First Capital
First Capital Research
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Strategy Report 2018

Jan 2018

SRI LANKA

Tough Conditions, but Cautiously Optimistic 2018

ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON SLIDE 45

Tough Conditions but cautiously optimistic

Executive Summary

Bond Market

- We expect the yield curve in Government securities to have upward pressure in 2Q & 3Q in 2018, but First Capital Research has reduced the expected peaks in bond rates (1Yr, 5Yr & 10Yr) amidst the sharp rise in the health of the economic indicators towards 4Q2017. We expect the yield curve to marginally ease off again towards the 4Q2018, but not too much considering 1Q & 2Q 2019 maturities including maturities of 2 sovereign bonds

Banking Rates

- Banking rates which has a 6 month lag effect to Government securities are likely experience a dip in deposit and lending rates during the 1Q2018 while maintaining less volatile movements for the rest of the year with only marginal movements.

Exchange Rate

- With further depreciation in the Dollar expected against global currencies and higher level of foreign inflows including FDIs our base case (65%) is slightly bullish with depreciation expected at only 2% at LKR 156 : 1 USD.

Equity Market

- We expect Market returns to be slow but generate returns of 10%-12%, above the expected earnings performance as some counters are likely to re-rate with expected better earnings outlook in the future. ASPI index is expected to reach 7000 (+10% or +650 points) towards end of 2018. Market returns are likely to accelerate towards the 2019 to reach 8000 level (+15% or +1000 points) with the actual earnings performance and renewed investor confidence. These targets however are highly dependent on the current stable outlook and reform agenda continuing during 2018 as well.

Business Confidence & Consumer Demand

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

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Track Record [Dec 2016 & Aug 2017]

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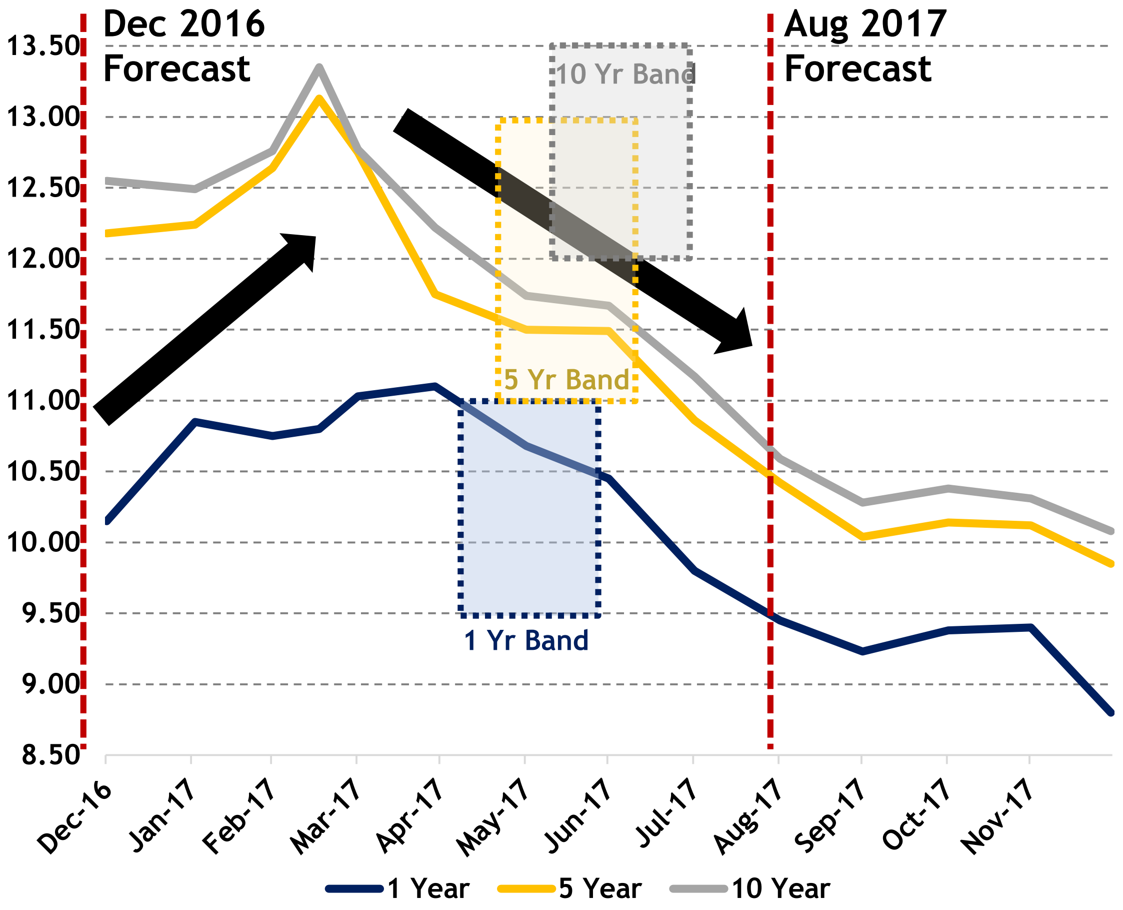
Section 1.0

Dec 2016 Re cap:
Uncertainty provides volatility; Hope in 2H2017



DEC 2016 FORECAST

- **First Capital Research : BEARISH on 1H2017**

Jan - Jul 2017	Probability
Interest Rates to be volatile within 150-200bps strip but will not break upper bands until uncertainty ends	65%
Macro Economic Conditions further worsens, upper band targets of the bonds will break	35%

- **First Capital Research : BULLISH on 2H2017**

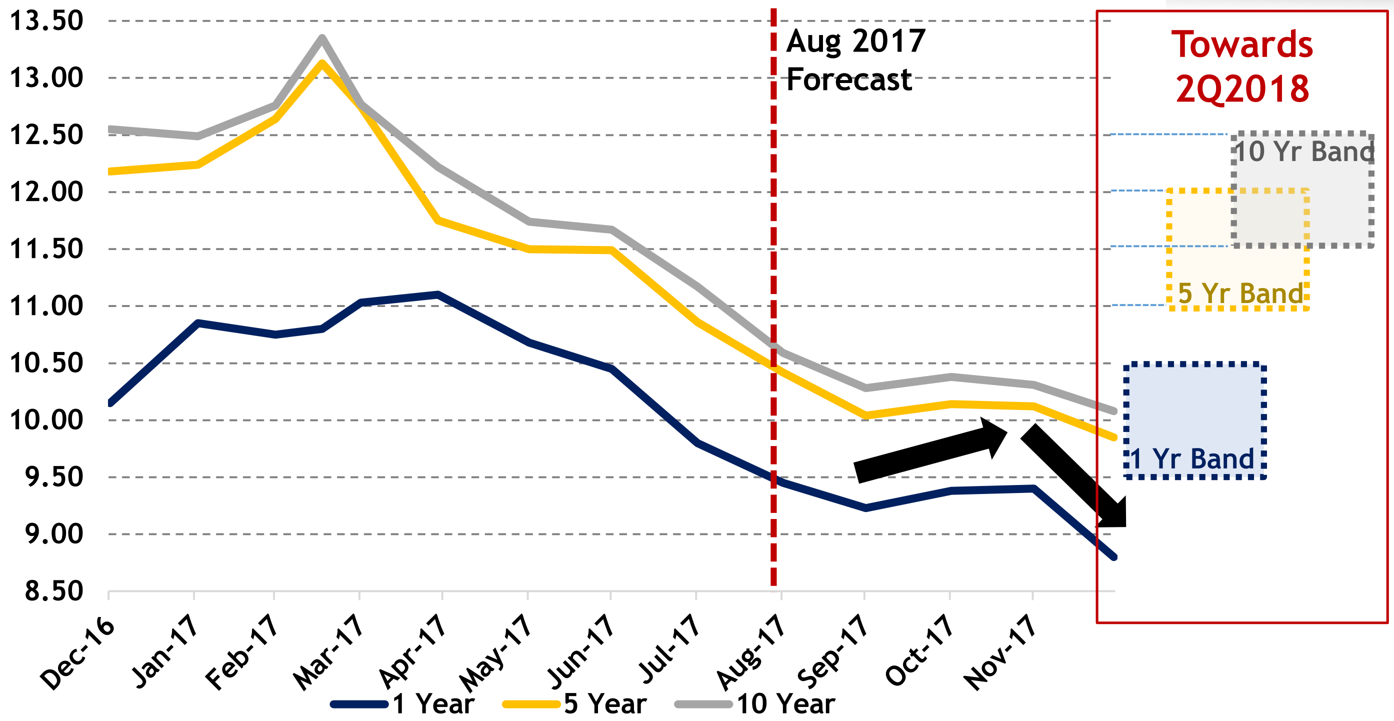
BY END 2017	Probability
Interest Rates to decline and hit the lower bands (1 Yr - 9.5%, 5 Yr - 11.0%, 10 Yr - 12.0%	65%
Macro Economic Conditions further worsens in 1H2017, end 2017 rates will remain same as current rates (1 Yr - 10.0%, 5 Yr - 12.0%, 10 Yr - 12.6%)	35%

Review on Recommendation Dec 2016

12 Month cycle completed in 8 months

- The upward and downward cycle for interest rates predicted to take place over 12 month period was achieved in a 8 month period thanks to the accurate timing of the USD 1.5 Bn sovereign bond.
- Though the 1st half 2017 was worse than we expected the rightful timing of the sovereign bond prevented the macro economic conditions from getting worse.
- The renewed foreign buying interest into equity and bonds also supported to cushion the weak period of the economy which was primarily from Feb - Apr 2017.
- The continued economic reforms program managed to improve investor confidence signified by healthy rates achieved for the sovereign bond and renewed foreign buying into fixed income and equity

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.

