STRATEGY REPORT 2022

ACUITY

A joint venture of DFCC Bank and HNB

"May you live in interesting times"[1]

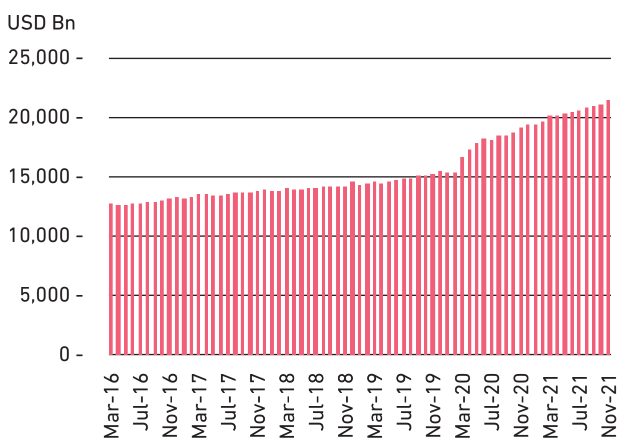
Contents

[1] Modern expression purported to be a translation of an ancient Chinese curse

Global Headwinds

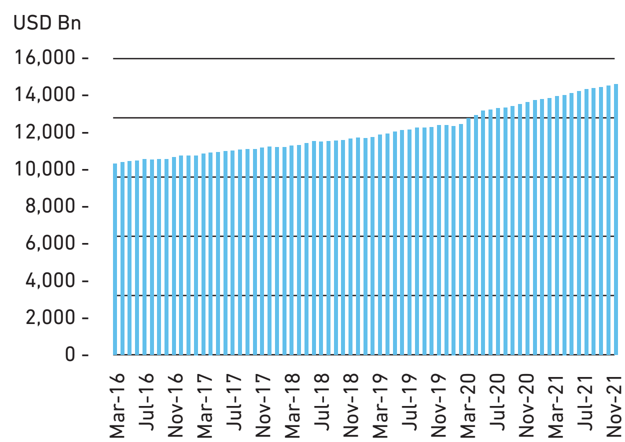
Over the last few months, **inflation** rates have increased to multi decade highs in the US, Eurozone and many countries the world over as accommodative monetary policy in the aftermath of the Covid pandemic and supply chain disruptions impact prices. Throughout much of 2021, concerns that inflationary build-up was **non-transitory** was outweighed by the need to support the recovery through record quantitative and fiscal stimulus, as evidenced by interest rates remaining at or near zero throughout most developed markets. We believe it is worthwhile to consider some of the possible headwinds that may derail the base case narrative of robust recovery and cooling prices that would allow for gradual monetary tightening in the US and Eurozone.

