First Capital
First Capital Research
Dimantha Mathew
Head of Research

Mid Year Outlook 2018-19

Jul 2018

SRI LANKA

Fundamentals strengthening, Growth remains key

ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON SLIDE 47

Fundamentals strengthening, Growth remains key

Executive Summary

Bond Market

- We expect the yield curve in Government securities to peak during 3Q in 2018, and register a slow downtrend. Despite having some pressure in 1Q2019 it is not expected to be as high as 3Q2018. Thereby, from bearishness at the start of 2018, we are now bullish on bonds beyond 3Q2018

Banking Rates

- Banking rates which has a 6 month lag effect to Government securities are likely experience less volatility over the next 12 months while a further slow dip in AWPLR is expected over the next 12 months to 10.0%

Exchange Rate

- With 4 fed rate hikes on the cards over next 12 months, a stronger dollar is more likely, thereby we downgrade our exchange rate target from LKR159 to LKR161 : 1USD for end 2018 and target LKR164.5 : 1USD over next 12 months upto Jun 2019

Equity Market

- We expect Market returns to be stronger despite slower earnings growth outlook of 5-7%. Healthy valuations may warrant a rerating of the market providing returns of 13% market return over the next 6 months while targeting 15% return for 2019E supported by accelerating earnings growth to 10-12%

Business Confidence & Consumer Demand

- We expect business confidence and consumer demand to normalize from 3Q2018 onwards improving overall business activity of the economy

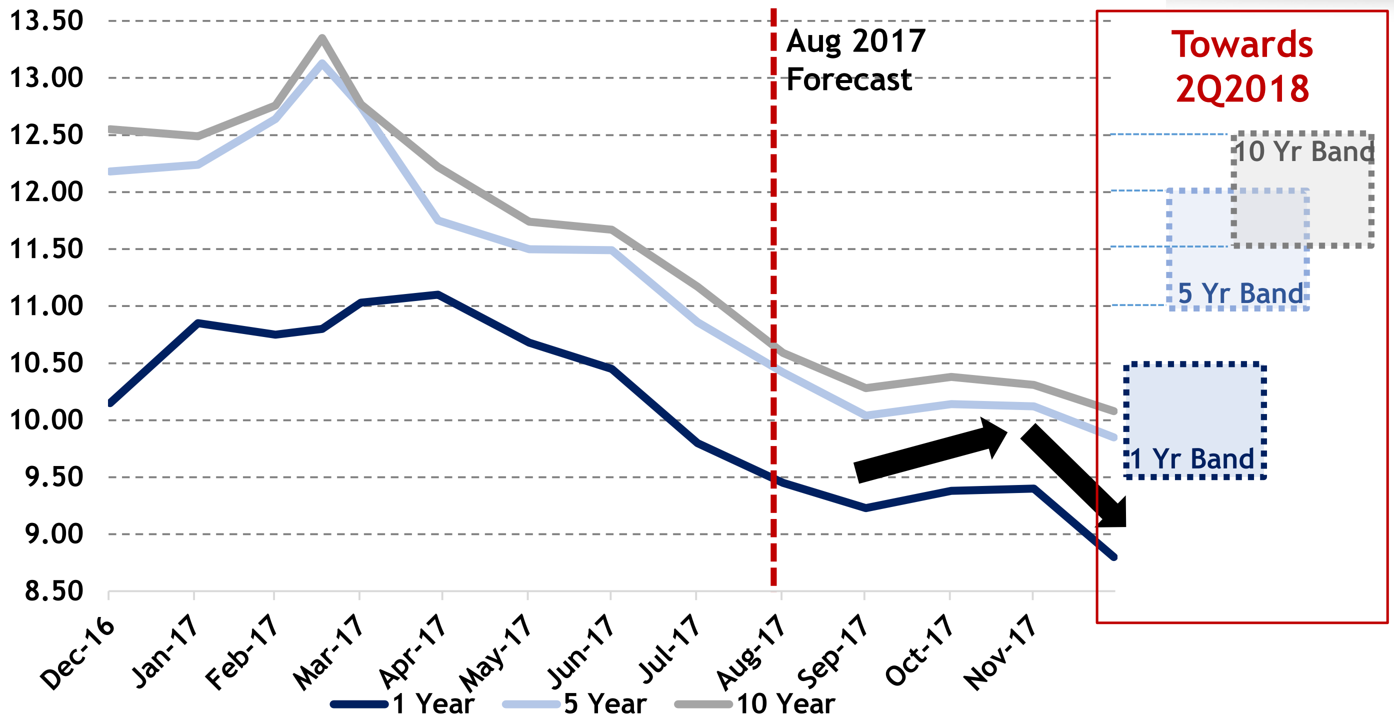
Table of Contents

Track Record [Aug 2017 & Jan 2018]

4

Section 1.0

Aug 2017 Re cap:
Glamorous 2H2017 with a cautious 1H2018



	3 Months Jul-Sep 2017	3-6 Months Oct-Dec 2017	6-9 Months Jan-Mar 2018	9-12 Months Apr-Jun 2018
Health Score Estimate	75-100	60-75	60-65	50-60
Risk Level Estimate	Remote	Medium-Low	Medium	Medium-High
Actual Risk Outcome	Remote	Remote		

AUG 2017 FORECAST FOR 12 MONTHS

- **First Capital Research : BEARISH towards 2Q2018**

Jul 2017 - Jun 2018	Probability
Interest Rates to be upward trending towards 2Q2018 and reaching upper bands	65%
Strong Foreign inflows stabilizing interest rates around the lower bands	35%

Review on Recommendation Aug 2017

Glamorous 2H achieved; Signs of bearishness reversed in Nov-Dec 2017

- Expectations of a glamorous 2H2017 was realized with a strong downtrend in yields with increased levels of Economic Health in 3Q2017.
- Despite some signs of economic health deterioration was expected towards end of 4Q2017, heavy net inflows amounting to almost USD 0.8Bn (Hambantota Port Deal, IMF 4th tranche and heavy inflows into Govt. Securities) in Dec 2017 reversed all signs of economic weakness further improving health and pushing yields down even further.

Lowering of target bands amidst reduced risk

- Previous Expectations for 2018 as at Aug 2017

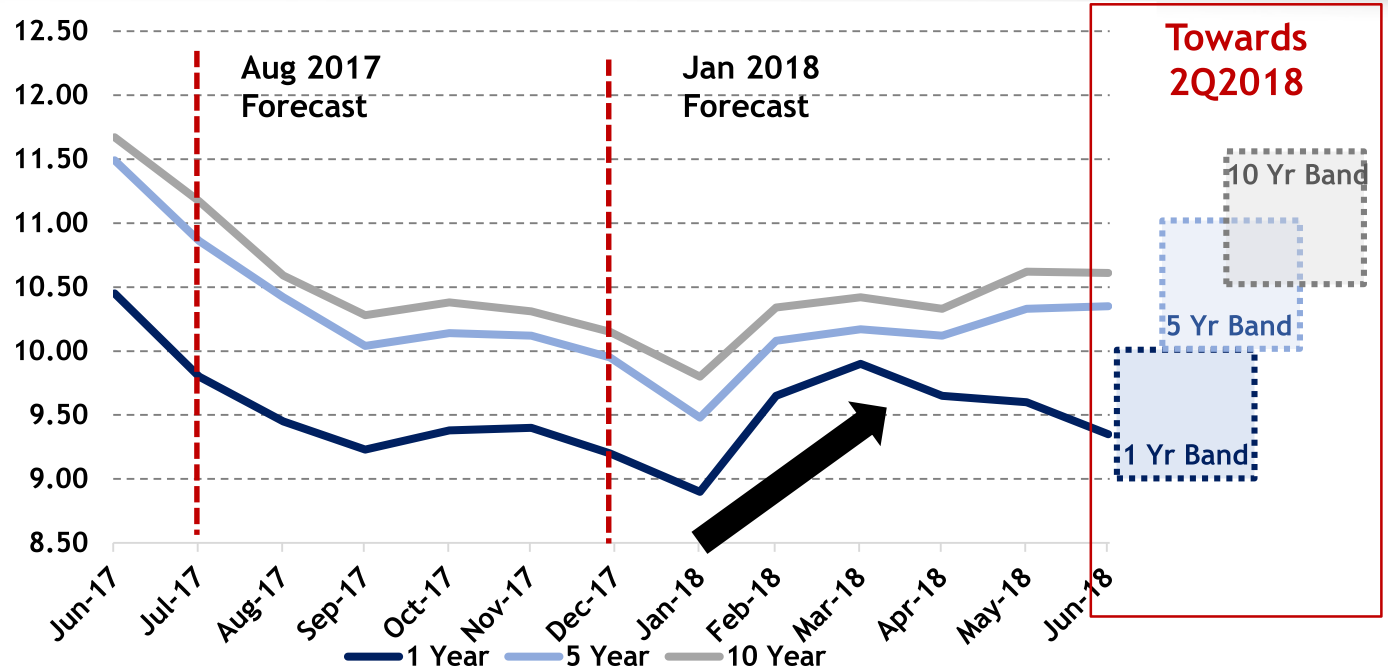
As at Aug 2017	1 Yr	5 Yr	10 Yr
2Q-3Q2018	9.5%-10.5%	11.0%-12.0%	11.5%-12.5%