Factors to Consider for 2018

Section 2.0

Factors to make decisions

- Political Factors
  - Local Government Elections
  - PC Elections
- Economic Factors
  - GDP Growth to improve
  - Stable Foreign Reserves
  - Controlled Inflation
  - Tightly managed Liquidity
  - Slow rise in Credit Growth
  - Rise in Government Borrowings Requirement
- External Factors
  - Better Global Growth Prospects
  - Fund outflows from emerging markets

Political Uncertainty may clear out beyond Feb 2018: *Neutral*

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Section 3.0

Political Uncertainty to partially clear out beyond Feb 2018

- Local Government Elections
    - First election under the new electoral system is likely to be held on 10th February 2018 beyond which we believe that the uncertain political outlook may clear out
- Provincial Council Elections (3 Councils)
    - Elections Commissioner has not yet called for nominations

Economic Outlook to slowly improve: Neutral

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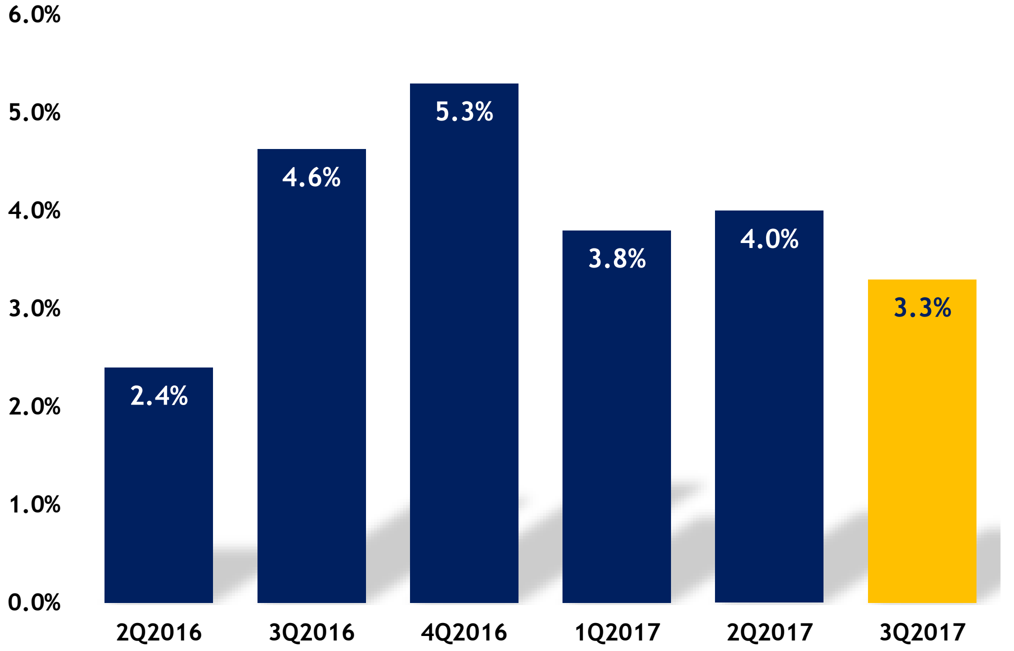
Section 4.0

GDP Growth Outlook 2018 & 2019

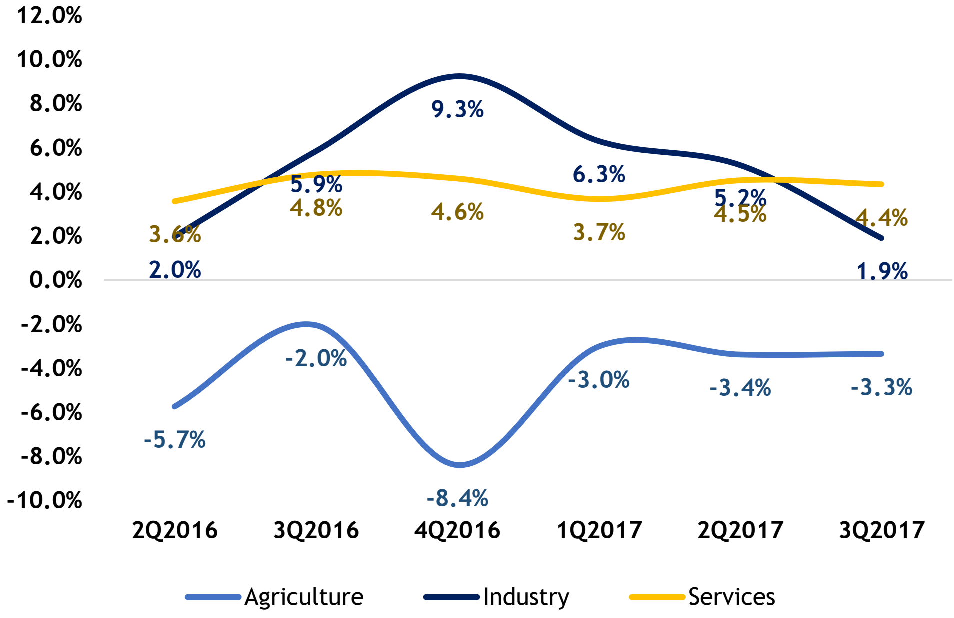
Section 4.1

Natural disasters & monetary tightening was a double blow in 2017….

Agriculture Segment severely affected by natural disasters while overall economy slowed down with lower consumer demand led by monetary tightening and 1st half experiencing lower level of exports