Chart 1: US Money Supply - M2



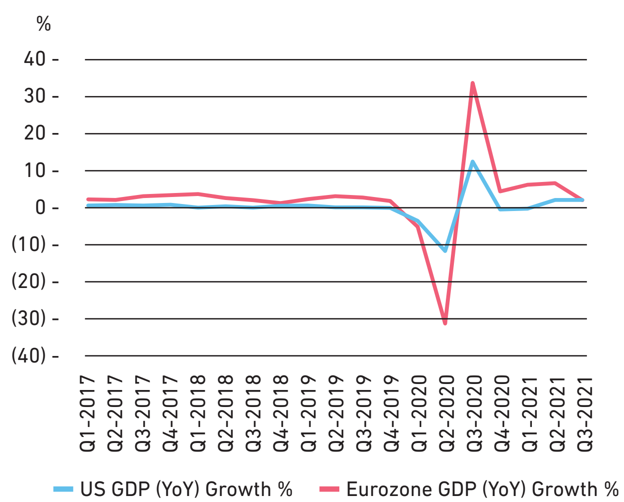
Source : Bloomberg

Chart 2: Eurozone Money Supply - M2



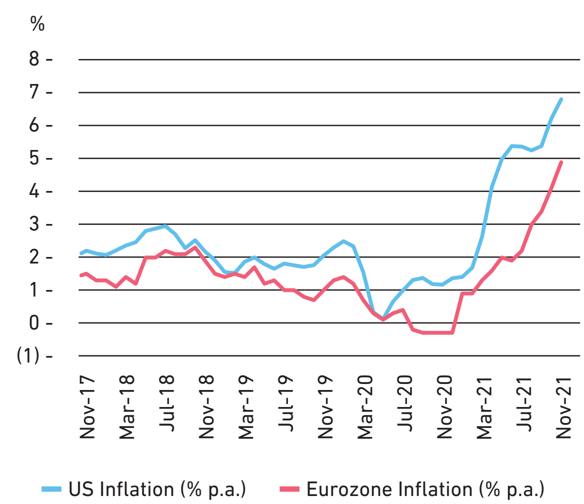
Source : Bloomberg

Chart 3: US & Eurozone – GDP Growth



Source : Bloomberg

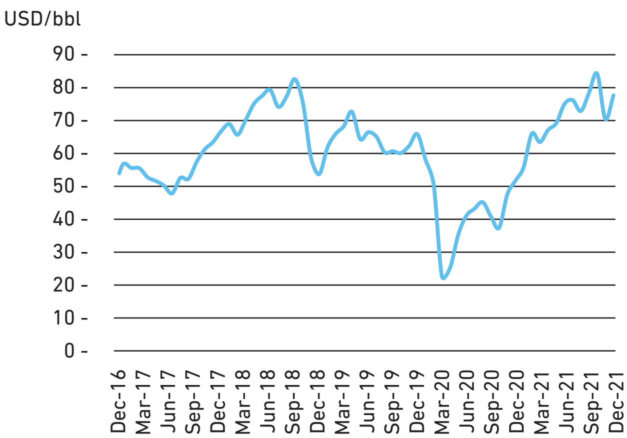
Chart 4: US & Eurozone – Inflation



Source : Bloomberg

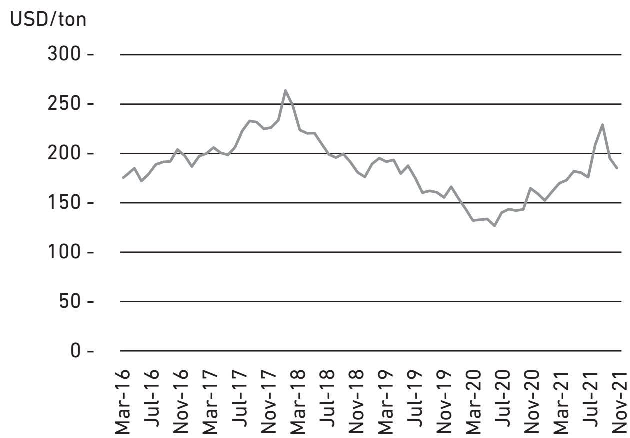
Although the impact of the pandemic on economic recovery has weakened significantly, new Covid variants and related restrictions could dampen growth prospects in key markets. Soaring energy prices which have increased to well above pre-Covid levels and protracted supply chain disruptions affecting key industries could both derail growth and exacerbate inflationary pressure in 2022 placing Central Bankers in a stagflationary tight spot with few policy levers. China and geopolitical risks in several hotspots are probable black swan events for 2022. China's Evergrande moment exposes many structural weaknesses which coupled with geopolitical tensions may render the world's second largest economy unable to support a global economic recovery to the extent previously anticipated with potential ripple effects for all major economies. In December 2021, the Federal Reserve signalled a faster pace of tapering with three possible rate hikes in the coming year. Given the past experience of taper tantrums, although growth stocks in the US have fallen sharply in response to potentially higher interest rates, the S&P 500 is still near record high territory at the time of writing. Rising US interest rates will likely be the primary risk factor for capital flows to emerging markets in 2022, particularly the BEAST markets (Brazil, Egypt, Argentina, South Africa and Turkey).