- As at Jan 2018 with reduction in future risk resulting from improving macro-economic conditions we have revisited our expectations and have made 2 adjustments
    - Overall upward movement of the yield curve expectations have been brought down by 50bps
    - Amidst lower long term risk 1 Yr to 5Yr and 1Yr to 10Yr spreads have been reduced by 50bps
    - Thereby 1Yr expectations are reduced by 50bps while 5Yr and 10Yr expectations are reduced by 100bps

- New Expectations for 2018 as at Jan 2018

As at Jan 2018	1 Yr	5 Yr	10 Yr
2Q-3Q2018	9.0%-10.0%	10.0%-11.0%	10.5%-11.5%

Jan 2018 Re cap:
Tough Conditions, but Cautiously Optimistic 2018



	3 Months Jan-Mar 2018	3-6 Months Apr-Jun 2018	6-9 Months Jul-Sep 2018	9-12 Months Oct-Dec 2018
Health Score Estimate	65-75	65-75	60-65	65-75
Risk Level - Jan 2018	Medium-Low	Medium-Low	Medium	Medium-Low
Previous Expectations - Aug 2017	*Medium*	*Medium-High*		

JAN 2018 FORECAST

- **First Capital Research : BEARISH towards 2Q-3Q2018**

Jan 2018 - Dec 2018	Probability
Interest Rates to be upward trending towards 2Q-3Q2018 and reaching upper bands	65%
Breakaway from the continuous reform program (Deviations affecting IMF program) may result in the breaking the upper bands	35%

Review on Recommendation Jan 2018
Unexpected early spike in yields

- The unexpected local polls victory by the opposition resulted in an early surge in yields across the yield curve with low level of investor confidence.
- Following the USD 2.5Bn sovereign bond some stability was seen during Apr 2018
- However, business confidence dropped to a 70 month low in Apr 2018.
- With investors expecting a further rise in yields, most switched to short tenors resulting in a continuous dip in yields

Targeted shocks as at Jan 2018

- Coalition Government falls off
  - Sharp increase in political uncertainty — Partly Materialized
- Surge in oil prices
  - Economic Uncertainty increases — Partly Materialized
- Heavy increase in US treasury rates may push fund flows towards US
  - May lead foreign outflows — Partly Materialized

Factors to Consider for 2018-19

Section 2.0

Factors to make decisions

- Political Factors
  - PC Elections
  - Next Leader???
- Economic Factors
  - GDP Growth to improve
  - Stable Foreign Reserves
  - Low Inflation
  - Liquidity may improve beyond 3Q
  - Credit Growth to remain moderate
  - Government Borrowings Requirement remain high
- External Factors
  - Better Global Growth Prospects
  - Fund outflows from emerging markets

Political Uncertainty may continue beyond 2018: *Negative*

11

Section 3.0

Political Uncertainty to continue affecting investor confidence

- Provincial Council Elections (6 Councils)
  - Elections Commissioner has not yet called for nominations
  - Sabaragamuwa, North Central and Eastern PC expired in 2017
  - Central, North Western and Northern PCs terms will expire in Oct 2018
  - Southern, Western and Uva PCs terms will expire on Apr.10, 21 and Oct.8 in 2019

- Next Leader???
  - All 3 major political parties silent on the issue?
  - No obvious candidate for any of the parties!!!

Economic Outlook to slowly improve: Neutral

13

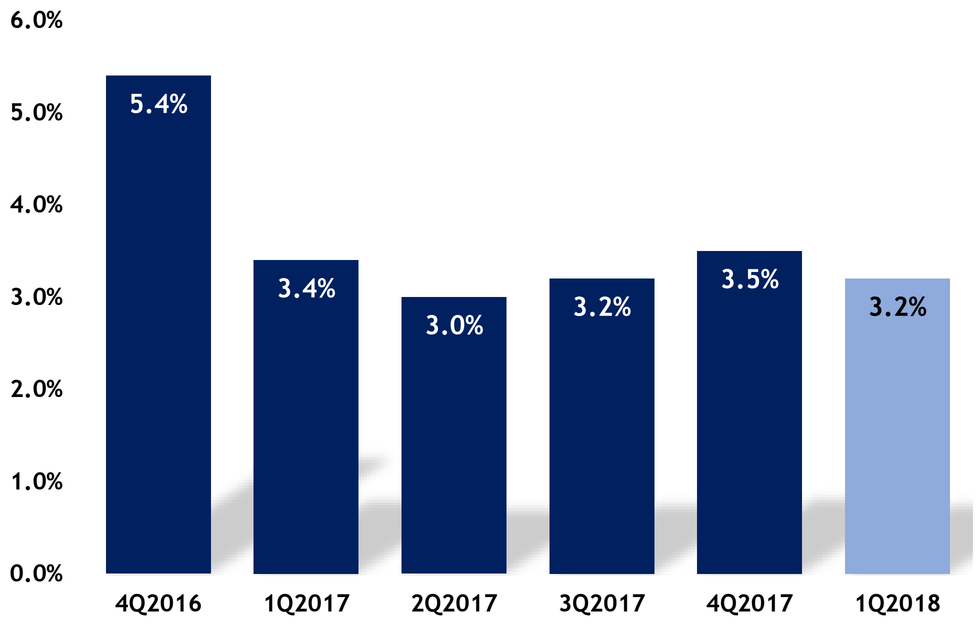
Section 4.0

GDP Growth Outlook 2018 & 2019

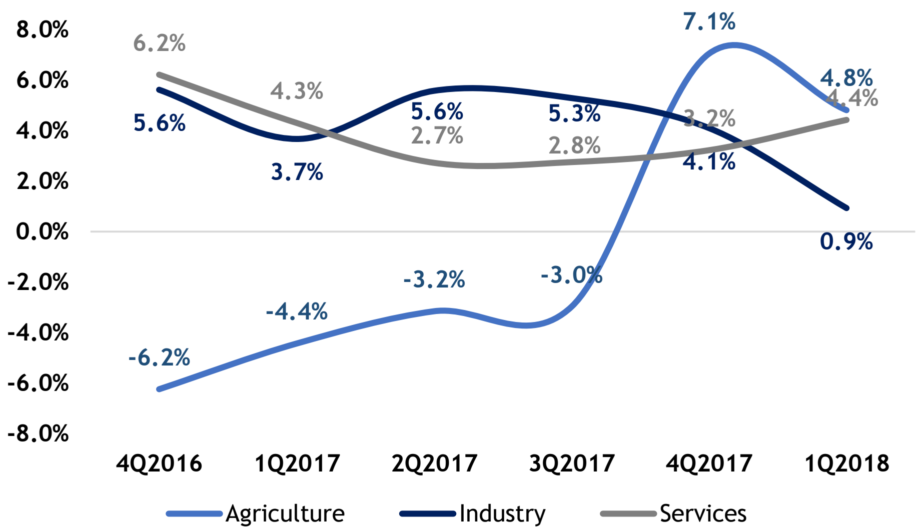
Section 4.1

1Q2018 growth continues to remain slow….

Agriculture and services segments saw relatively strong growth rates while the industrial sector suffered lower growth of a mere 0.9% in 1Q2018.



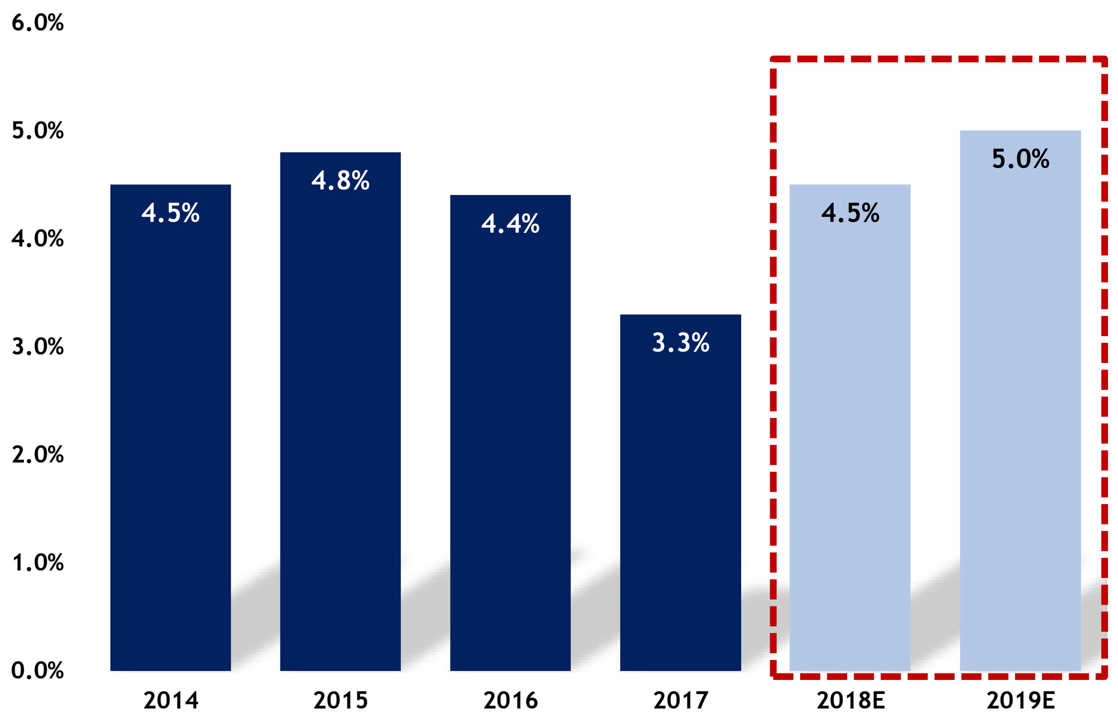
Source: CBSL



Source:

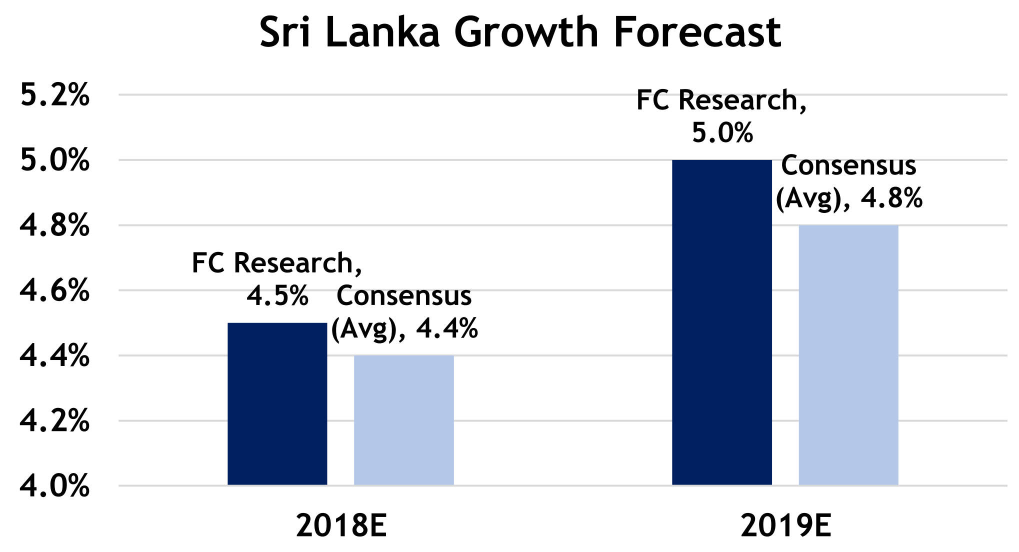
First Capital Research downgrades 2018E but remains positive on uptick in growth

First Capital Research 2018E forecast downgraded from 5.1% to 4.5% amidst lower than expected 1Q2018 GDP growth



Source: CBSL

SL GDP Growth Forecasts	2017	2018E	2019E
CBSL	3.3%	4.5%	5.5%
World Bank		4.8%	4.5%
IMF		4.0%	4.5%
ADB		4.2%	4.8%
Standard Chartered		4.5%	4.7%
Average		4.4%	4.8%



Economy slow to recover

GDP Growth:

2018E - 4.5% (downgraded from 5.1%), 2019E - 5.0%

- *GDP growth 2018E to be 4.5% with 2Q likely to be slow similar to 1Q:* 1Q continued to be slow with growth of only 3.2%. Similarly 2Q is also likely to be slow amidst business confidence levels falling to a 70 month low. However, we expect a gradual pickup in business activity and consumer demand during 2H2018 with an acceleration in GDP growth towards 4Q2018.

- *GDP growth 2019E to rise to 5.0%:* Stronger macro fundamentals, higher investments and pickup in consumer demand is likely increase growth in 2019E to 5.0%. Potential election in 2019E may also push authorities accelerate relaxation of para tariffs which may also support stronger consumer demand.

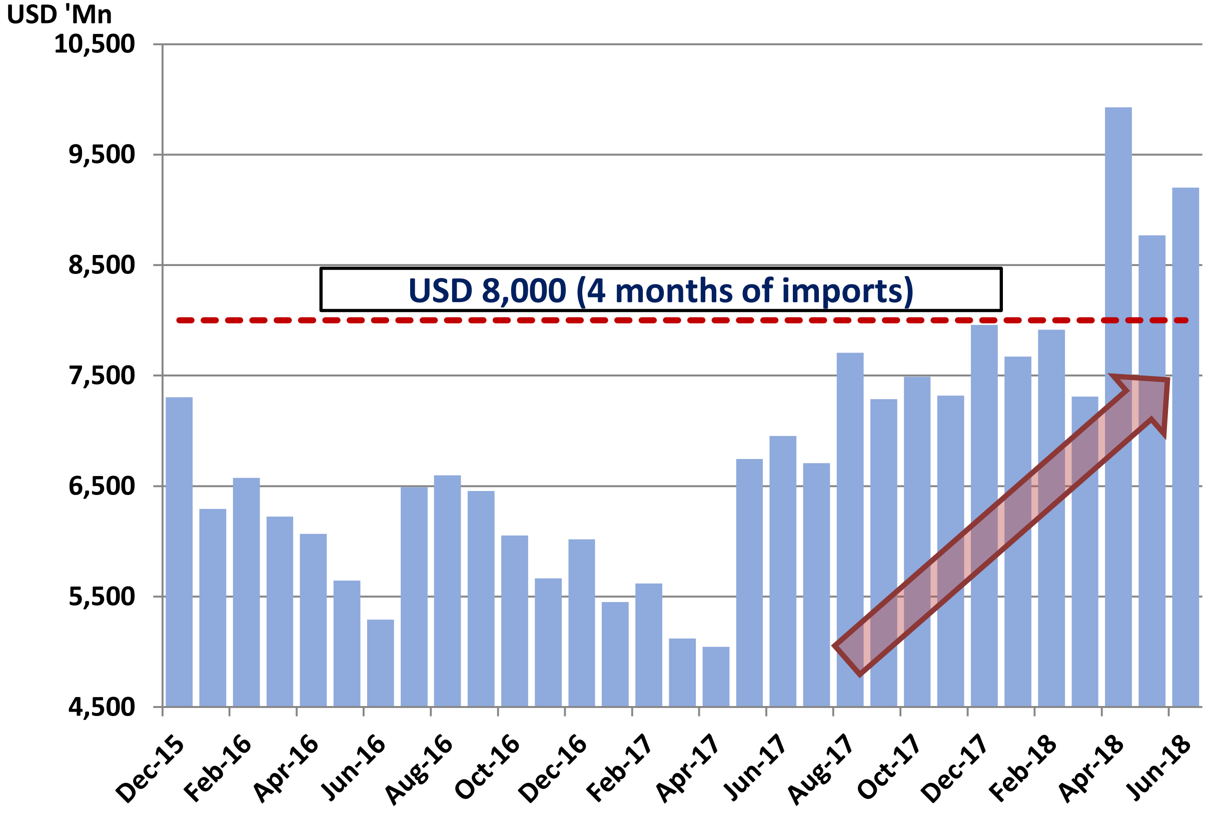
Outlook of Economic Indicators for 2018

Section 4.2

Foreign Reserves jumps back up, but so does imports

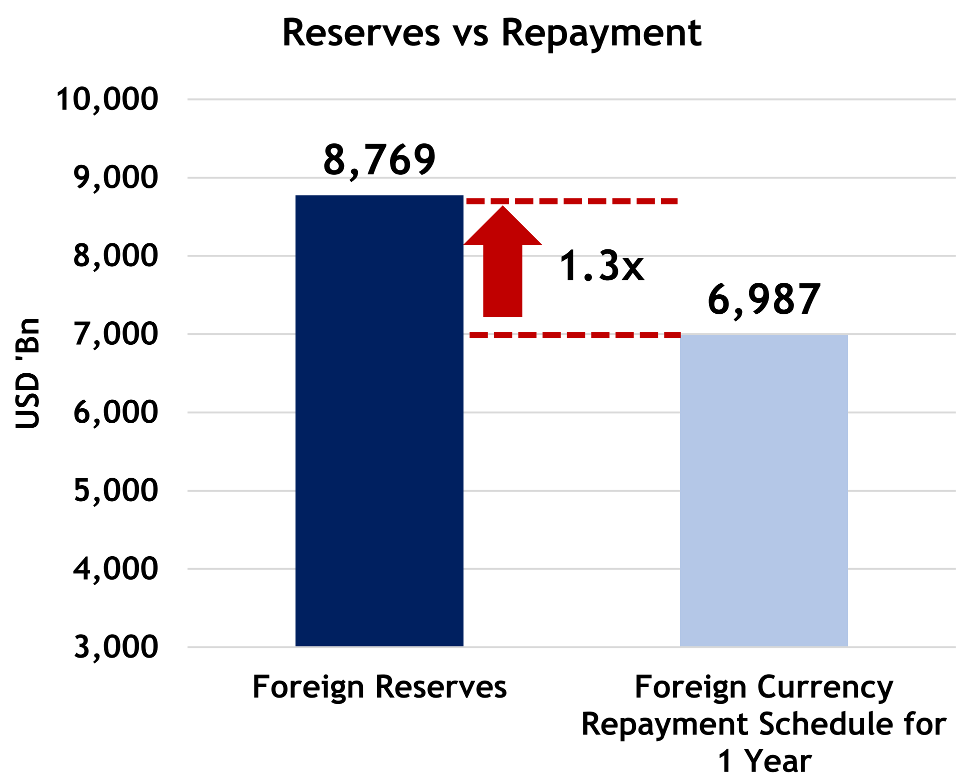
- *The USD 2.5Bn Sovereign Bond has resulted in jump in reserves. Despite large outflows final payment of Hambantota Port deal of USD 0.5Bn and syndicated loan of USD 1.0Bn is likely to assist reserves to remain above USD 9.0Bn.*
- *However, growing imports have resulted in an increase in the minimum amount of reserves required (4 months of imports) to USD 8.0Bn*