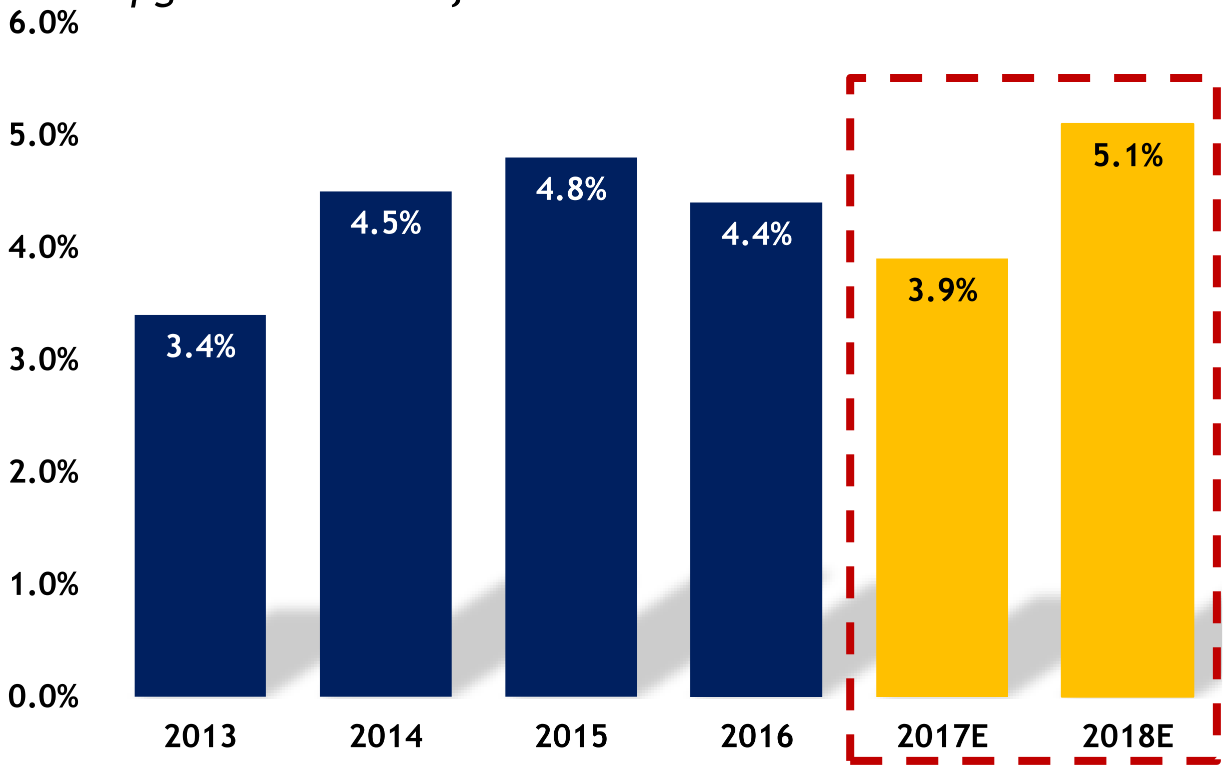
Source: CBSL



Source: CBSL

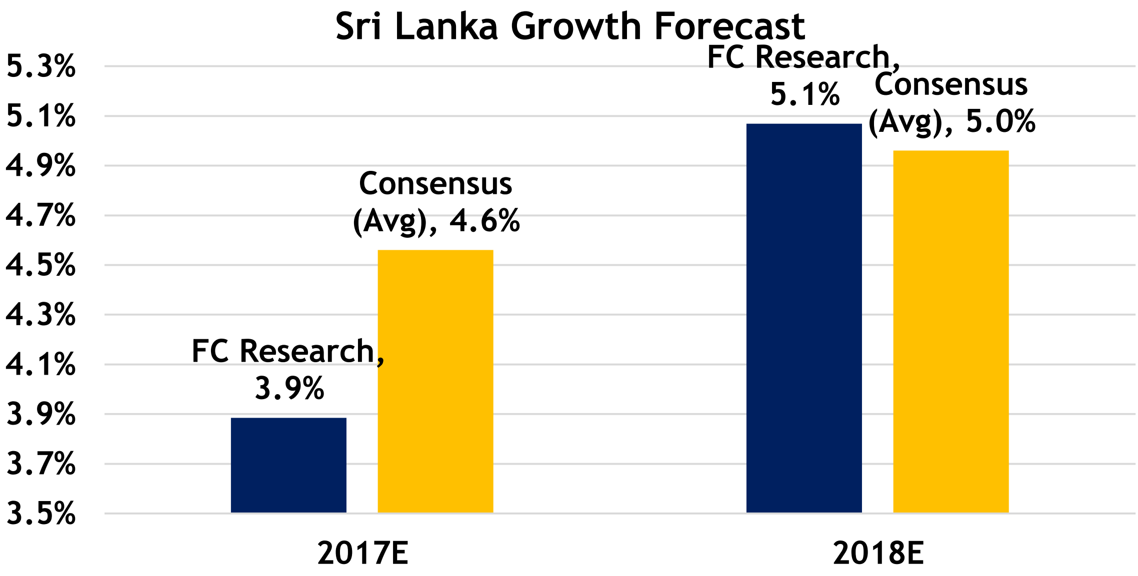
First Capital Research further downgrades 2017E GDP Growth but maintains positivity in 2018E

First Capital Research 2017E forecast downgraded from 4.3% to 3.9% while 2018E forecast is marginally upgraded to 5.1% from 5.0%.



Source: First Capital Research

SL GDP Growth Forecasts	2016	2017E	2018E
CBSL	4.4%	4.5%	5.0%
World Bank		4.7%	5.0%
IMF		4.2%	4.8%
ADB		4.7%	5.0%
Standard Chartered		4.7%	5.0%
Consensus (Average)		**4.6%**	**5.0%**



Reforms to strengthen economy via increased investments

GDP Growth: 2017E - 3.9%, 2018E - 5.1%

- *GDP growth 2017E to be 3.9%:* Monetary tightening coupled with adverse weather conditions resulted in a continued dip in agriculture sector while also disturbing manufacturing and services segments. Despite a rise expected in 3Q2017 spillover effects kept growth at a low level. However, conditions somewhat improved towards which may result in slightly higher growth numbers. Overall annual growth is more likely to end below 4.0%.

- *GDP growth 2018E to rise to 5.1%:* As Sri Lanka progresses on its reforms, economy strengthens providing room to provide additional support to boost investments for better infrastructure and higher FDIs with improved confidence. We believe higher FDIs and improved private investments and recovery in consumption towards 2H2018 is likely to boost GDP growth.

Outlook of Economic Indicators for 2018

Section 4.2

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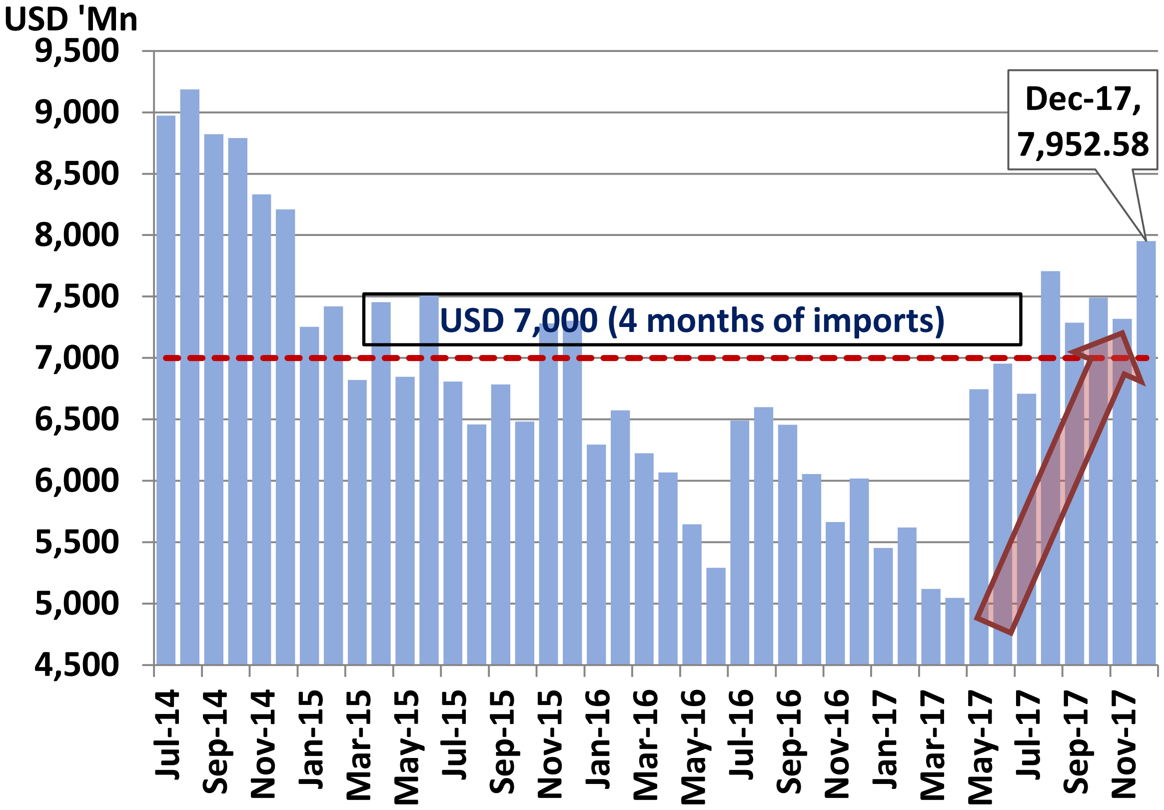
Steep rise in Foreign Reserves lowers future risk