Chart 5: Oil Prices -Brent Crude



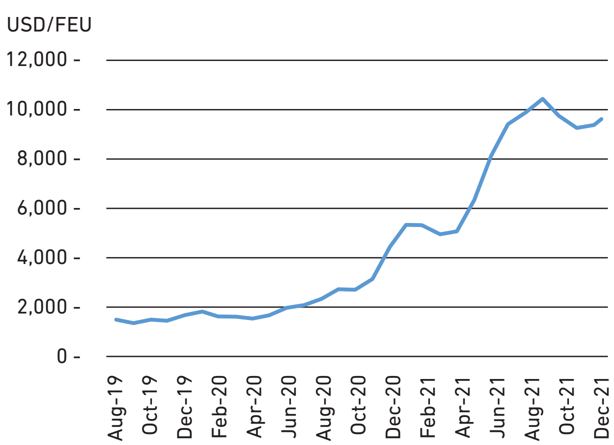
Source : Investing.com

Chart 6: Coal Prices



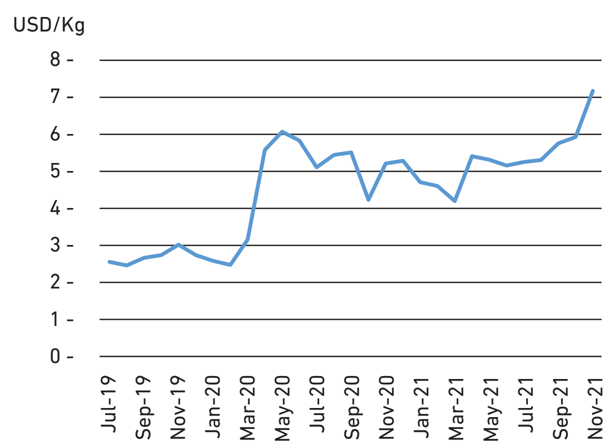
Source : Bloomberg

Chart 7: WCI Composite Container Freight Benchmark



Source : Bloomberg

Chart 8: DrewryAir Freight Average Rate



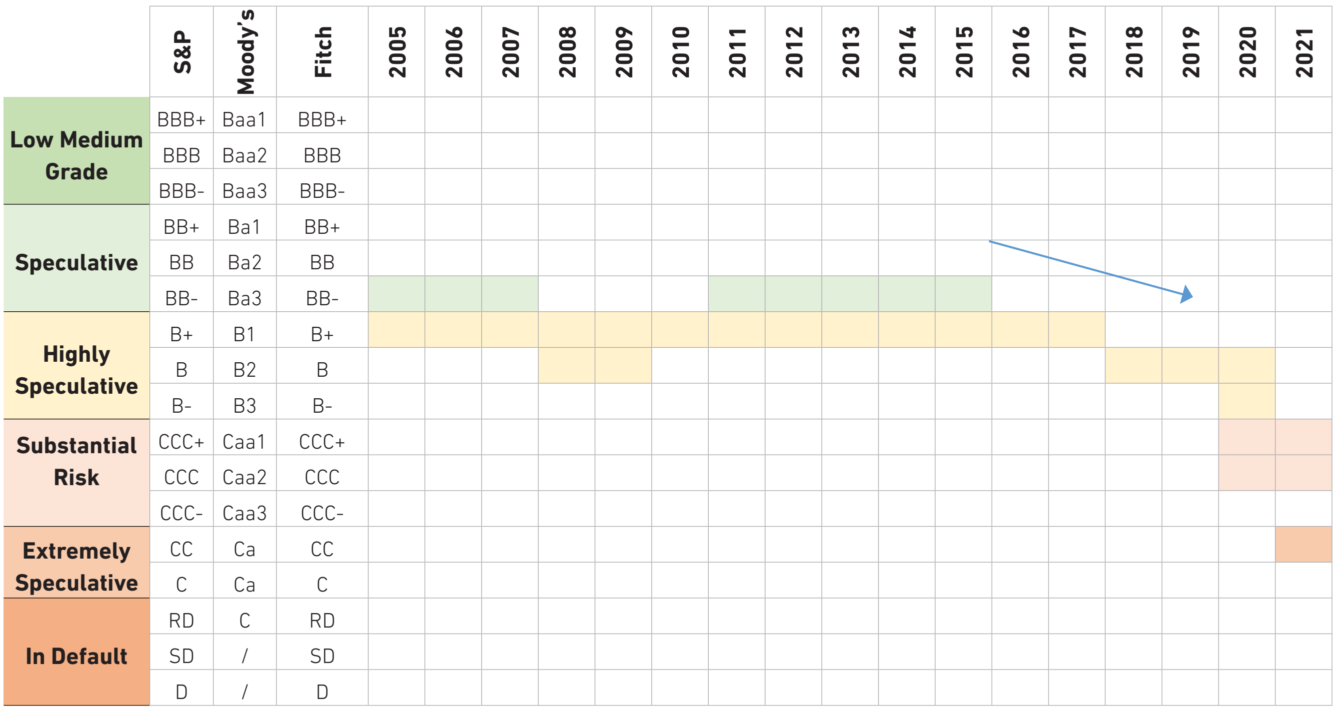
Source : Bloomberg

Global energy prices, which have increased beyond pre-Covidlevels in recent months coupled with continuing supply chain disruptions and high freight rates are fuelling concerns of non-transitory inflation.

Sri Lanka Outlook

Although Central Bankers in developed markets may successfully navigate the difficult path between balancing the economic recovery whilst containing inflation, Sri Lanka is poised for more difficult times.

The recent downgrade of the sovereign by Fitch to CC, places Sri Lanka in an untenable position effectively locking out the country from **international capital markets** in the short term until the country rating improves to at least speculative or highly speculative grade. Building up **foreign exchange reserves** will be the main determinant for improving the credit rating.



Source : Tradingeconomics

Sri Lanka's sovereign credit rating was under pressure even prior to the pandemic given its weak debt profile and low reserve position compared to its peer group.

Fitch Rating	Country	Selected USD Sovereign Bond Maturities (5-8 years)	USD Sovereign Bond Yields	Reserves to Imports (no. of months)
B-	Iraq	9-Mar-23	5.6%	12.69
	Gabon	16-Jun-25	5.8%	5.50
	Maldives	26-Apr-26	9.4%	4.66
	Pakistan	8-Apr-31	7.8%	4.10
	Ecuador	31-Jul-30	9.2%	3.47
	El Salvador	28-Feb-29	19.2%	2.87
	Tunisia	NA	NA	4.60
CCC	Angola	26-Nov-29	8.5%	11.92
	Argentina	24-Feb-28	17.2%	8.78
	Congo	30-Jun-29	9.1%	2.70
	Ethiopia	11-Dec-24	22.9%	1.67
CC	Sri Lanka	14-Mar-29	22.4%	1.04
RD	Lebanon	NA	NA	11.25
	Zambia	31-Aug-27	20.4%	5.40

Source : Bloomberg, IMF, World Bank

Sri Lanka's current economic predicament (in common with many of its peers around the same rating scale) has its roots in persistent **fiscal profligacy** coupled with unsound **monetary policy** leading to continuous external deficits and inefficient allocation of resources, largely to speculative and non-tradeable sectors. A short period of fiscal consolidation in the post-war period ended prematurely in 2014 long before the pandemic induced deterioration in Government finances. Whilst most developing countries are net importers of capital, imprudent monetary policy exacerbates the strain on the **external sector** and depletes **foreign currency reserves** if policy makers attempt to anchor both the exchange rate and domestic interest rates.

