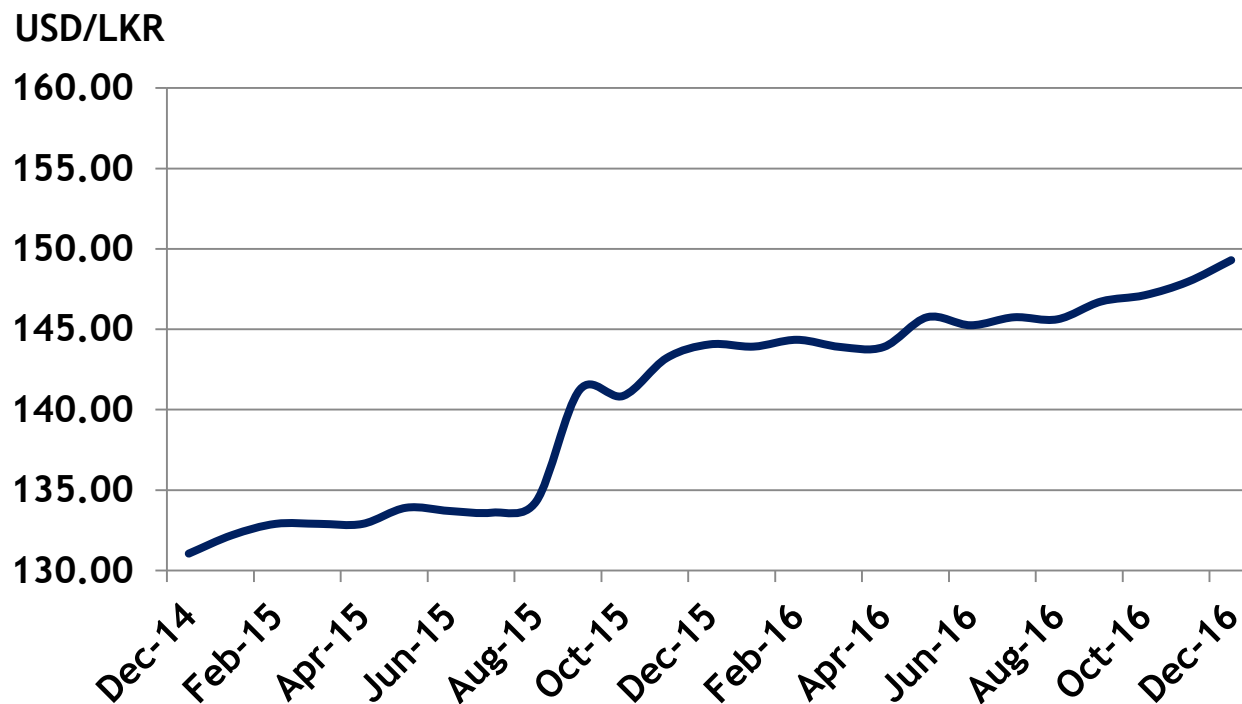
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Section 8.0

Exchange Rate to continue to weaken throughout 2017

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FC Research 2016 Year end target USD:LKR of LKR 149.0 has been accurate



Source: CBSL

Recommendations

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Section 9.0

Recommendations

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Fixed Income

- We recommend to invest in shorter tenors to counter the risk in the system and prevent capital erosion. If risk in the system reduces as in our base case (65% probability) towards Apr-Jul 2017 period initiate mid to long term investments.

Equity

- We recommend a low level of equity allocation amidst significant uncertainties during Jan-Jul 2017. ASPI is likely to be volatile similar to the interest rates between 6,000-6,500 unless macro economic conditions worsen during the period. If risk in the system reduces as in our base case (65% probability) towards Apr-Jul 2017, we recommend increase equity investments aiming positive returns in 2H2017

Consumer Demand

- Amidst the tight monetary policy consumer demand is likely to significantly decline during 1H2017 with some pick towards 4Q2017

Requirements to improve weaknesses

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Section 10.0

Requirements to amend expected weaknesses

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- Current Government obtains majority votes
 - Political uncertainty reduces
- Significant Foreign inflows of USD 4-5 Bn is achieved during 1H2017
 - Economic Uncertainty reduces
- External sector improves with Trump presidency and reactions from other countries favour Sri Lanka
 - External environment becomes supportive for inflows

Disclaimer

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