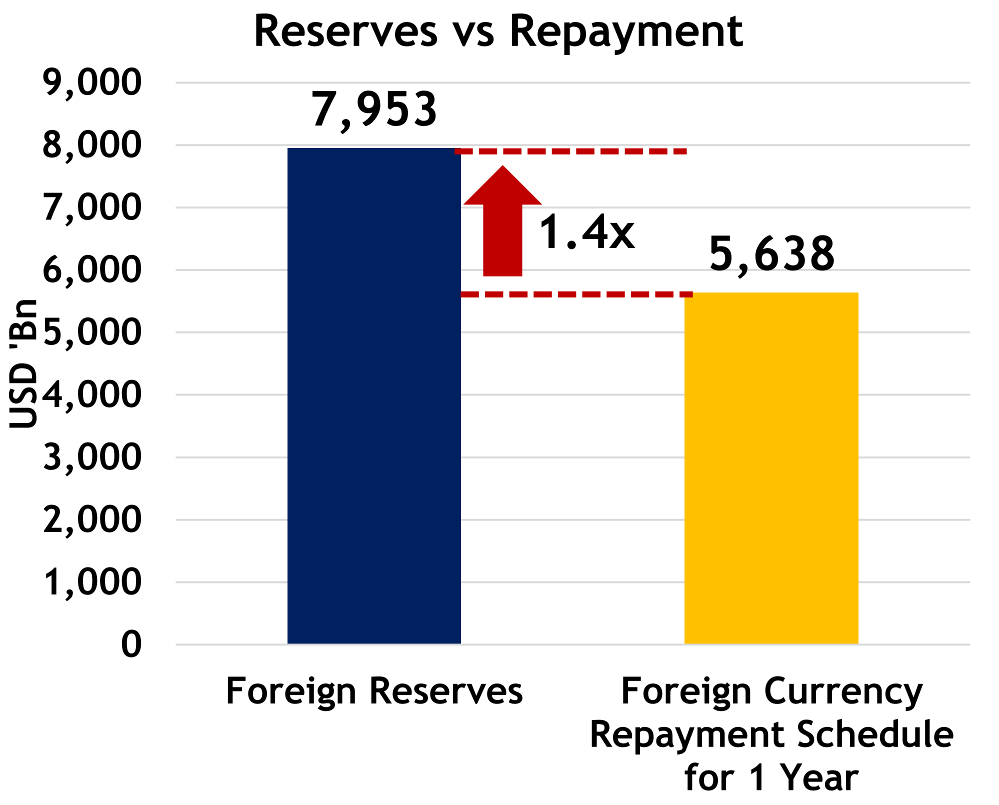
- *Sri Lanka's Foreign Reserves recovered at comfortable levels supported by heavy inflows through USD 1.5Bn Sovereign Bond issue in May 2017, Hambantota Port Sale, CBSL's dollar buying process and net inflows into Equity and Government Securities market. CBSL also completed USD 1 Bn syndicated loan in 2 tranches*
- *However, growing imports have resulted in an increase in the minimum amount of reserves required (4 months of imports) to USD 7Bn*

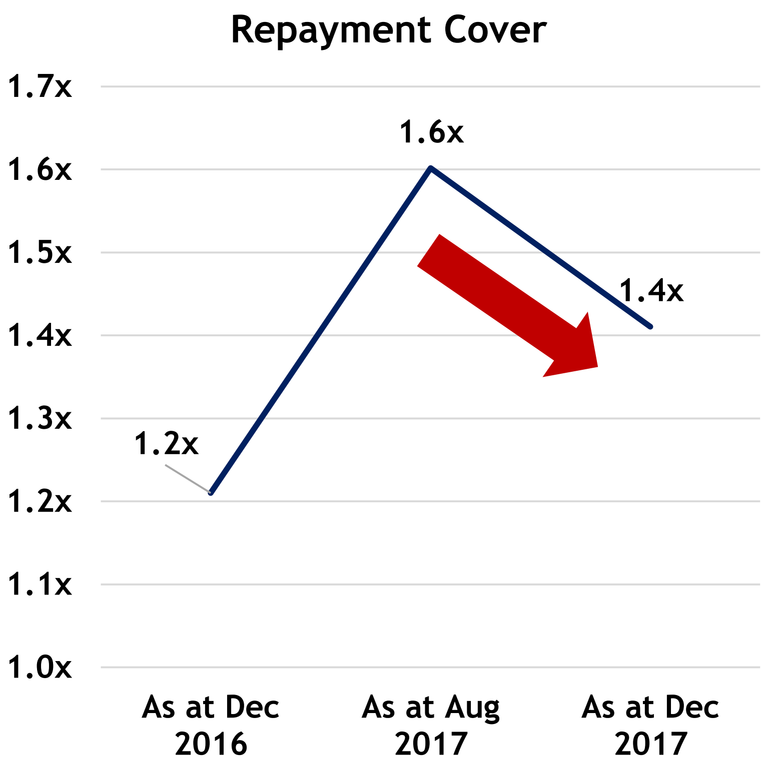
Further foreign reserve accumulation need to continue amidst the continuous rise in foreign debt payments & BoT deficit



Source: CBSL

Foreign Reserves dips to 1.4x of Foreign Currency Repayments (1Yr) despite being higher 4 months ago amidst rise in debt repayments



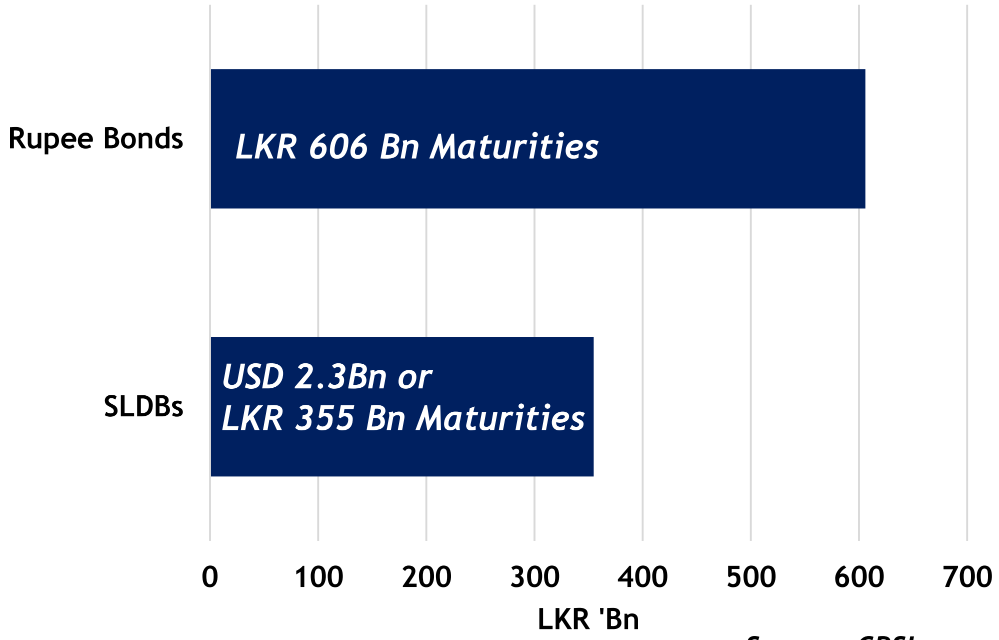


- The ratio again dropped to 1.4x amidst the rise in foreign currency repayment requirement after increasing to a high of 1.6x in Aug 2017. The ratio was as low as 1.2x as at Dec 2016. The USD 2.0Bn Sovereign Bond due in Mar 2018 is likely to improve the ratio in the short term

Source: CBSL

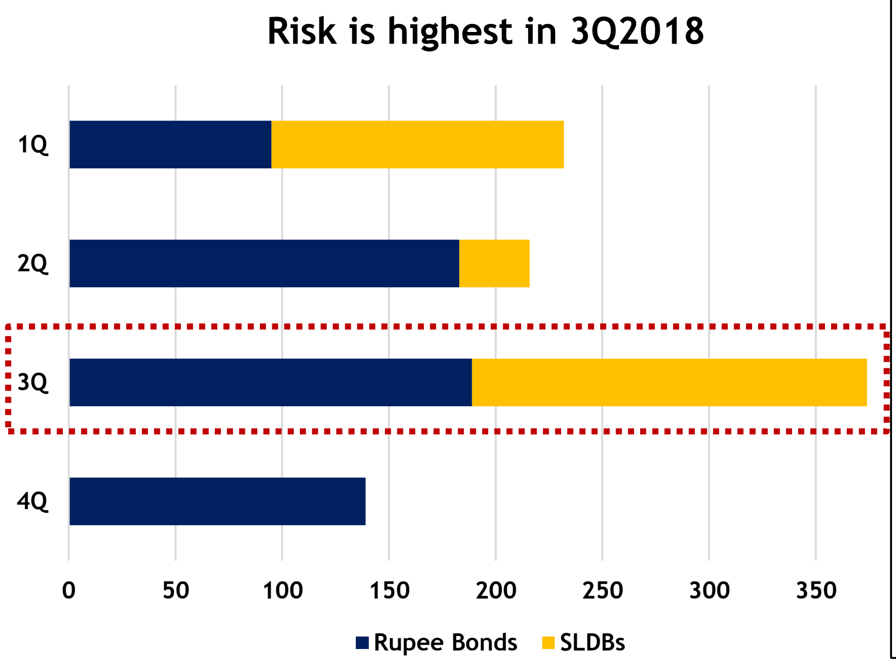
High level of maturities through 1Q-3Q while peaking in 3Q2018