Table 2: Country Comparisons

(as a % of GDP)	2016	2017	2018	2019	2020	2021
Budget Deficit						
Sri Lanka	-5.3%	-5.5%	-5.3%	-8.0%	-12.8%	-10.5%
Turkey	-2.3%	-2.2%	-3.8%	-5.6%	-5.3%	-4.9%
Argentina	-6.7%	-6.7%	-5.4%	-4.4%	-8.6%	N/A
Savings Gap						
Sri Lanka	-2.1%	-2.6%	-3.2%	-2.2%	-1.3%	-3.2%
Turkey	-3.0%	-4.7%	-1.7%	1.0%	-5.0%	-1.9%
Argentina	-2.7%	-4.8%	-5.2%	-0.8%	0.9%	1.0%
Current Account Deficit						
Sri Lanka	-2.1%	-2.6%	-3.2%	-2.2%	-1.3%	-3.2%
Turkey	-3.1%	-4.8%	-2.8%	0.9%	-5.2%	-2.4%
Argentina	-2.7%	-4.8%	-5.2%	-0.8%	0.9%	1.0%
Debt to GDP						
Sri Lanka	79%	78%	84%	87%	101%	109%
Turkey	28%	28%	30%	33%	40%	38%
Argentina	53%	57%	85%	89%	103%	N/A

Source : International Monetary Fund, World Economic Outlook Database, October 2021

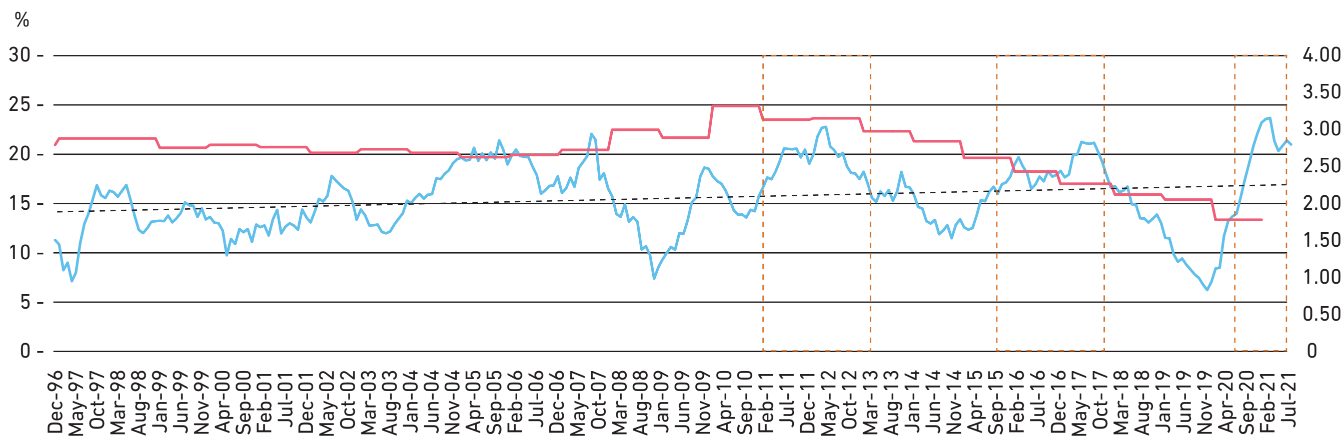
Table 3: Country Comparisons

	2016	2017	2018	2019	2020	2021
Inflation						
Sri Lanka	4.0%	6.6%	4.3%	4.3%	4.6%	5.1%
Turkey	7.8%	11.1%	16.3%	15.2%	12.3%	36.0%
Argentina	N/A	25.7%	34.3%	53.5%	42.0%	N/A
Money Supply M2 (YoY Growth)						
Sri Lanka	16%	17%	11%	8%	23%	N/A
Turkey	18%	16%	18%	27%	34%	N/A
Argentina	42%	30%	N/A	N/A	N/A	N/A
Exchange Depreciation (to USD)						
Sri Lanka	7.1%	4.7%	6.6%	9.9%	3.8%	9.2%
Turkey	19.0%	7.4%	39.6%	12.5%	25.0%	79.2%
Argentina	0.2%	17.3%	102.3%	59.1%	40.5%	22.1%
Reserves to imports (no. of months)						
Sri Lanka	3.07 x	3.76 x	3.10 x	3.74 x	3.67 x	1.03 x
Turkey	5.73 x	5.06 x	4.57 x	5.55 x	4.80 x	4.35 x
Argentina	6.09 x	7.38 x	9.27 x	8.21 x	8.96 x	8.64 x

Source : International Monetary Fund : World Economic Outlook Database - October 2021, World Bank, Bloomberg, Investing.com, IMF database, CBSL

We can gain some insights on the potential economic risks in the coming years by looking at recent events in other emerging economies with similar macro indicators and credit ratings. Sri Lanka shares many of the same structural imbalances as countries like Argentina and Turkey, where high inflation and exchange depreciation have become persistent phenomena as **inflationary expectations** have become part of the national psyche, contributing to **capital flight** and pressure on the **exchange rate.** Since price stability can be fragile, the commendable effort by Sri Lanka's policy makers in keeping inflation relatively in check over the last couple of decades could come undone if high inflation is allowed to persist and is built into the public memory. The main difference we see is that imbalances and policy excesses have a more immediate impact on inflation and exchange rates in the above mentioned countries which have more open capital accounts, whereas Sri Lanka's closed capital account and import/ price controls allows the Government some leeway to kick the can further down the road and delay the inevitable policy requirements.

