



June 2023 | Sri Lanka | Economy & Strategy

Summary on impact of proposed domestic debt optimization

The envisaged DDO is highly market positive in terms of the potential impact on listed counters such as commercial banks and insurance companies which have an exposure to government treasuries. However, the proposed DDO treatment which excludes the bulk of the outstanding Treasury Bonds is much lighter than expected. The impact of a shallow DDO on future debt sustainability is more ambiguous as it allows for less fiscal space and places a greater expectation on foreign creditors to deliver on debt relief to meet the required DSA targets as part of the ongoing external debt restructuring. However, the positive impact on the domestic banks who are exempted from any DDO treatment on their bond portfolios may allow for a faster recovery in credit and economic growth which will support the growth side of debt sustainability.



Out of total LCY market domestic debt, only the instruments held by CBSL and ETF are subject to reprofiling.

- LCY instruments holdings of both institutes in aggregate account to only c. 45% of total LCY market debt (of LKR 12.8 Trn as at 31-Dec-2022).



No impact to Treasury Bills or Bonds held by LCBs, insurance companies, primary dealers, private sector and general public.

- Banking and insurance sector stocks are expected to observe a notable price gains in the short to medium term.



Bonds held by Superannuation Funds to be swapped for 12 new bonds series of equivalent value. New bonds will mature from 2027 onwards with a step-down coupon structure.

- Participation of the funds have been incentivized with the income tax scheme, where non-participating funds will be subject to 30% CIT (compared to their current CIT of 14%).
- In Phase 2 of DDO, CBSL holdings of Treasury Bills (as at 31-Dec-2023) are proposed to be converted in to 10 bond series of equivalent value maturing from 2033-2038 with a step-down coupon structure.



DDO is vital to reach the GFN to GDP target set by IMF (average of 13% during 2027 – 2032 period), as avg. GFN to GDP of only 14.2% is achieved with External Debt Restructure (EDR) alone, whereas with EDR and DDO both Sri Lanka's avg. GFN to GDP will reduce to 12.7%.

The envisaged DDO is fairly shallow in terms of the value of bonds reprofiled and length of maturity extensions entailing a very gradual reduction in GFN to the target levels by 2027. A lighter DDO leaves less fiscal space for slippage in other areas (such as fiscal consolidation and primary balance targets over the EFF program period) and would require a greater effort from foreign creditors to deliver on debt relief to maintain DSA targets within the required range as part of the ongoing EDR.



Proposed DDO treatment

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DDO measures proposed by CBSL versus expectations

Instrument/ DDR Scenario	Acuity/ Market Expectations for DDO	Proposed DDR outcome as announced by CBSL
Restructuring of Treasury Bills	DDR treatment limited to CBSL Treasury Bill holdings	DDR treatment limited to CBSL Treasury Bill holdings
Restructuring of Treasury Bonds	Bond reprofiling involving replacing Current bonds with; <ol style="list-style-type: none"> Longer dated bonds (maturity extension) and /or Longer dated bonds with amortization. Lower coupon rate bonds 	GoSL has proposed the following, <ol style="list-style-type: none"> Maturity extension with amortization. Step-down coupon rate bonds.
Treasury Bond Reprofiling Scenario		
Bonds to be reprofiled	Target of c. 60% of total Bonds - Maturing within 2024 – 2028 and in 2031 <ul style="list-style-type: none"> Held by EPF, Commercial banks and other institutional entities. 	100% Bond holdings of Superannuation Funds and 100% bills held by CBSL as at Dec-2022 are proposed to be reprofiled. <ul style="list-style-type: none"> <i>Holdings of Commercial banks and other entities are excluded.</i>
Maturity extension with amortization and coupon reductions	Maturity extensions up to 10 years Reduced coupon rates – as low as 10% p.a	<p><u>Bonds held by Superannuation Funds</u></p> <ol style="list-style-type: none"> 100% of total value held maturity period extended to 2027-2038 - to be amortized in 12 equivalent amounts. Proposed step-down coupon structure - 12% (till 2025E) and 9% (till maturity). <p><u>CBSL holdings of T'bills (Phase 2 DDO) –</u></p> <ol style="list-style-type: none"> Proposed to be converted to T'bonds - to be amortized in 10 equivalent amounts. For 16% of total value, maturity period extended to 2029-2032 period and remaining 84% maturity period extended to 2033-2038. Proposed lower coupon rate 12.4% (till 2024E), 7.5% (till 2026) and 5% (till maturity).
Bondholders		
1. Bonds held by EPF/ ETF	Voluntary exchange for c. 100% of EPF's and ETF's Bonds.	100% of EPF's and ETF's bonds.
2. Bonds held by NSB/ CBSL	Voluntary exchange for c. <60% of NSB's and CBSL's bonds.	CBSL – 100% of CBSL's bonds.
3. Bonds held by Commercial Banks	Voluntarily exchange for c. <60% of the bonds held by LCB's	All Others Excluded.
Others (Options proposed by GoSL to SLDBs and FCBUs)	SLDB holders given 3 options: <ol style="list-style-type: none"> Exchanging against USD instruments with a 30% nominal haircut, 6-year maturity with no grace period at 4% interest. Exchanging against USD instruments with no nominal haircuts, 15-year maturity with a 9-year grace period at 1.5% interest. Exchanging against LKR instruments with no nominal haircuts, 10-year maturity, 0 grace periods, at a floating rate (SLFR + 1%). 	