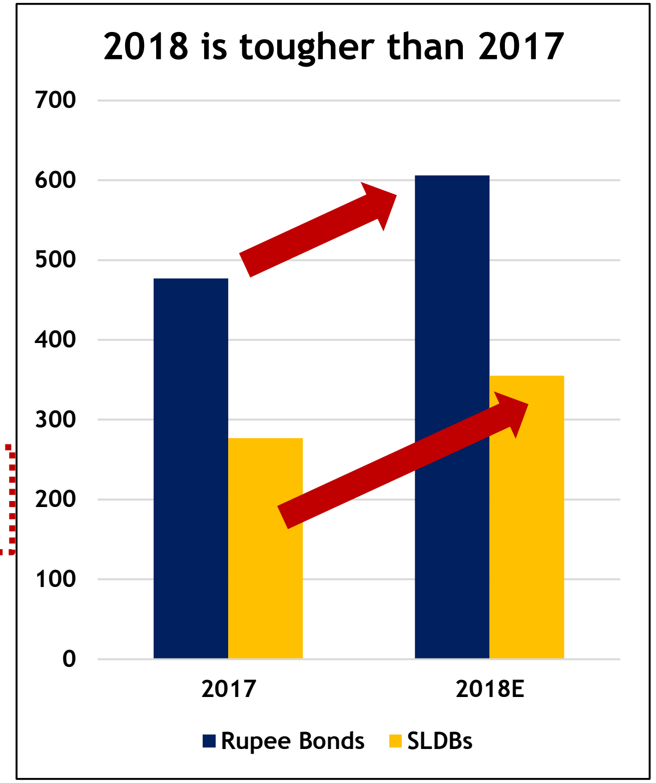
Full Year 2018



Source: CBSL

In spite of high maturities throughout 2018 the peak is expected in 3Q





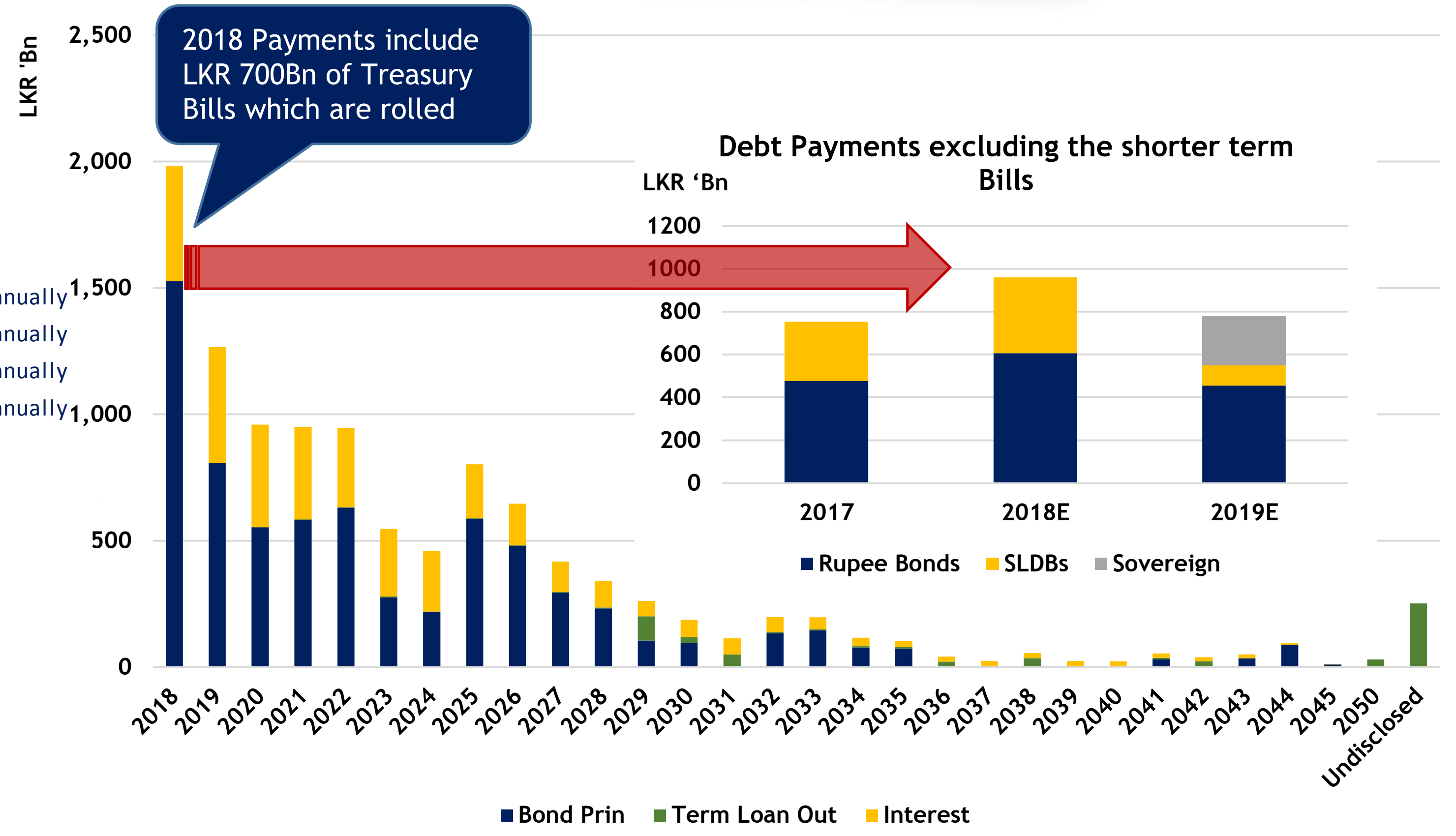
Despite Overall High Debt Payments 2018E Debt to GDP is expected to reduce to 78% on the back of large equity investments

Sri Lanka's Current Debt Payments are as follows:

Date	Bond Principal* (LKR 'Bn)	Term Loan Outstanding (LKR 'Bn)	Interest (LKR 'Bn)	
2018	1,526.84	0.00	454.37	
2019	807.81	0.00	459.67	*Bills will get added Annually
2020	552.99	1.00	405.68	*Bills will get added Annually
2021	582.63	2.42	365.30	*Bills will get added Annually
2022	630.13	2.86	313.40	*Bills will get added Annually

*Includes Bills, Bonds, SLDBs and Sovereign Bonds

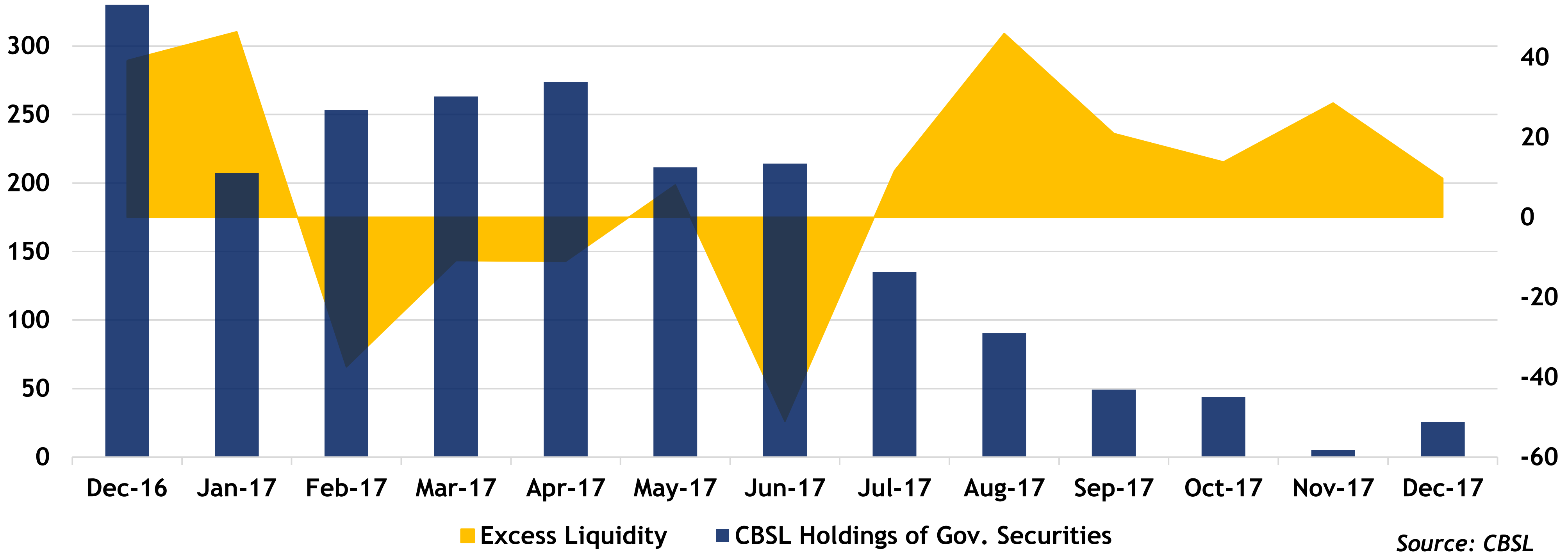
We expect Sri Lanka's Debt to GDP to have reached 80% in 2017E. However, supported by large equity investments led by PPP deals, the debt level starts to reduce to 78% in 2018E and continue to decline