Chart 10: Sri Lanka Money Supply - M2b (YoY Growth) and Velocity



Source : CBSL

M2b (YoY Growth) (LHS)   Velocity of M2b (RHS)   - - Trendline

Sri Lanka's periodic spikes in money supply growth have often preceded periods of balance of payments stress necessitating higher exchange rate depreciation in 2012, 2017-18 and post 2020. Declining velocity of money may have contributed to moderate inflationary pressure.

We don't buy into the argument that a revival in the tourism industry in 2022 will allow the country to meet both its import requirements and external debt obligations. We maintain that Sri Lanka's current balance of payments crisis and high indebtedness is merely a manifestation of underlying structural imbalances, namely its oversized state sector, poor tax collection and fiscal dominance in the absence of an independent Central Bank. Whilst it may be possible that Sri Lanka will continue to avert a debt default by using short term currency swaps/ loans from friendly countries to refinance maturing debt obligations and possibly even rescheduling some bilateral or multilateral debt, this strategy in the absence of a credible policy path to address the underlying structural imbalances would likely see recurring foreign currency shortages necessitating ongoing import controls and shortages of imported goods. Persistent foreign currency shortages and low sovereign credit ratings (which by implication also reduces the external ratings of Sri Lankan banks) have the potential to disrupt trade financing channels used for the import of raw materials and other essential inputs for local industries, thus derailing the trajectory of economic growth and leaving the country vulnerable to external shocks such as rising global energy prices. Our calculations indicate **high external funding gaps** for the coming years in the absence of net foreign portfolio inflows into LKR bonds and equities.

Table 4: Sri Lanka Estimated External Funding Gap

(USD Mn)			
Year	**2022**	**2023**	
Opening Balance of Reserves	3,100	4,000	Note 1
Current Account Deficit	(2,000)	(2,000)	Note 2
Debt Servicing			
- ISB principal	(1,500)	(1,250)	Note 3
- Other LT Debt Servicing	(4,980)	(3,500)	Note 4
FDI	500	750	Note 5
Net Portfolio Inflows	-	-	
Financing Required	**8,880**	**6,000**	
Closing Balance of Reserves	4,000	4,000	Note 6

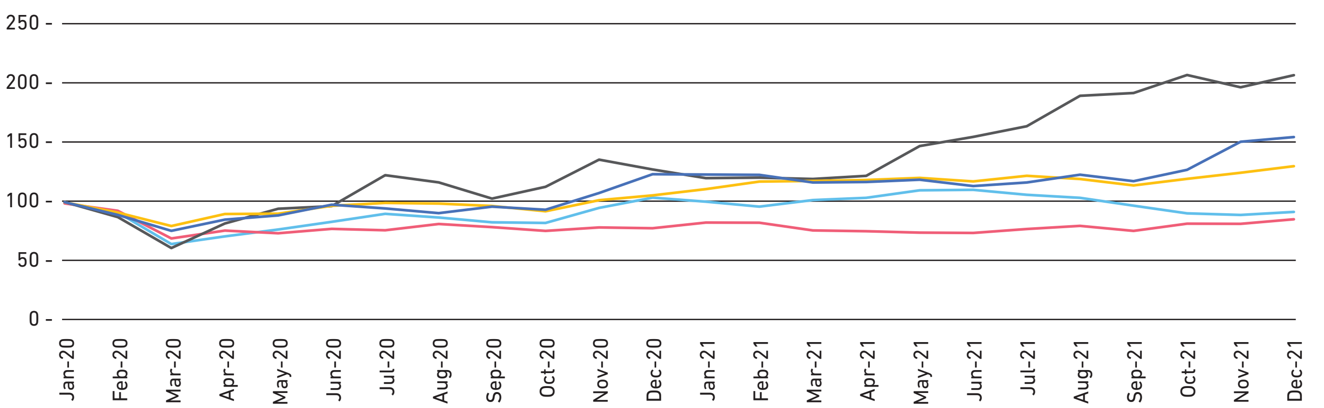
Note 1: Based on CBSL statement for end 2021
Note 2: Estimate based on past trends
Note 3: CBSL data
Note 4: CBSL reserve position statement and estimates
Note 5: Estimate based on past trends
Note 6: Estimate assuming gradual build-up of reserves

Based on the current economic situation and the lack of resolve from policy makers to map out a credible path, we believe it would be prudent to align investment strategies for a potentially higher inflationary environment in 2022 triggered by both demand pull inflation in response to the significant monetary stimulus post-Covid and from the supply side as higher prices for imported goods and supply shortages impact prices. We expect elevated inflation to be coupled with steep exchange rate depreciation and higher nominal interest rates, amongst other possible macro shocks. The outlook for 2023 and beyond would largely depend on firm policy response if any to Sri Lanka's current economic quagmire. We see an **IMF stabilisation program** coupled with **debt restructuring** as the optimal outcome that would give the most confidence to both domestic and foreign investors, and normalise the country's access to international capital markets.