Further foreign reserve accumulation need to continue amidst the continuous rise in foreign debt payments (large sovereign bond repayment 1Q & 2Q 2019) & BoT deficit

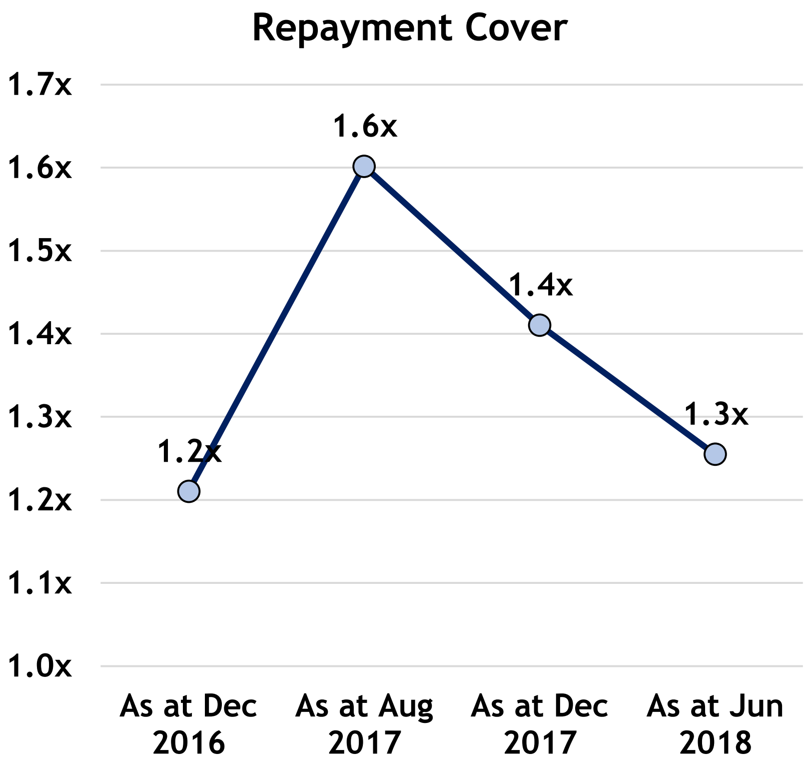


Source: CBSL

Rise in Foreign Reserves has further lowered the foreign currency debt repayment cover to 1.3x of Foreign Reserves



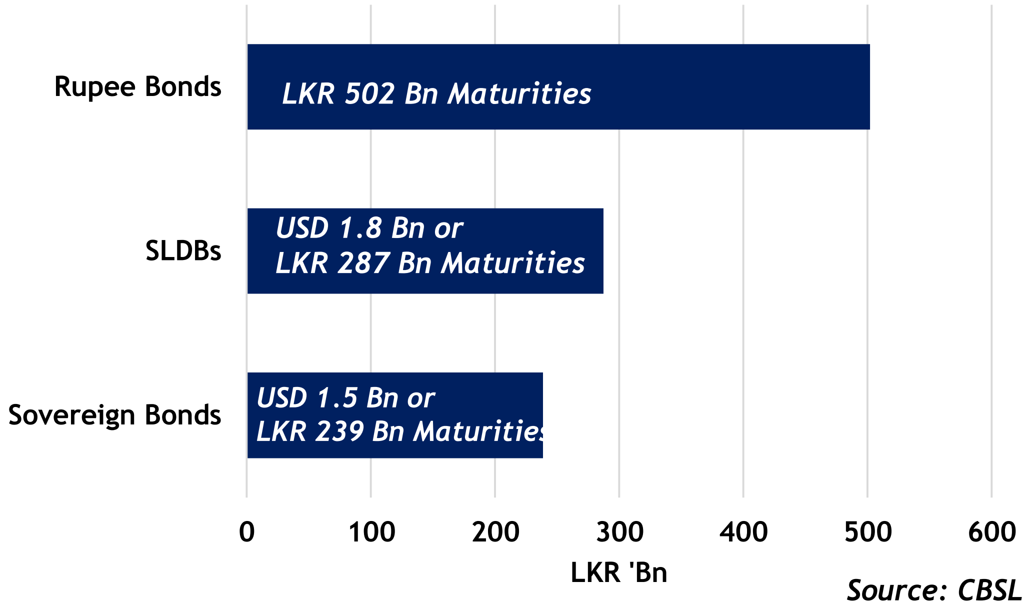
Source: CBSL



- The strengthening of reserves have improved the foreign currency repayment cover at a time, when the next 12 months is having the highest level of foreign debt payments before overall debt levels start to ease off.

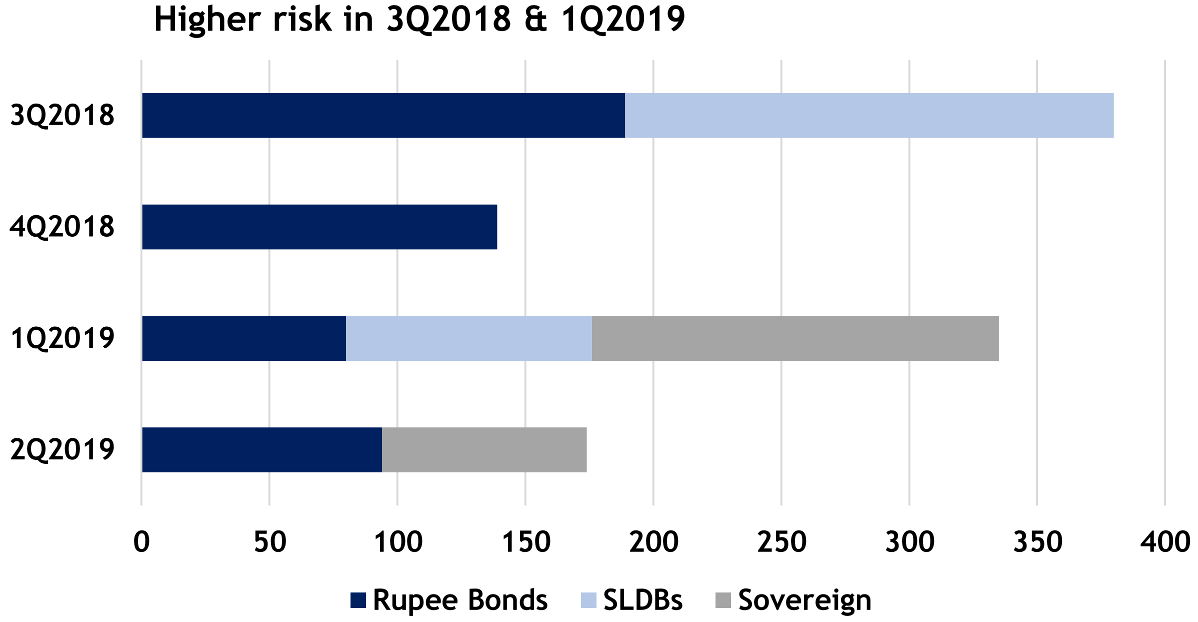
High level of maturities coming up in 3Q2018 & 1Q2019

Next 12 Months (as at 30-Jun-2018)