Liquidity may tighten amidst debt payments and possible rise in credit demand…

Liquidity levels were maintained in the range of LKR 20-50Bn in 2H2017 supported by lower maturities and reducing CBSL Holdings

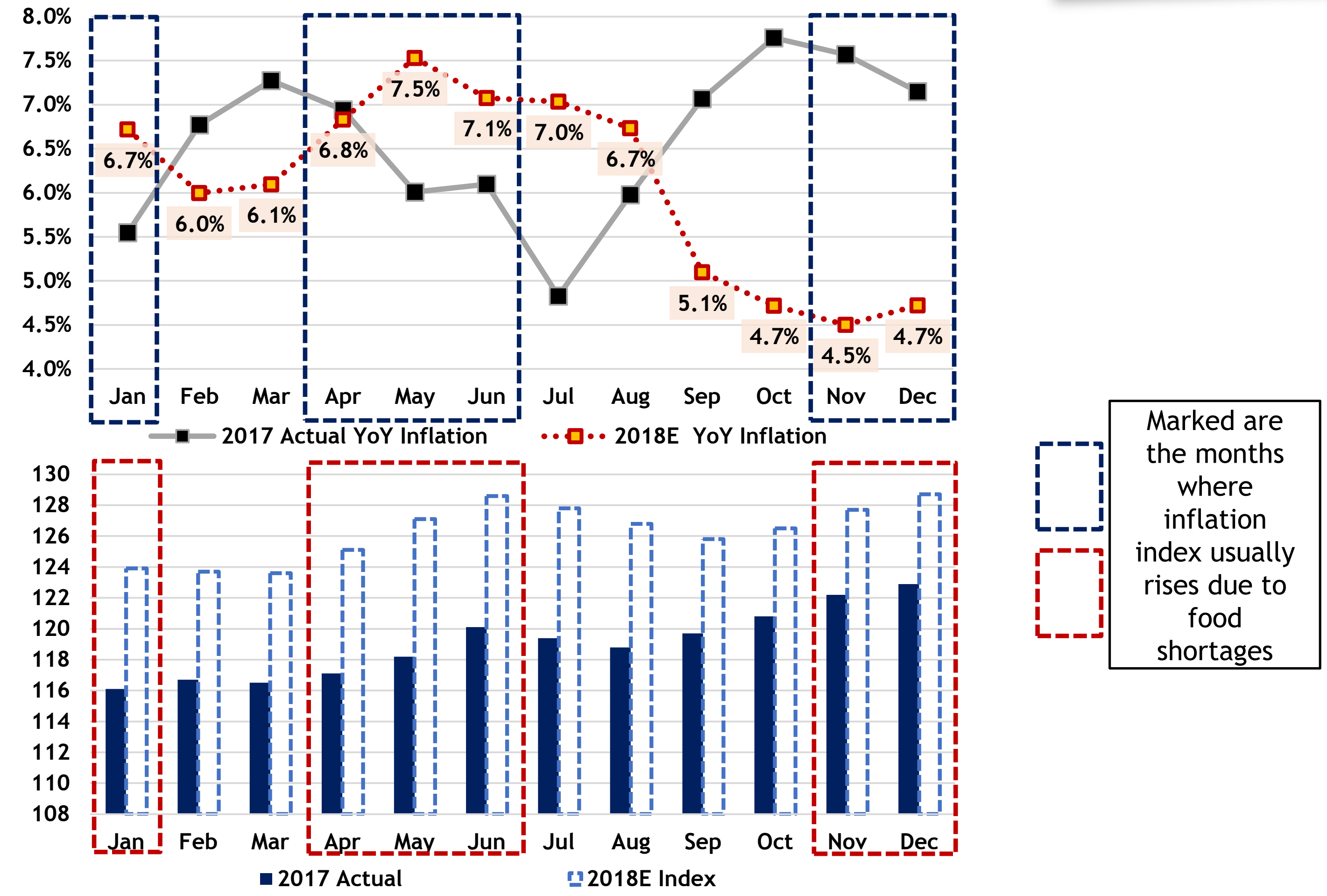
Expectations: Liquidity levels are likely to tighten towards 3Q (possibly even going short) amidst high debt repayments and possible rise in credit demand; 3Q2018 may even see a rise in CBSL Holdings in order to manage interest rates



Source: CBSL

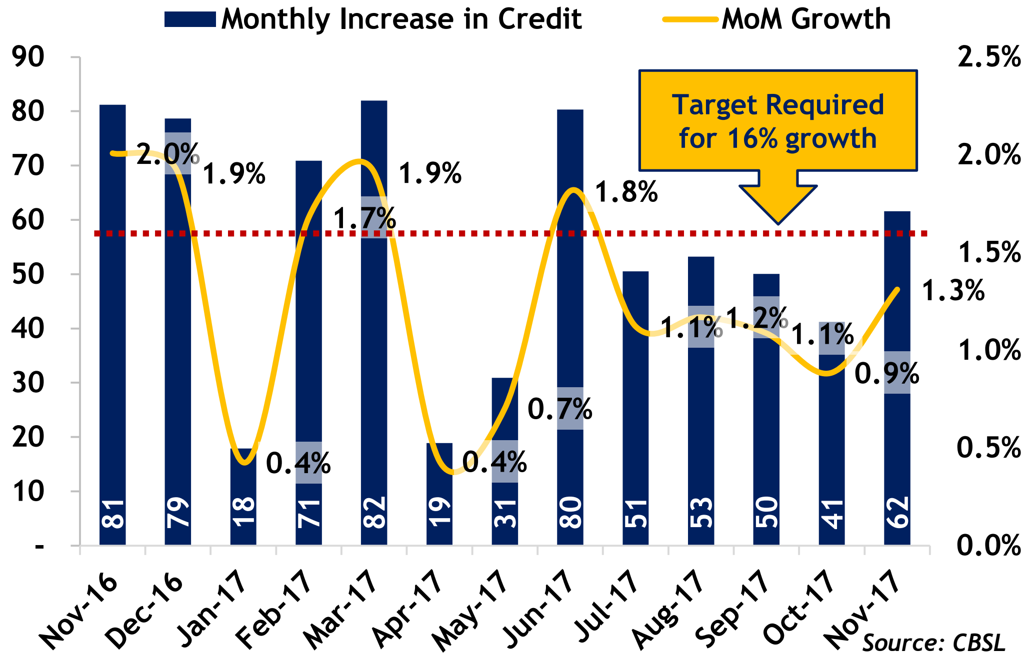
Pricing formulas and food shortages may have a short term impact on the index

- *Point to point Inflation may rise in the months from Apr – Sep 2018 partly due to food shortages and partly due to the pricing formulas*
- *Overall the index will be between 4.5%-7.5% during 2018E*
- *The average annual rate for 2018E is 6.1% marginally below 2017 (6.6%)*



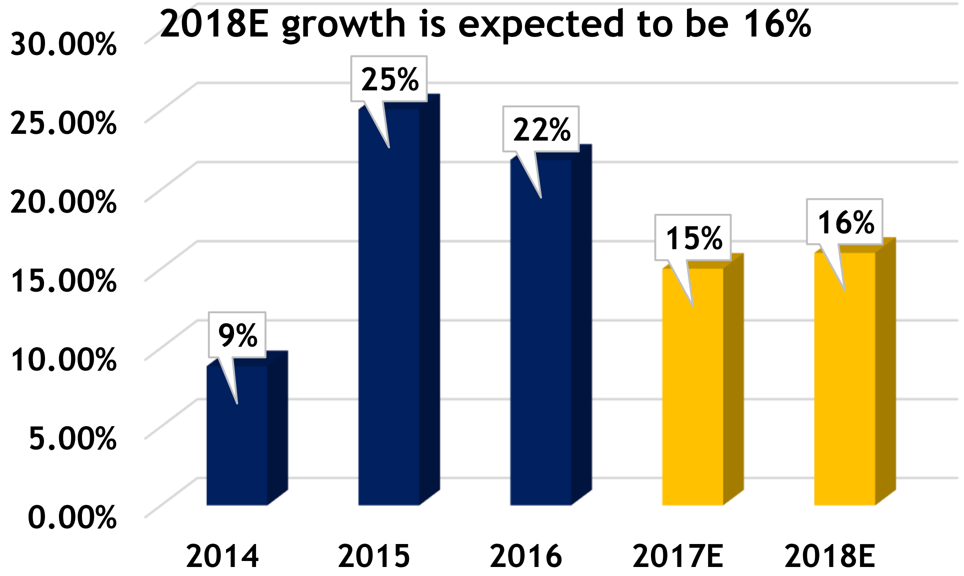
First Capital Research expects Private sector credit growth pickup towards 2H2018 signifying a steady growth of 16%

Private sector credit growth will continue to remain slow in the 1H2018 while picking up in 2H2018.