And Now for the Good News

Although we're pessimistic on the economic prospects for the country over the next year, we're optimistic that markets may still do well. Conventional wisdom holds that cash is trash during periods of higher inflation and lower real interest rates. Anecdotally we can see that stock markets in other countries experiencing high inflation and exchange rate volatility have performed relatively well in nominal terms despite the macroeconomic stress, particularly in the post pandemic era.

Chart 11: Stock Index Movement (since January 2020)



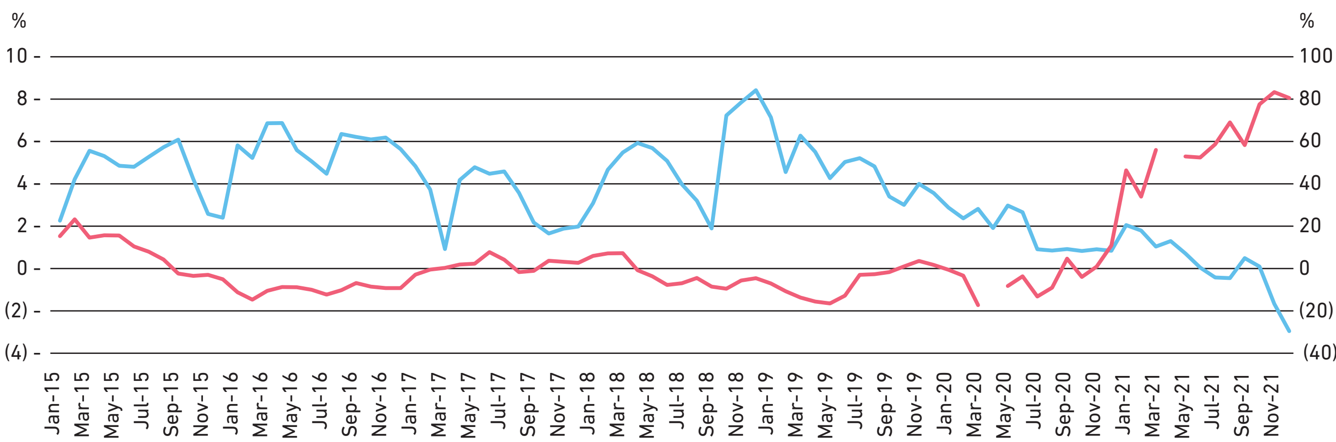
Source : Investing.com

Brazil Egypt Argentina South Africa Turkey

Equity markets have remained buoyant in a number of emerging economies experiencing macroeconomic stress as domestic investors likely shifted to stocks and other asset classes in the context of lower real interest rates.

In the absence of a clear road map for monetary tightening and given the past history of fiscal dominance of monetary policy, we believe that real interest rates may not increase significantly over the year as policy makers will most likely use captive sources and moral suasion to moderate the rise in interest rates amidst rising inflation. Therefore investors would benefit from maintaining a reasonably high exposure to equities based on their respective risk tolerances.

Chart 12: ASPI Performance vs Real Interest Rates



Source : CBSL

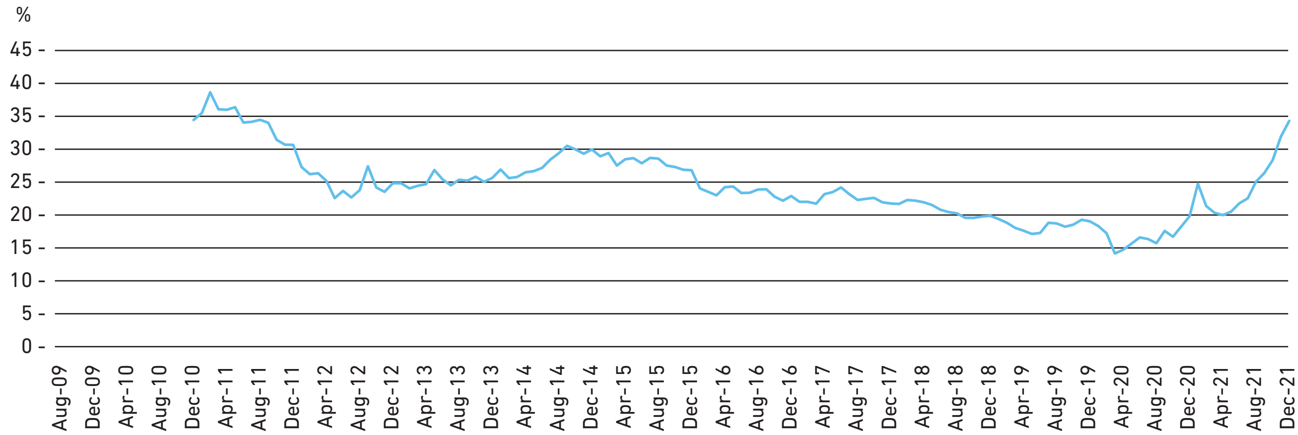
Real interest rate (LHS) ASPI growth (YoY) - RHS

The performance of the ASPI is sensitive to prevailing real interest rates. We would expect equities to continue to outperform while real interest rates are close to or below zero.