Source: CBSL

High maturities continue with debt payments bunching up in 3Q2018 & 1Q2019



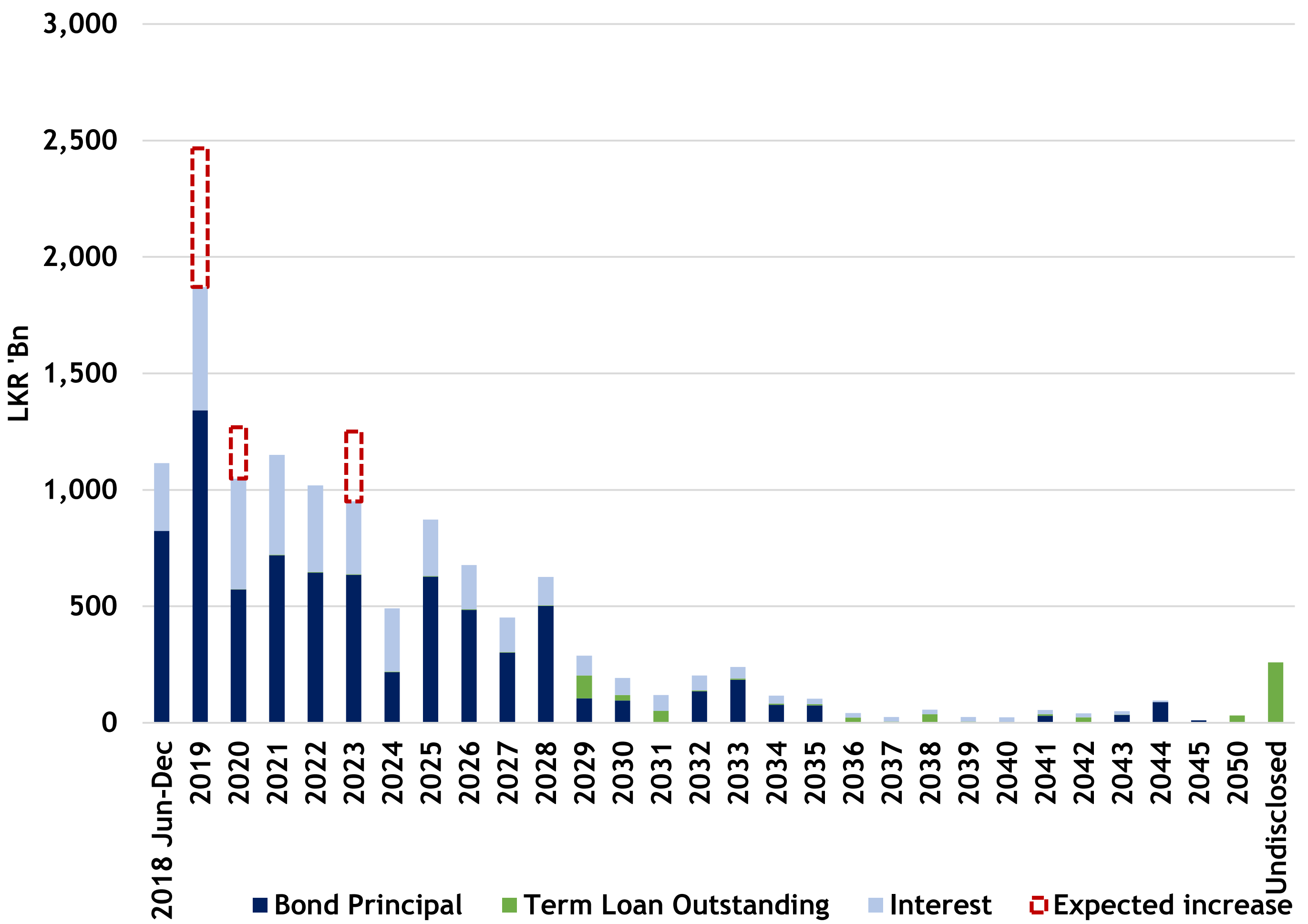
Beyond 1H2019 overall debt payments to ease off with less bunching off of debt while debt to GDP levels are likely to be on a downtrend

Sri Lanka's Current Debt Payments are as follows:

Date	Bond Principal* (LKR 'Bn)	Term Loan Outstanding (LKR 'Bn)	Interest (LKR 'Bn)	Expected increase with Bills and interest rollover	Short Term Rollover of Bills
2018 Jun-Dec	823.87	0.00	291.01		
2019	1,341.21	0.00	529.96	594.87	
2020	572.48	1.02	475.04	220.00	*Bills will get added Annually
2021	719.32	2.49	428.76		*Bills will get added Annually
2022	644.13	2.93	371.97		*Bills will get added Annually
2023	635.39	2.93	312.19	300.00	*Bills will get added Annually

*Includes Bills, Bonds, SLDBs and Sovereign Bonds

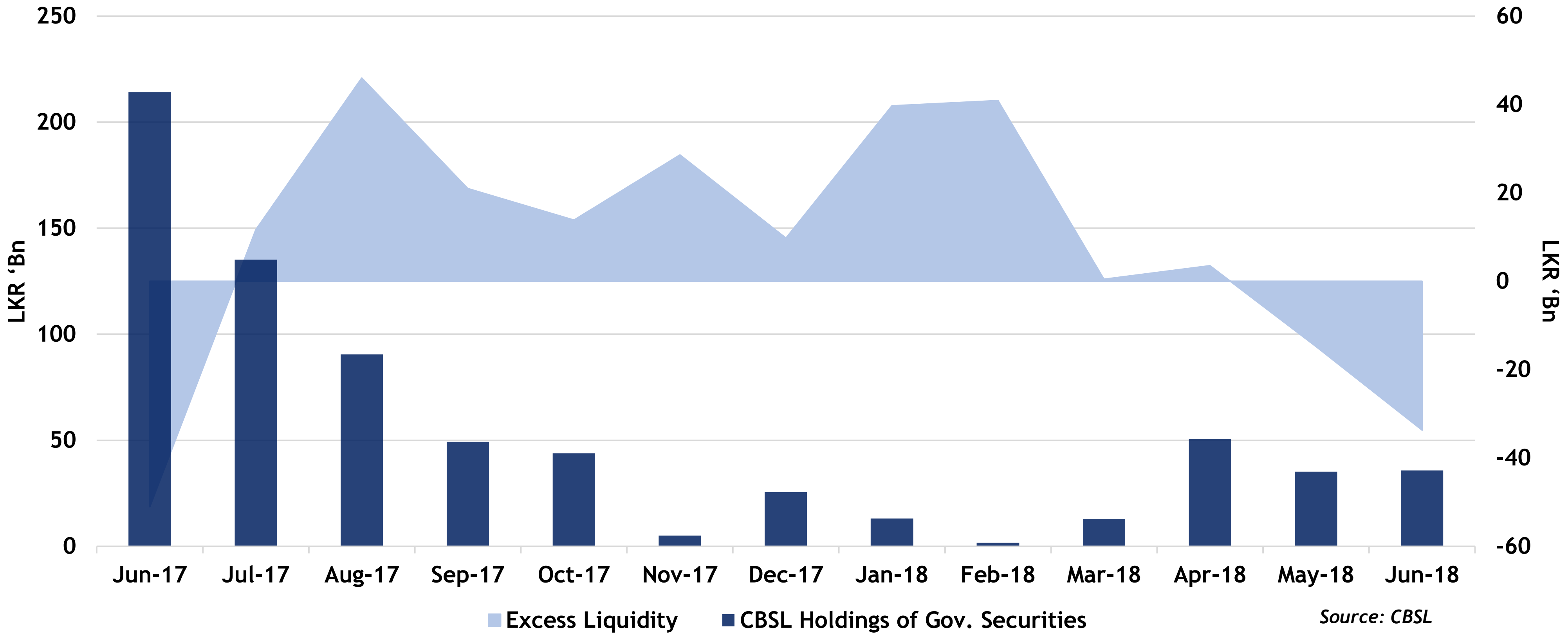
We expect Debt to GDP to reduce to 76.5% in 2018E while any SoE selloffs (such as Hyatt or Hilton) and PPPs for Mattala Airport works off the ratio is likely further dip below 76.0%.



Liquidity may improve towards 4Q, but is likely to remain tight during 1H2019 as well…

In line with expectations, we are experiencing a liquidity shortage towards 3Q

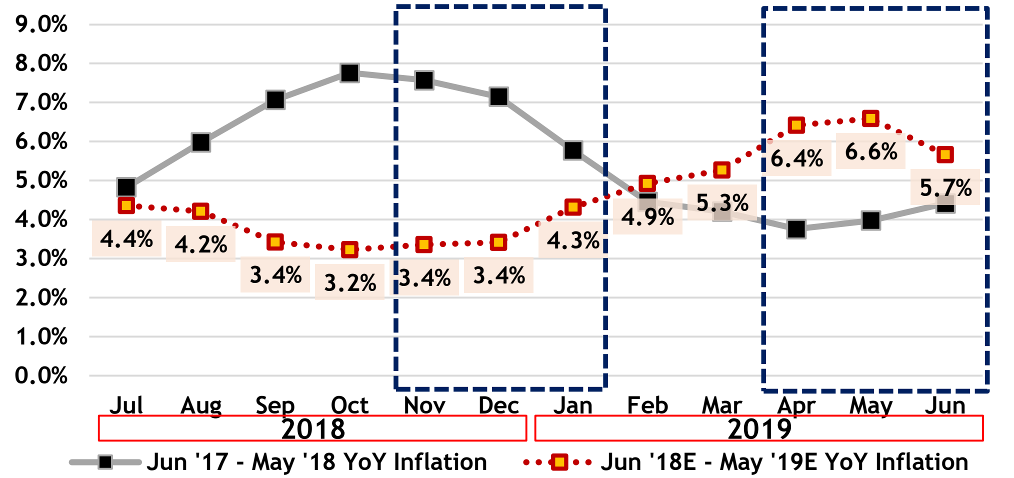
Expectations: We expect the shortage to continue and ease off towards 4Q2018, but low level of liquidity of LKR 20-50Bn is likely to be experienced during 1H2019