Source: CBSL

Private Sector Credit Growth for 2017E to end at 15% marginally below target while 2018E growth is expected to be 16%



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. As at Aug 2017 IMF upgraded its global growth forecasts to 3.6%. In Oct 2017 it was upgraded to 3.7%. Finally in Jan 2018 it has been further upgraded to 3.8%. Upgrades are driven by improved US growth and surprises in growth in Europe and Asia.

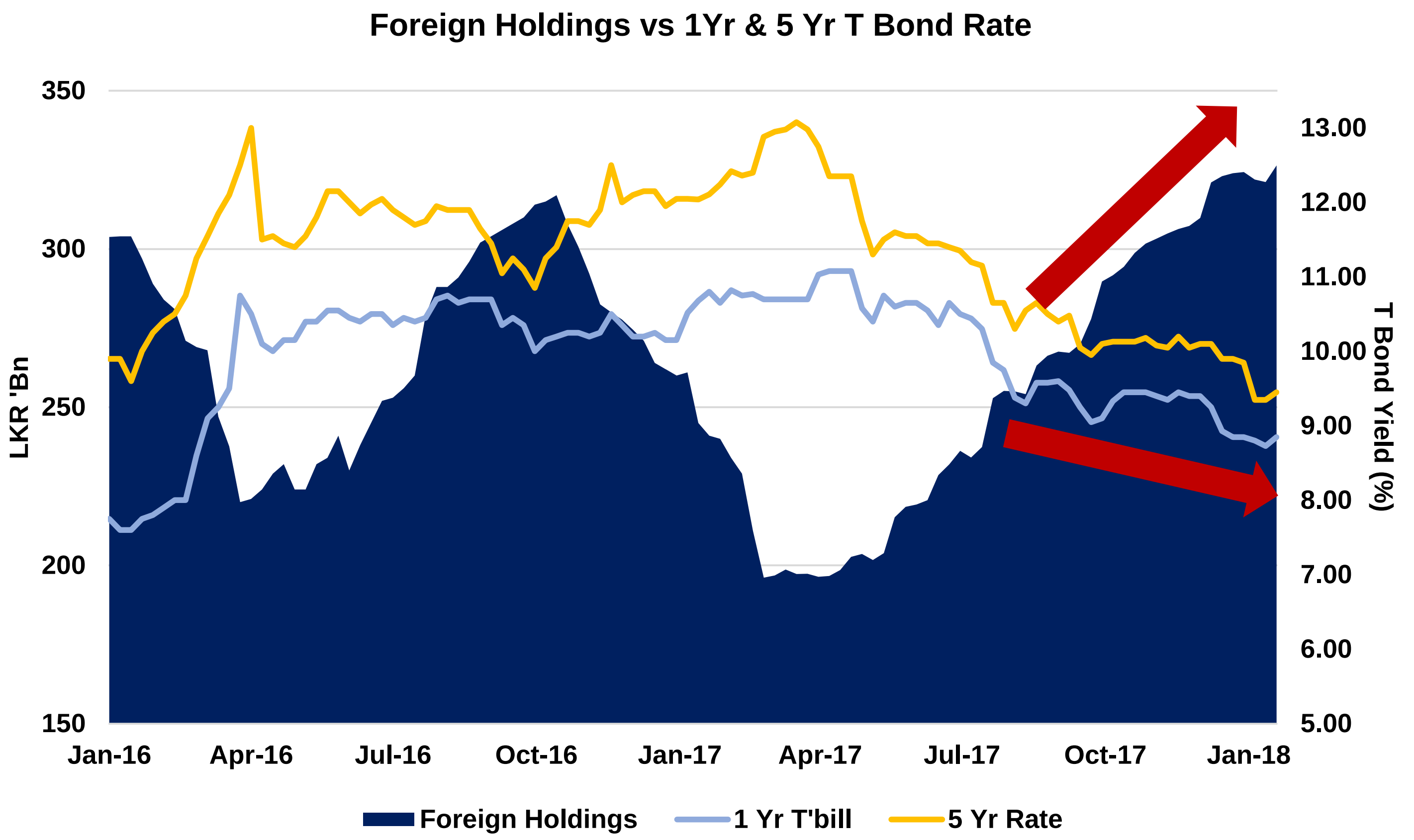
- Growth rates for many of the euro area economies have been marked up, especially for Germany, Italy, and the Netherlands, reflecting the stronger momentum in domestic demand and higher external demand. Its positive with Sri Lanka regaining GSP+ and export growth momentum picking up over the last few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

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

Further 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 & First Capital Research

What does the indicators say for investments?

- Political Outlook : Neutral
  - ❑ Political Uncertainty to partially clear out beyond Feb 2018
- Economic Outlook : Neutral
  - ❑ Strengthening Foreign Reserves, improving economic conditions & possible Equity inflows to support High Foreign Debt payments, High bond maturities. Inflation to be manageable while some money shortages may be noted in 3Q with improved credit demand
- 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

Indicators register continuous improvement

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

Economic Health Expectations

	3 Months Outlook Jan-Mar 2018	3-6 Months Outlook Apr-Jun 2018	6-9 Months Outlook Jul-Sep 2018	9-12 Months Outlook 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***		

Recommendations

Section 6.0

First Capital Research View on Bond Market in 2018

Section 6.1

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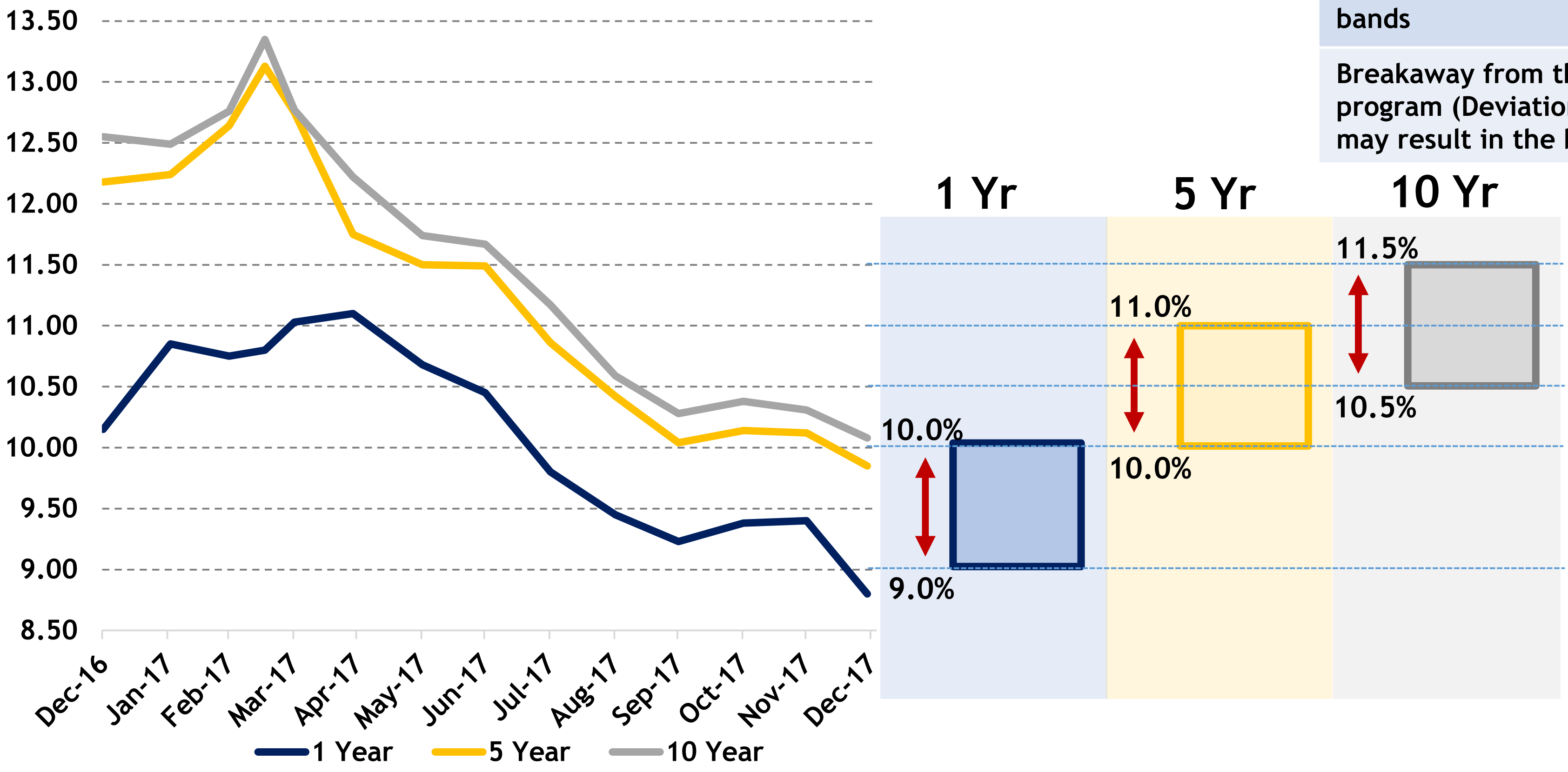
Interest Rates to be Bearish towards 2Q-3Q2018 (12 months)