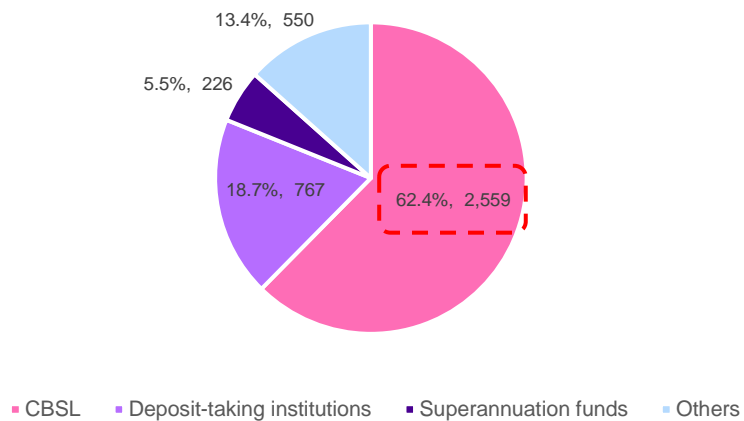
Source: Acuity Research and GoSL

The DDO treatment is lighter than expected; reprofiles a smaller portion of the bond stock...

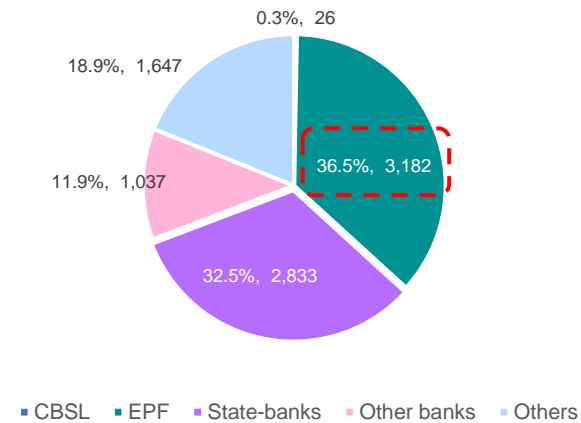
Reprofiled treasury bill and treasury bond stock held by CBSL and superannuation funds/ EPF.

Instrument	Conversion value (of Tendered amount)	Conversion Value (LKR Bn)	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	2032F	2033F	2034F	2035F	2036F	2037F	2038F
CBSL T-Bills	100%	2,599.3																
4 instruments	16%	409.5							102.4	102.4	102.4	102.4						
6 instruments	84%	2,149.8											358.3	358.3	358.3	358.3	358.3	358.3
Coupon rate			12.40%	12.40%	7.50%	7.50%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Superannuation Funds/ EPF T-Bonds																		
12 instruments	100%	3,181.6						265.1	265.1	265.1	265.1	265.1	265.1	265.1	265.1	265.1	265.1	265.1
Coupon rate			12.00%	12.00%	12.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%

T Bills holding structure as at Dec-2022 (LKR Bn)



T Bonds holding structure as at Dec-2022 (LKR Bn)