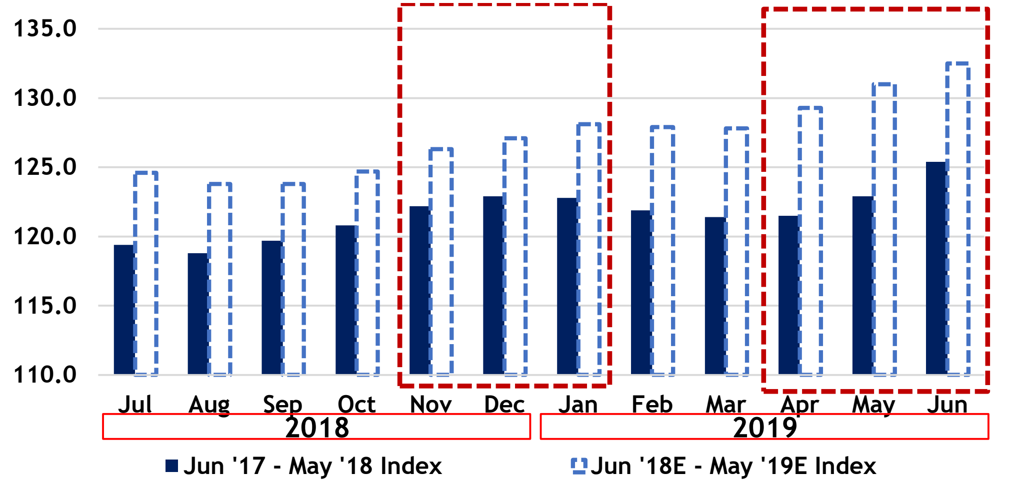


Source: CBSL

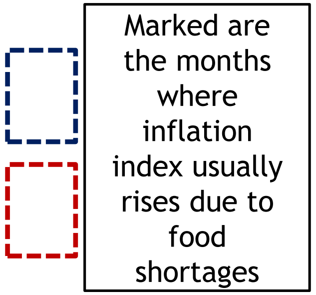
Higher base effect in 2017 may result in low point to point inflation in 2H2018

- *Point to point Inflation may illustrate a drastic reduction in the months from Oct 2018 – Jan 2019 due to higher base effect amidst heavy food shortages witnessed last year.*
- *Overall the index is expected to be between 3.2%-6.6% during the next 12 months*
- *The average annual rate for 2018E is likely to be 4.0% while its expected to increase to 5.3% in 2019E*



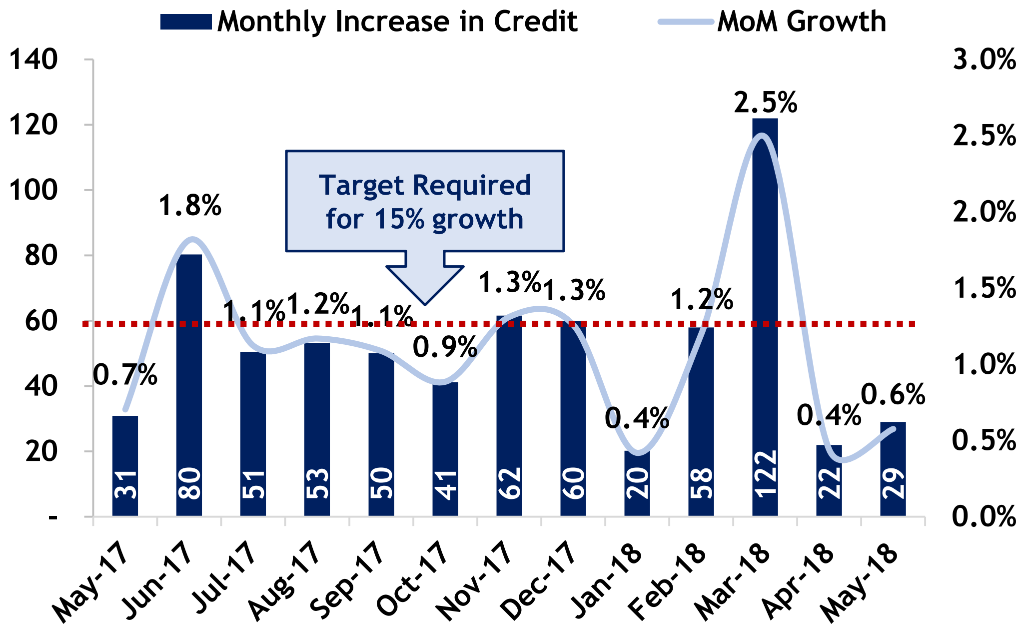


Source: Dept. Census and Statistics



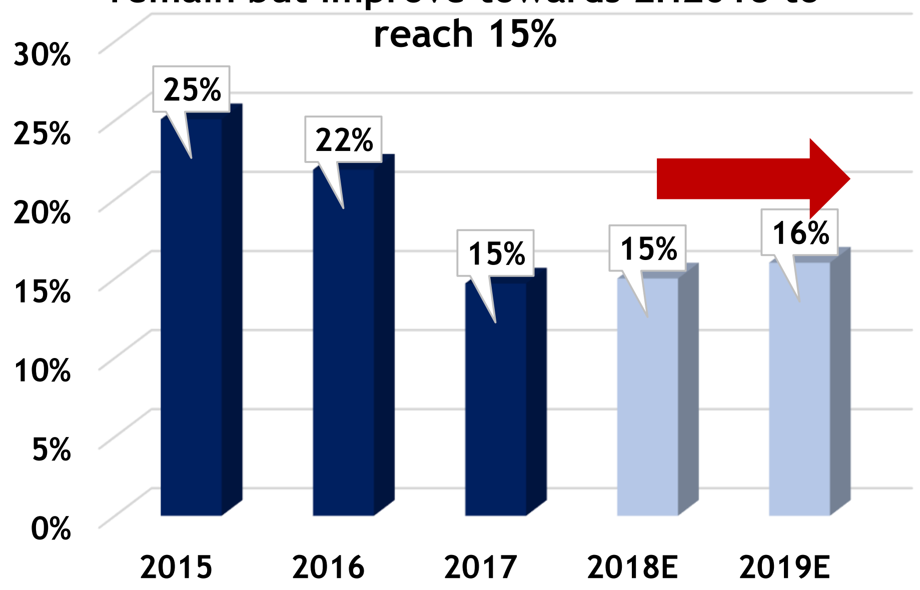
First Capital Research expects Private sector credit growth pickup towards 2H2018 signifying a steady growth of 15%

Private sector credit growth may marginally pick up in 2H2018 while 2019E is expected to record a moderate growth of 16%.



Source: CBSL

Private Sector Credit Growth is likely to remain but improve towards 2H2018 to reach 15%



Source: CBSL

External Environment : Neutral

Section 5.0

Global Growth further revised upwards

- Global growth indicators have been consistently providing positive feedback resulting in IMF continuously upgrading its global growth forecasts for 2018. In Jan 2018 it has been further upgraded to 3.9% for both years 2018 & 2019. Upgrades are driven by improved US growth and surprises in growth in Europe and Asia.

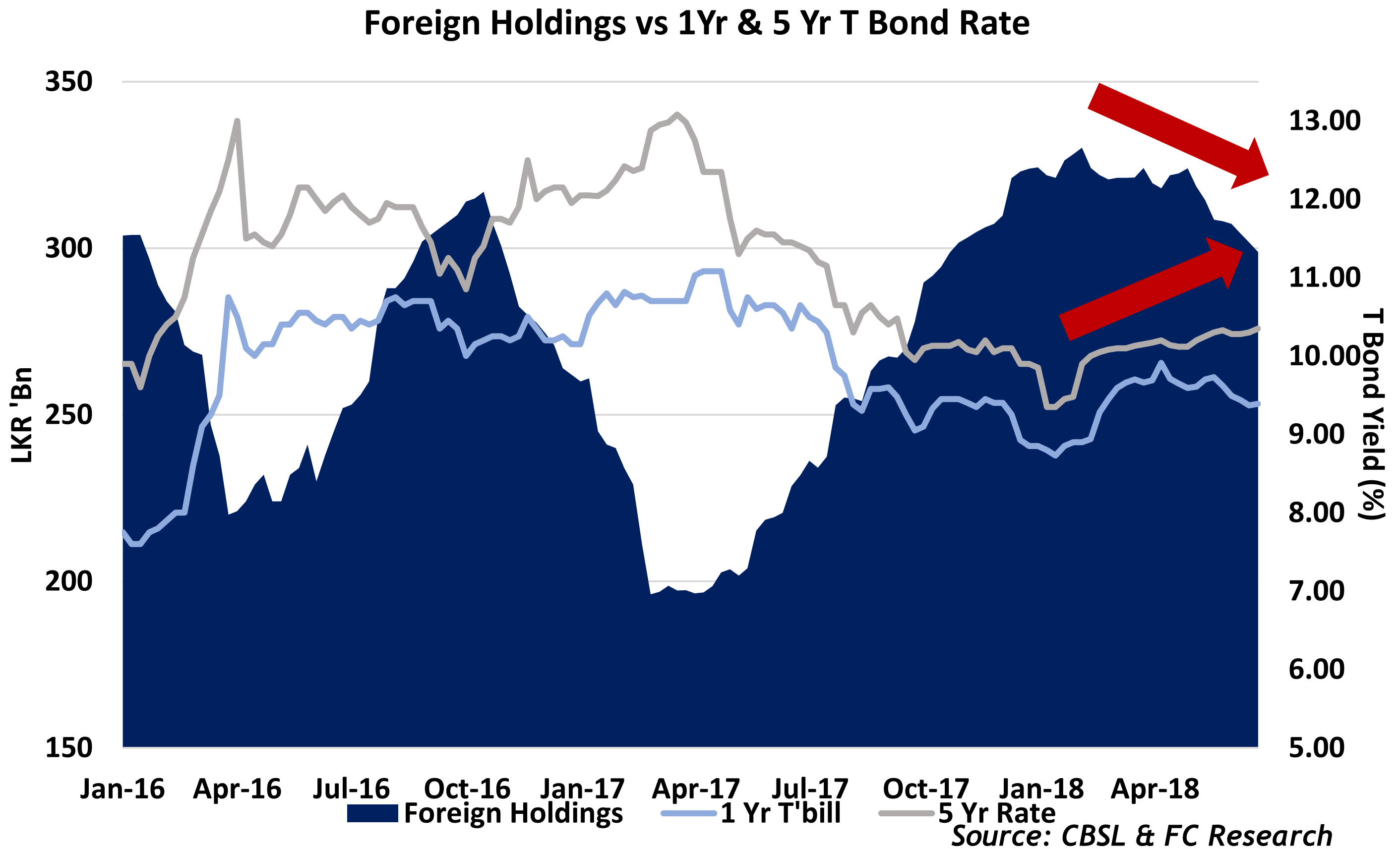
- Growth rates for many of the euro area economies have been marked up, especially for Germany, Italy, and the Netherlands, reflecting the stronger momentum in domestic demand and higher external demand. Its positive with Sri Lanka regaining GSP+ and export growth momentum picking up over the last few months.