Expectations: Bearish towards 2Q-3Q2018



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

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

Justification for Revision of Bond Yield Expectations

- 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%

First Capital Research View on Banking Rates for 2018

Section 6.2

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Banking Rates to be stable in 2018

- 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.

2017 Review:

- We expected 5 Year Bond to peaked at 13.0% in 2017 and after months for AWPLR to peak at same level. In line with expectations 5 Yr Bond peaked at 13.1% but earlier than expected in Mar 2017. Thereby, AWPLR peaked in Sep 2017 at 12.6%.

2018 Expectations

- The AWPLR is expected to be on a declining trend in the 1H2018 to touch 10% and is expected to stabilize at 10.0% during the 2H2018 before moving towards 10.5-11.0% towards end of 4Q2018. Similarly we expect the AWDR and AWLR to be on a declining trend during the 1H2018 and stabilize towards 2H2018

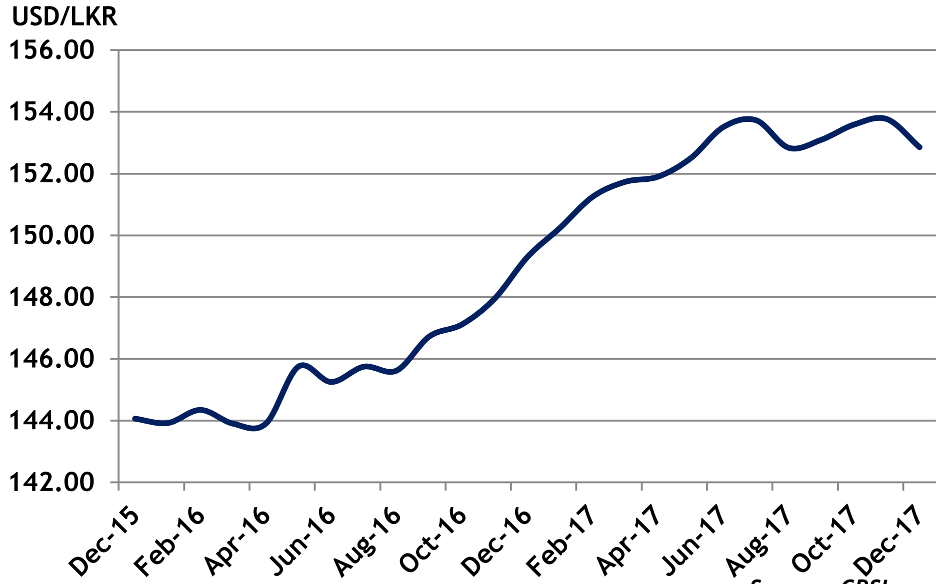
Base Case	2Q2017	4Q2017	2Q2018E	4Q2018E
5Y T-Bond	Actual 11.6%	Actual 10.0%	Expected 11.0%	
AWPLR		Actual 11.6%	Expected 10.0%	Expected 11.0%

First Capital Research View on Exchange Rate for 2018

Section 6.3

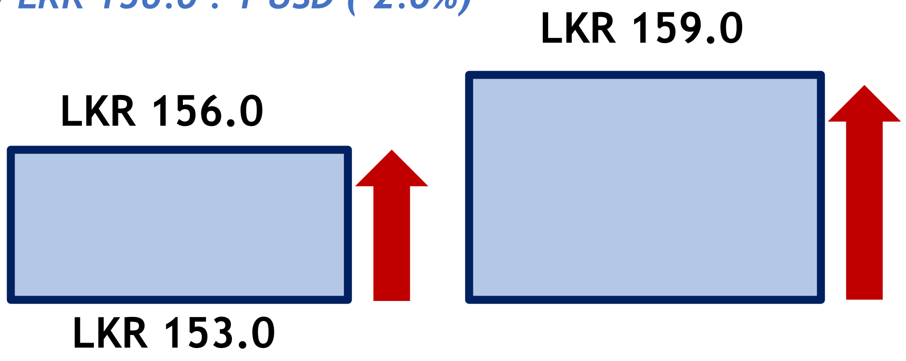
2018E Exchange Rate target is a more bullish 156.0 LKR: 1 USD on the back of weaker dollar & stronger inflows

2017 Review:
Dollar recorded the worst year in 14 years (after 2003) depreciating as much as 10% against its currency basket providing positivity for the Sri Lankan rupee during 2017 depreciating only 2.4% against the green back. The rupee was also supported by some heavy inflows during 2H2017



Source: CBSL

2018 Outlook Base Case:
Dollar index is expected to continue to be weak over the next 12 months against its currency basket despite the expected rate hikes due to the likely tax cuts proposed.
Weaker Dollar and Strong Foreign Currency inflows are likely support a our base case depreciation of only LKR 156.0 : 1 USD (-2.0%)



Bullish Case	Bearish Case
65% Probability	35% Probability

First Capital Research View on Equity Market for 2018

Section 6.4

Equity Market Investments: BULLISH

ASPI to touch 7000 in 2018E

- ***Market earnings:*** The current tight monetary policy has slowed down the economy significantly reducing earnings growth for most companies. The situation is expected to ease off towards 2H2018. Therefore the companies are likely to have a better earnings performance in 2018E/19E compared to the weak performance we are experiencing in CY17/FY18E. We believe overall market earnings are likely to grow by a modest 5%-7% during 2018E/FY19E supported by a recovery in economic performance in the 2H2018. Earnings Growth is likely to accelerate to 10%-12% towards CY19E/FY20E backed by further improvement in economic health of the country and also easing of the monetary policy with more stability in the system.
- ***Market Returns:*** Market returns are likely to be slow but positive in the 1H2018 due to attractive valuations prevailing in the economy and is likely to improve in the 2H2018 supported by expectations of a better economic outlook and earnings performance. Thereby, we expect overall market returns are likely to be 10%-12% approximately 50% above the expected earnings performance as some counters are likely to re-rate with an expected better earnings outlook in the future. In terms of the ASPI index it is only likely to reach 7000 (+10% or +650 points) towards end of 2018. Market returns are likely to accelerate towards the 2019 to about 15% with the actual earnings performance and renewed investor confidence. Index is likely reach 8000 level (+15% or +1000 points) towards 2019. These targets however are highly dependent on the current stable outlook and reform agenda continuing during 2018 as well.
- ***Key Sectors:*** We believe the key sectors that are likely to outperform the market and expected to provide high returns are the Banking Sector, Building Materials Sector and Apparel Sector while the energy sector also may turnaround depending on the implementation of the pricing formulas by the Government which is also a condition of the IMF.
- ***First Capital Top Recommendations:*** We expect First Capital top recommendations portfolio to achieve a capital gain return of 25% as against the market return of 10% while dividend yield is likely to be around 3-4%.

First Capital Research View on Business Confidence and Consumer Demand for 2018

Section 6.5

Business Confidence & Consumer Demand Expectations: Bullish in 2H2018

- With political uncertainty likely to settle beyond Feb 2018 and the continued reform agenda, 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 similar to Nov – Dec 2017. We believe business confidence and consumer demand are likely to be stronger during the 2H2018

Requirements to improve weaknesses

Section 7.0

Key Shocks to look out for in 2018

- Coalition Government falls off

  - Sharp increase in political uncertainty

- Surge in oil prices

  - Economic Uncertainty increases

- Heavy increase in US treasury rates may push fund flows towards US

  - May lead foreign outflows

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