... and envisages a more gradual GFN trajectory

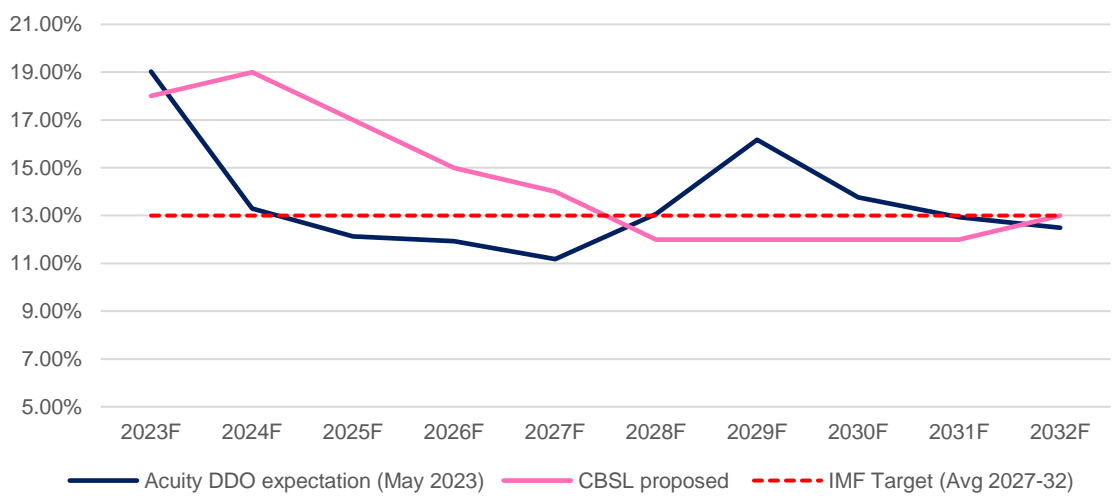
GoSL's Debt to GDP Target

	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
IMF Target										95%
Debt to GDP Target as per DDR proposed by GOSL	115.0%	113.0%	112.0%	111.0%	108.0%	104.0%	101.0%	98.0%	94.0%	91.0%

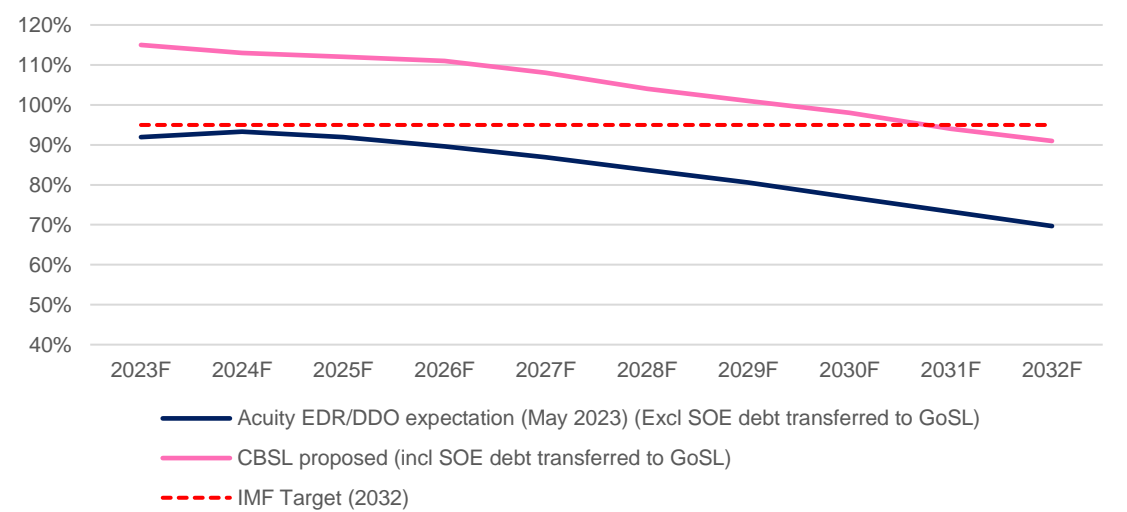
GFN to GDP Target

	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
IMF Target (average for the period)					13%					
GFN to GDP Target as per DDR proposed by GOSL	18.0%	19.0%	17.0%	15.0%	14.0%	12.0%	12.0%	12.0%	12.0%	13.0%