- Emerging and developing Asia will grow strongly at around 6.5% over 2018–19, broadly at the same pace as in 2017.

Further 4 Fed rate hikes may increase fund flows towards US, but there are positives in the SL economy as well….NEUTRAL OUTLOOK

- Global Growth outlook improves while outlook for South Asia led by India Growth continues to remain strong - Positive
- Higher growth across the world is likely to create significant competition for capital and investments - Negative
- Despite rising global yields the improving macro conditions neutralizes the overall outlook for Sri Lanka unless reform agenda is reversed

External Outlook: Neutral



Source: CBSL & FC Research

What does the indicators say for investments?

- Political Outlook : Negative
  - ❑ Political Uncertainty to continue affecting investor confidence
- Economic Outlook : Neutral
  - ❑ Strengthening Foreign Reserves, improving economic conditions & possible Equity inflows to support High Foreign Debt payments, High bond maturities. Inflation and credit to be under control despite some liquidity shortages during 3Q2018 and 1Q2019
- External Outlook: Neutral
  - ❑ Though strengthening global growth and our key market's positive rising global interest rates led by Fed rate hikes carry some risks to continue SL's reform program.

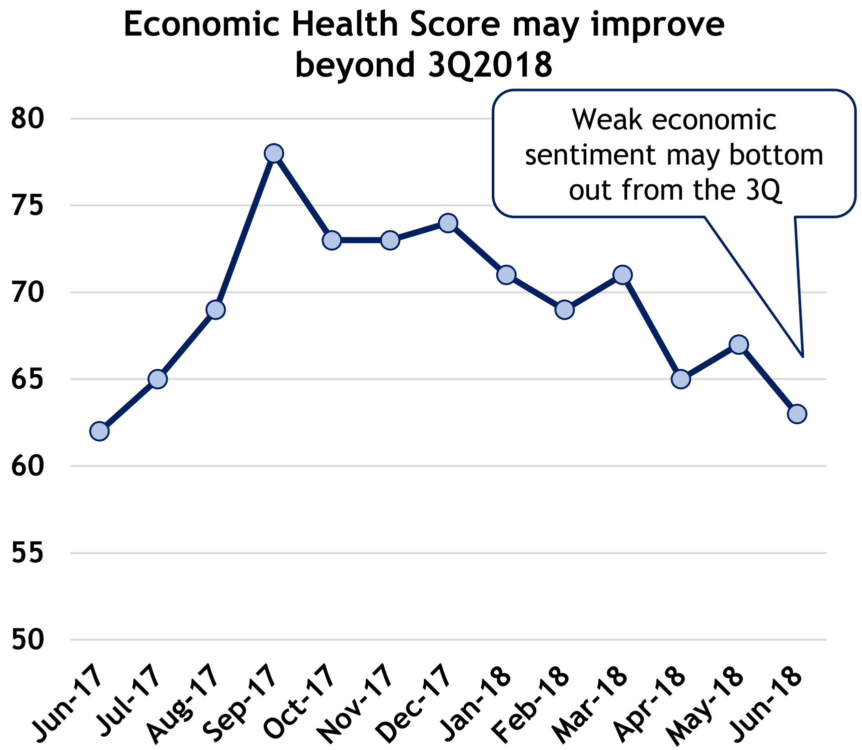
Overall Outlook : Neutral

Political outlook offsets Economic and External improvements

Time Period	Political	Economical	External
Dec 2016	Negative	Negative	Neutral
Aug 2017	Negative	Neutral	Neutral
Jan 2018	Negative	Neutral	Neutral
Jun 2018	Negative	Neutral	Neutral

Economic Health Expectations

	3 Months Outlook Jul-Sep 2018	3-6 Months Outlook Oct-Dec 2018	6-9 Months Outlook Jan-Mar 2019	9-12 Months Outlook Apr-Jun 2019
Health Score Estimate	**60-65**	**65-75**	**60-65**	**65-75**
Risk Level - Jun 2018	**Medium**	**Medium-Low**	**Medium**	**Medium-Low**
Previous Expectations - Jan 2018	***Medium***	***Medium-Low***		



Recommendations

32

Section 6.0

First Capital Research View on Bond Market 2018-19

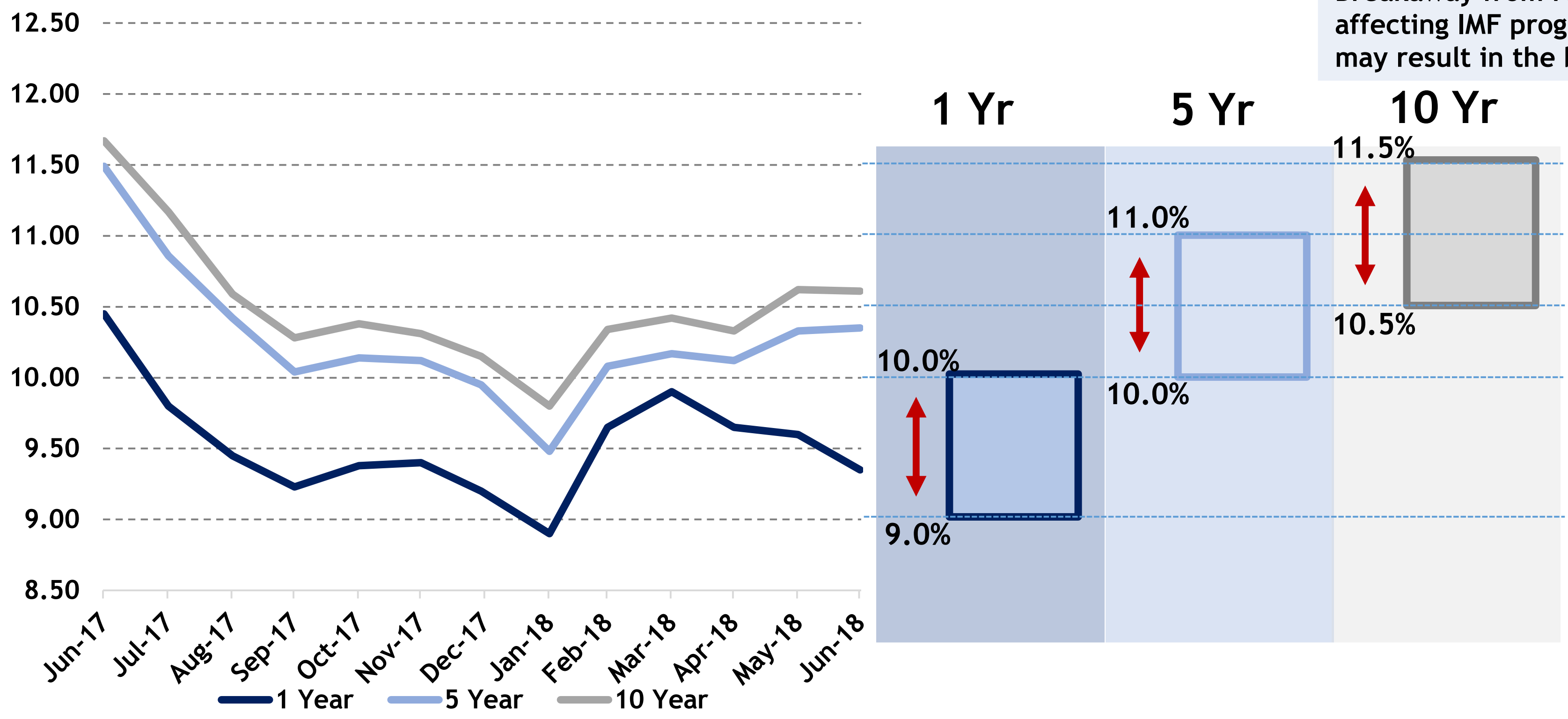
Section 6.1

33

Bond Rates to peak in 3Q2018 and gradually ease (12 months)

Jul 2018 - Jun 2019	Probability	Impact
Bond Rates to peak in 3Q2018 and gradually ease	65%	Moderately Bullish / Stable
Breakaway from reform program (Deviations affecting IMF program) or political deadlock may result in the breaking the upper bands	35%	Bearish

Expectations: Moderately Bullish beyond 3Q2018



Base Case (65% Probability) - Explanation

With higher borrowing requirement resulting in tight monetary conditions and increase in inflation could push the yield curve towards the upper bands. It could result in an increase in CBSL Holdings as well to manage interest rates.