Market Outlook

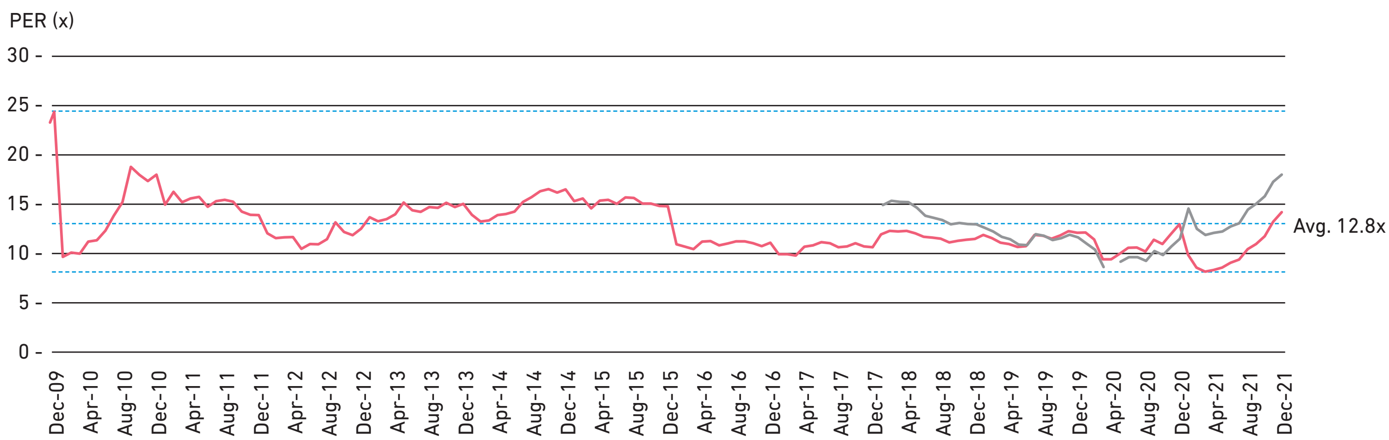
Although our Market P/E and 10-year Cyclically Adjusted Market P/E charts show significant **multiple expansion**, which is to be expected given the run up in equities since mid-2020 through 2021, valuations are still within historical averages. However, we would be cautious at these valuation levels and invest selectively into fundamentally sound counters with strong secular tailwinds.

Chart 13: Sri Lanka Market Cap to GDP



Source : CSE, DCS (Department of Census and Statistics)

Chart 14: Market Valuations



Source : CSE, CBSL, DCS (Department of Census and Statistics)

Market PER   P/E10 or CAPE

Market valuations as measured by Market P/E (current market capitalisation over prior year earnings) does not show significant overvaluation at these levels, despite the significant run up in 2020 and 2021. The average Market P/E over the last 12 year period is 12.8x with a standard deviation of 2.71x. The prevailing Market P/E of 13.9x is within 0.4 standard deviations from the historical average. We would expect market valuations to further moderate if the positive earnings momentum continues in Q4 2021.

Sector and Stock Selection for 2022

In the context of higher inflation, higher exchange depreciation and rising nominal interest rates and macro volatility, we believe stocks having the following characteristics would be best placed to outperform the overall market.

High Growth: We believe growth stocks have a better chance of outpacing inflation. Globally growth stocks trade at high valuations relative to value stocks based on their future earnings potential. In a rising interest rate environment, growth stocks typically see heavy price declines as higher interest rates impact their valuations based on the discount factors applied on forward earnings. In the local context we don't see the available growth counters trading at comparable premiums to developed markets. Therefore we're bullish on growth plays even going into a higher interest rate environment.

Brands and Pricing Power: We would be looking for stocks with stable margins and strong brands/ differentiated offerings which allows for pricing power. Companies with high pricing power are more likely to be able to pass on higher costs to their end consumers thus sustaining margins. Entities engaged in agriculture, healthcare and other essential services are also likely to be able to pass on costs to the end consumers.

Limited Recurring Capex Requirements: In an inflationary and higher interest rate environment, we prefer entities with limited recurring capex requirements as both the cost of new/ replacement capex and cost of capital will likely rise. We would be looking for companies with strong operating leverage with limited capex requirements going forward.

Foreign Currency Revenue Streams: In the Sri Lankan context, entities deriving a large part of their revenues in foreign currency and having the bulk of their fixed costs in local currency are likely to benefit the most from the expected depreciation of the LKR. Such gains are however temporary as inflation will subsequently exert pressure on domestic costs.

Selected Real Estate Players: Investors and households typically see real estate as a store of value during inflation and as real purchasing power is eroded through exchange depreciation. We favour residential real estate developers as commercial real estate owners may not be able to escalate pricing of long term rental agreements at the same pace as inflation.

Moderate Financial Leverage: We would avoid highly leveraged companies with significant LKR or foreign currency denominated debt as rising local interest rates and exchange depreciation will likely impact earnings through higher interest costs and exchange losses.

Our preliminary stock selection for the current year based on the strategy and outlook for the year are as follows. We hope to initiate coverage on several of our picks with more detailed initiation reports during the course of the year. We will also periodically update our strategy and stock selection for the year based on macro outcomes, market conditions and earnings releases/ management guidance.