Sri Lanka Gross Financing Needs to GDP



Sri Lanka Central Government Debt/ GDP

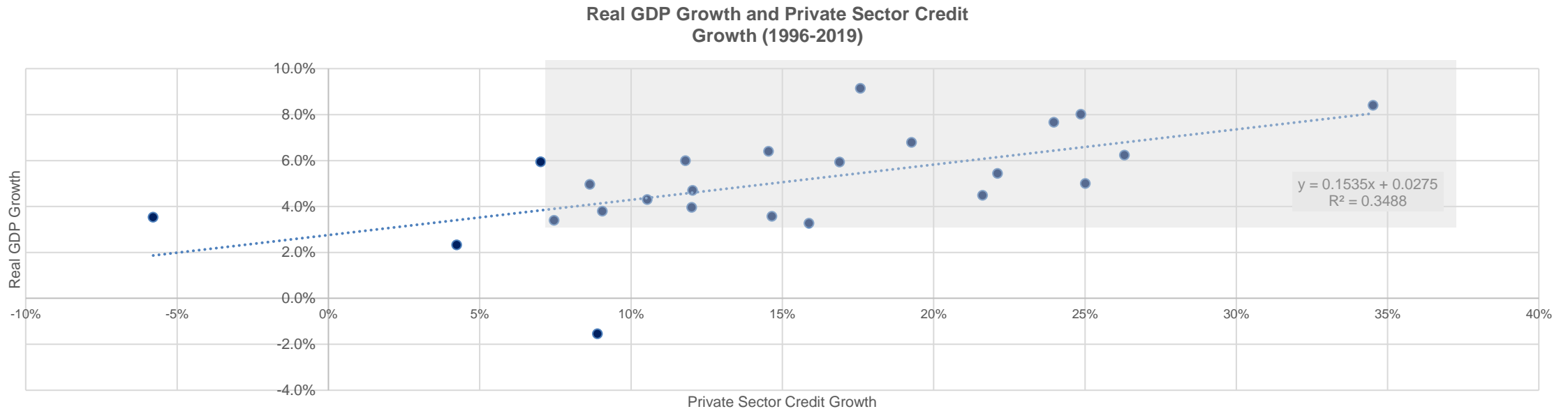


Source: Acuity Research and GoSL

Taking the path of least resistance; pros and cons of a shallower DDO

✓	✗
Less risk of financial instability.	Less fiscal space/ buffer to meet medium term DSA targets.
Path of least resistance with fewer objections from the public/ opposition parties.	Greater reliance on foreign creditors to agree to debt relief to meet GFN/ DSA targets.
Potentially more growth friendly, higher probability of inducing credit growth if banks are less impacted by DDO.	Although CBSL policy rate is the primary tool impacting market interest rates, the less ambitious/ more gradual reduction in GFN/ GDP may keep the current high-cost interest rate structure at elevated levels for longer.
Market participants in the treasury bill/ bond market are more likely to continue to fund the government deficit. Market participants may be more reluctant to fund the government deficit after a deeper DDO treatment.	

Light DDO/ exempting banks; more supportive of credit growth needed for the recovery