Pressure could ease somewhat in 4Q2018, but will be short lived as debt payments continue to be high in 1Q & 2Q in 2019 with the maturity of the Sovereign Bonds

Policy Rate Expectations

On a base case First Capital Research expects a policy rates to remain stable throughout 2018. However, if GDP growth fails to pickup we expect policy rates to be cut by 25 basis points towards end of 3Q2018

First Capital Research View on Banking Rates 2018-19

Section 6.2

Banking Rates to be stable within a 100bps band

- Banking Rates are usually reflective of the bond rates with a 6 month lag. AWPLR has a 6 month lag effect for the 5 year bond.

1H2018 Review & next 12 Month Expectations:

- 5 Year Bond bottomed out in mid-January 2018 at about 9.4% thereby AWPLR is likely to further decline during Jul-Aug 2018 while it is expected to rise to 10.4% towards the end of the year. Despite the marginal rise towards 2H2019E AWPLR is expected to dip again to 10.0%
- In a more broader sense during the next 12 months (Jul 2018-Jun 2019), we expect AWPLR to broadly stay within the band of 10.0% - 11.0%.

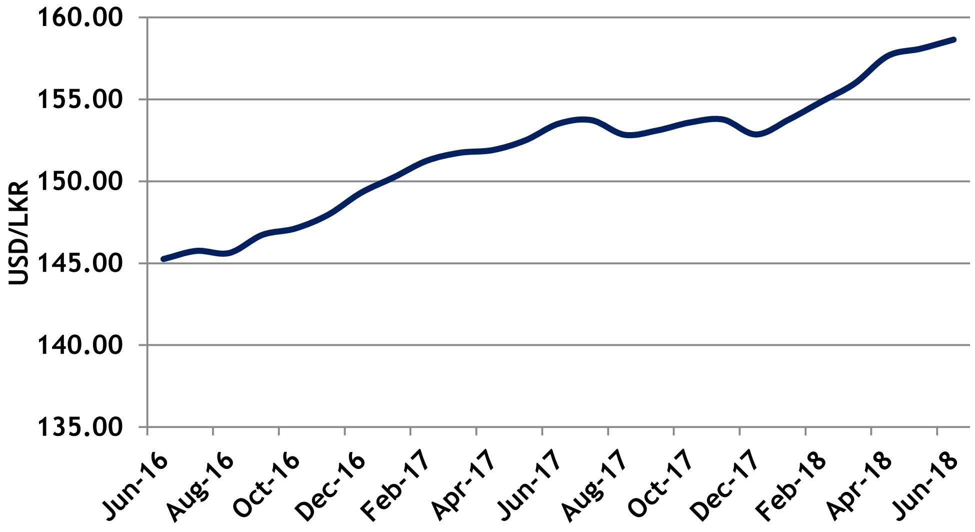
Base Case	2Q2017	4Q2017	2Q2018	4Q2018E	2Q2019E
5Y T-Bond	Actual 11.6%	Actual 10.0%	Actual 10.4%	**Expected 10.0%**	
AWPLR		Actual 11.6%	Actual 10.9%	Expected 10.4%	**Expected 10.0%**

First Capital Research View on Exchange Rate 2018-19

Section 6.3

2018E Exchange Rate target downgraded to LKR161.0 while 2Q2019E is likely to reach 164.5

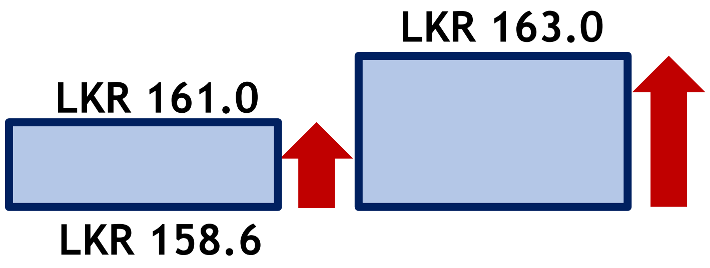
2018 Review:
Dollar index which was expected to be weak started strengthening over the last few months with fed rate hikes and Trump's tax cuts falling far short of expectations. Dollar appreciation coupled with foreign outflows from both capital market in Sri Lanka resulted in a weaker rupee showcasing a depreciation of 3.3% YTD



Source: CBSL

2018 Outlook Base Case:

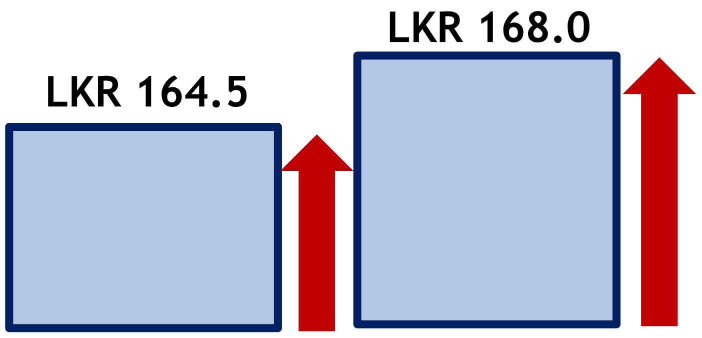
Dollar index is expected to remain strong over the next 12 months while with continued reforms inflows into Sri Lanka debt and equity capital markets are likely with the attractive yields. Further Sri Lanka moves into the peak season of exports Sep-Mar. We expect more stability in the rupee in 2H2018, but downgrade our target to LKR161.



Bullish Case	Bearish Case
65% Probability	35% Probability

12 Months Outlook Base Case (Jun 2019):

With further 4 fed rate hikes on the cards, we expect the dollar to remain strong. However, we expect inflows to Sri Lanka to be stronger than 2018 which may counter part of the dollar strengthening resulting in USD:LKR targeted at LKR164.5:1USD



Bullish Case	Bearish Case
65% Probability	35% Probability

First Capital Research View on Equity Market 2018-19

Section 6.4

Equity Market Investments: BULLISH

ASPI to touch 7000 in 2018E

- ***Market earnings 5-7%:***
  - Market earnings are continuing to remain strong during the Dec 2017 & Mar 2018 quarters indicating a recovery in business activity. We continue to maintain our target Earnings growth for CY2018E/FY19E of 5%-7% while improving to 10%-12% in CY2019E / FY20E.
- ***Market Returns of 13%:***
  - Despite slower earnings, overall market is likely to re-rate due to current lower valuations, possibly showcasing ASPI target of 7,000 or a market return of 13% while targeting further market return of 15% with a ASPI target of 8,000 as earnings start to accelerate supported by stronger consumer demand.
- ***Key Sectors:***
  - Banking Sector / Food, Beverage and Tobacco Sector / Material Sector.
- ***First Capital Top Recommendations:***
  - We expect First Capital top recommendations portfolio to achieve a capital gain return of 43% as against the market return of 13% while dividend yield is likely to be around 3-4%.

First Capital Research View on Business Confidence and Consumer Demand 2018-19

Section 6.5

Business Confidence & Consumer Demand Expectations: Normalize in 2H2018

- With stable interest rates and low inflation, we expect the stability of the economy to further improve during 2018.
- The stable environment is expected to slowly improve business confidence and consumer demand towards 2H2018. We believe business confidence and consumer demand are currently below average and they are expected to normalize during the period.
- However, the prevailing policy uncertainty created through the political uncertainty is a major deterrent which may slow down the gradual improvement.

Key shocks to increase weakness

Section 7.0

Key Shocks to look out for in 2018-19

- Further defeats in PC Elections or Coalition Government falls off
  - Further increase in political uncertainty
- Surge in oil prices or falling off of IMF agreement
  - Economic Uncertainty increases
- Heavy increase in US treasury rates may push fund flows towards US or weak SL policies leading to foreign outflows
  - May lead foreign outflows

Fundamentals strengthening, Growth remains key

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.

- 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.

- 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.

- 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.

- 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

Dimantha Mathew	+94 11 2639 853		
Atchuthan Srirangan	+94 11 2639 863	Amanda Lokugamage	+94 11 2639 868
Nisansala Kuruppumudali	+94 11 2639 866		