GICS Sector/ Stock	Outlook	Comments
Energy	**N/A**	
Lanka IOC: LIOC	Neutral	Energy stocks are potentially a good hedge during higher inflation. Our main concern is forex shortages which could disrupt imports and/ or the re-imposition of fuel price controls.
Materials	**N/A**	
Dipped Products: DIPD	Overweight	We like selected counters within the sector that have both growth potential and foreign currency revenue streams.
CIC Holdings: CIC	Overweight	The stock is a potential hedge against higher inflation given its exposure to food prices. Our main concern is forex shortages, price controls and import controls that may disrupt the agricultural sector.
Capital Goods	**N/A**	
Hemas Holdings: HHL	Neutral	
Hayleys: HAYL	Overweight	In the current economic environment, we believe HAYL is better positioned relative to its peers within the diversified conglomerates sector as one of the largest export businesses in the country spanning multiple product segments.
Transportation	**N/A**	
Expolanka: EXPO	Neutral	We will be closely tracking data points on air/sea freight prices and trade volumes to gain further insight on the near term prospects for the company. We believe freight rates will still remain well above pre-Covid levels in the short term although rates have come off from the peak levels last October.
Consumer Durables & Apparel		
Hayleys Fabric: MGT	Neutral	The apparel manufacturers are among the primary albeit temporary beneficiaries of exchange rate depreciation given foreign currency based revenue with the bulk of overhead costs denominated in local currency. For the fabric manufacturers our main concerns would be the ability to pass on higher cotton prices and maintain margins in the backdrop of escalating global commodity prices.
Teejay Lanka: TJL	Neutral	
Hela Apparel: HELA	Overweight	
Retailing	**N/A**	
Kapruka: KPHL	Neutral	The stock has run up significantly since its IPO. At the current valuations we would be looking for evidence of sustained revenue growth and stable margins over the next few quarters to revise our rating.
Food, Beverage & Tobacco		
Melstacorp: MELS	Neutral	High exposure to the alcoholic beverages business provides MELS with a relatively inflation proof product with high pricing power and somewhat inelastic demand. The recovery in the tourism segment and removal of pandemic restrictions would further support earnings growth in the current year. Key risk factors are higher excise duties/ taxes on the beverages business.
Distilleries Comp: DIST	Neutral	
Banks	**Overweight**	Given low valuations, the financial sector is a potential beneficiary of a rotation into value stocks. Our main concerns would be higher impairments and/ or lower credit growth in the event of further macro shocks. We would recommend the fundamentally sound large cap banking stocks. Improvement in credit growth and the macro environment could provide upside to our rating.
Diversified Financials	**Neutral**	
Software Services	**Overweight**	
hSenid: HBS	Neutral	The stock has run up significantly since its IPO. At the current valuations we would be looking for evidence of strong customer acquisition/ revenue growth over the next few quarters to revise our rating.
Utilities	**Underweight**	
Real Estate	**N/A**	
Prime Lands Residencies: PLR	Neutral	We favour residential property developers, particularly players in the affordable housing segment as among the best placed to gain from households turning to real estate as a store of value amidst higher inflation and low real interest rates. Given the somewhat cyclical nature of the business, we would be looking for evidence of sales traction over the next few quarters to validate or revise our thesis. Escalation in building costs and the impact on margins would be concerns.

Company	Revenue CAGR (5 Yr)*	PER (x)	GP Margin (%)	FCF to Sales (%)	ROCE (%)	Debt to Equity (%)
HHL	11.18%	13.81 x	30.1%	7.3%	14.9%	71.2%
MELS	18.08%	10.45 x	31.2%	26.7%	6.1%	20.8%
HAYL	21.20%	16.17 x	25.4%	11.1%	13.8%	72.0%
DIST	6.30%	11.23 x	46.7%	40.7%	134.1%	152.2%
CIC	6.90%	7.03 x	25.9%	20.6%	22.0%	36.0%
LIOC	-1.33%	16.58 x	5.0%	8.5%	0.4%	103.0%
DIPD	16.16%	5.45 x	25.5%	-6.3%	24.0%	59.0%
EXPO	31.32%	28.67 x	17.6%	-0.3%	32.9%	46.9%
TJL	12.27%	15.29 x	11.9%	4.5%	12.0%	22.4%
MGT	5.22%	16.07 x	13.7%	5.5%	12.0%	79.2%
HBS	12.16%	33.44 x	53.4%	12.8%	28.5%	8.1%
HELA	14.98%	19.23 x	18.9%	5.0%	54.0%	398.0%
PLR	21.35%	7.86 x	24.5%	16.7%	46.2%	268.0%
KPHL	17.59%	58.82 x	36.5%	-11.6%	13.7%	30.0%

1 * HBS, Hela, KPHL 4 year CAGR is used. PER and PBV are based on FY2021 data.
2 For others PER and PBV are based on TTM EPS as at 30-Sep-2021.
3 CMP as at 19-Jan-2022 is used for computations.

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Acuity: Stock Ratings Scale

Acuity rating	Sell	Underweight	Neutral	Over-Weight	Buy
Equivalent ratings	Strong Sell	Underperform Moderate Sell Weak Hold Reduce	Hold	Outperform Moderate Buy Accumulate Add	Strong Buy