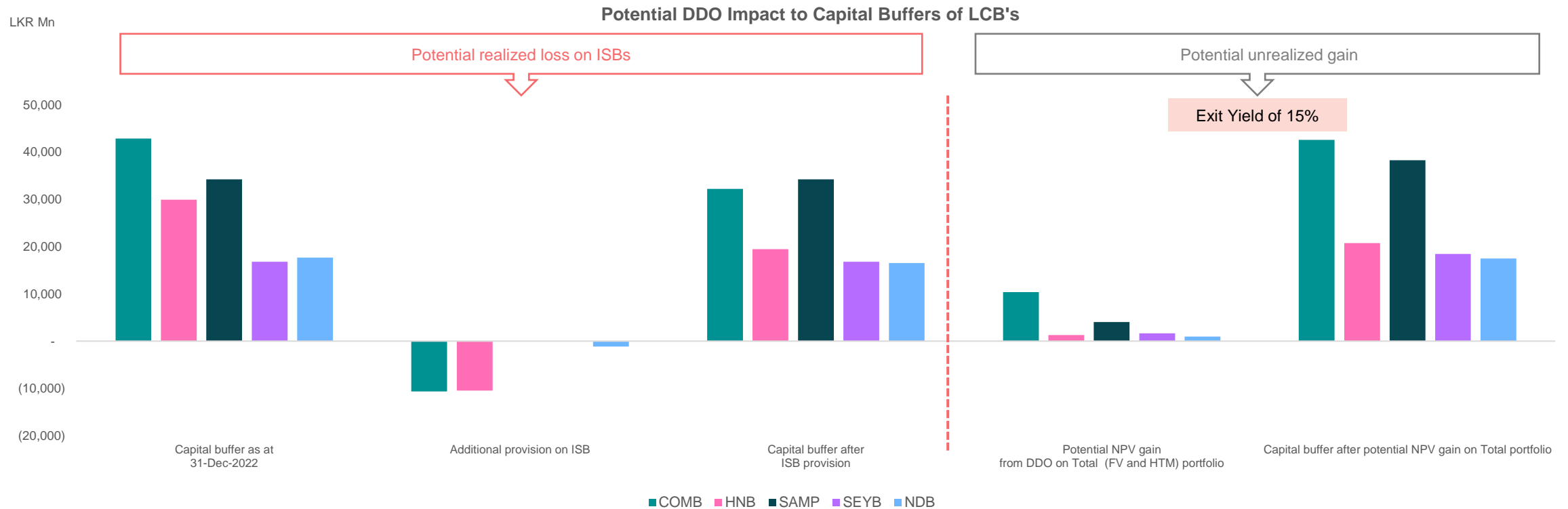
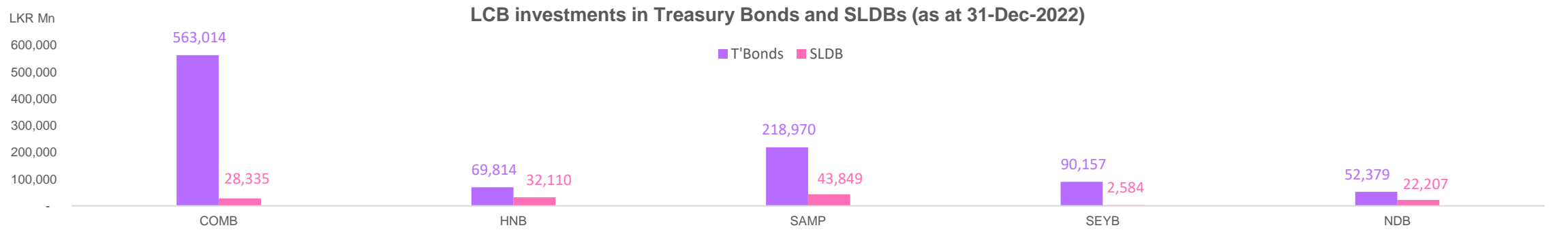
Returning the economy to a positive growth trajectory of at least 3% real GDP growth on an average annual basis is required during the EFF program period to meet the DSA targets. The light DDO which leaves the banking sector untouched may support an expansion in private sector credit growth, which has recorded negative credit growth in the last couple of quarters as interest rates escalated and economic conditions deteriorated. In the past, private sector credit growth of min c. 7.5% per annum has been necessary to achieve positive economic growth, except in a few outlying years.



Market Impact of DDO

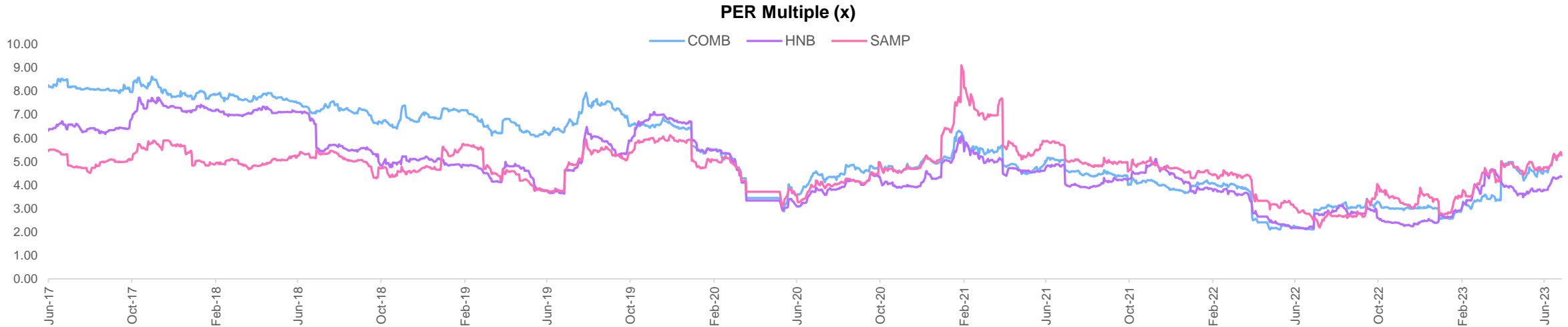
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CBSL proposed bond reprofiling has a positive effect on major LCB's capital buffers...

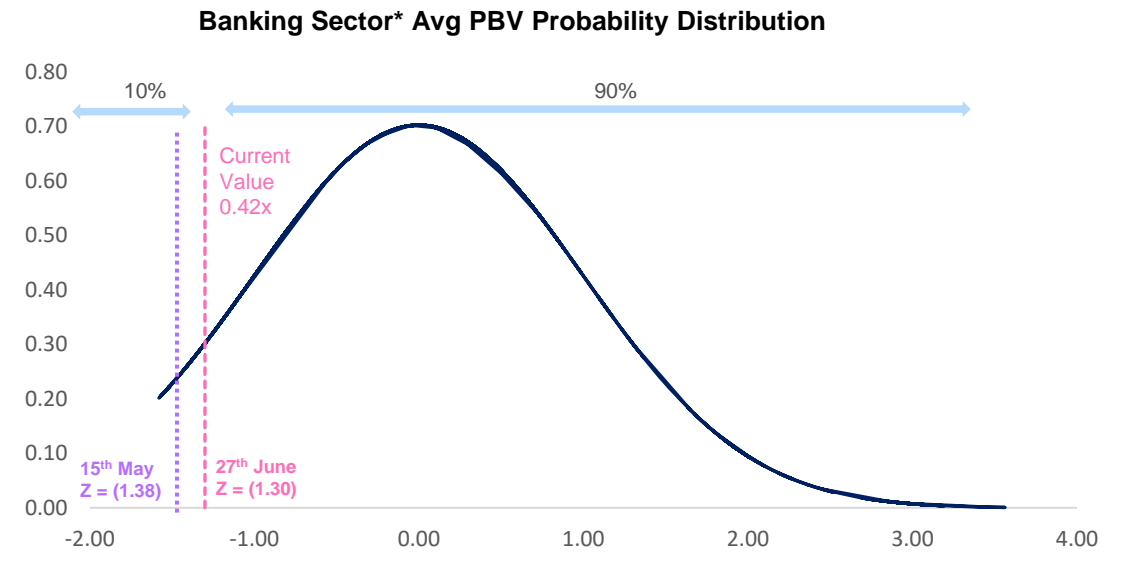
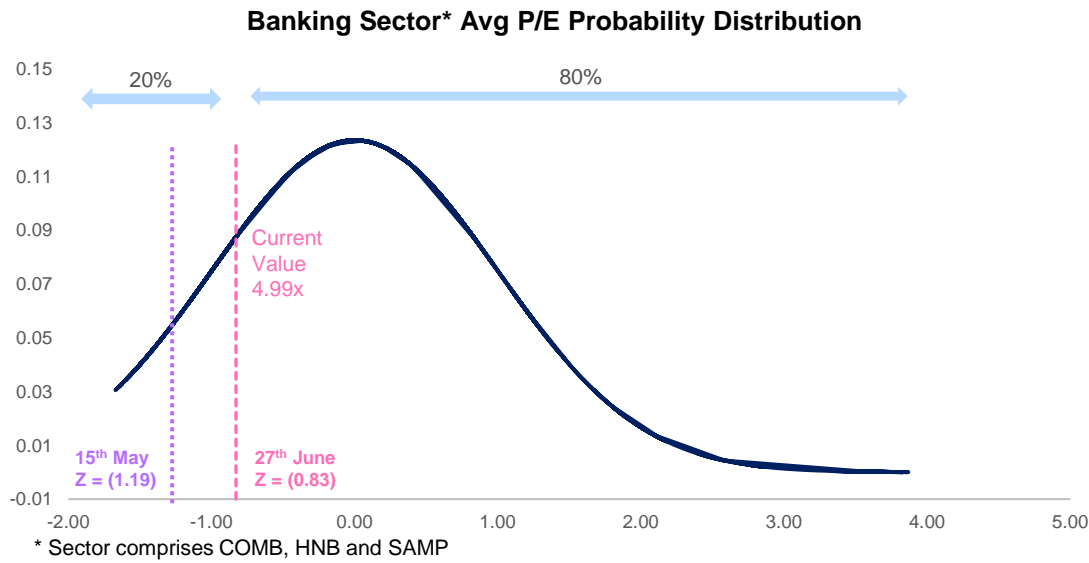


Source: Company financials, Acuity research

High share price gains are anticipated in banking sector stocks post DDO announcement...



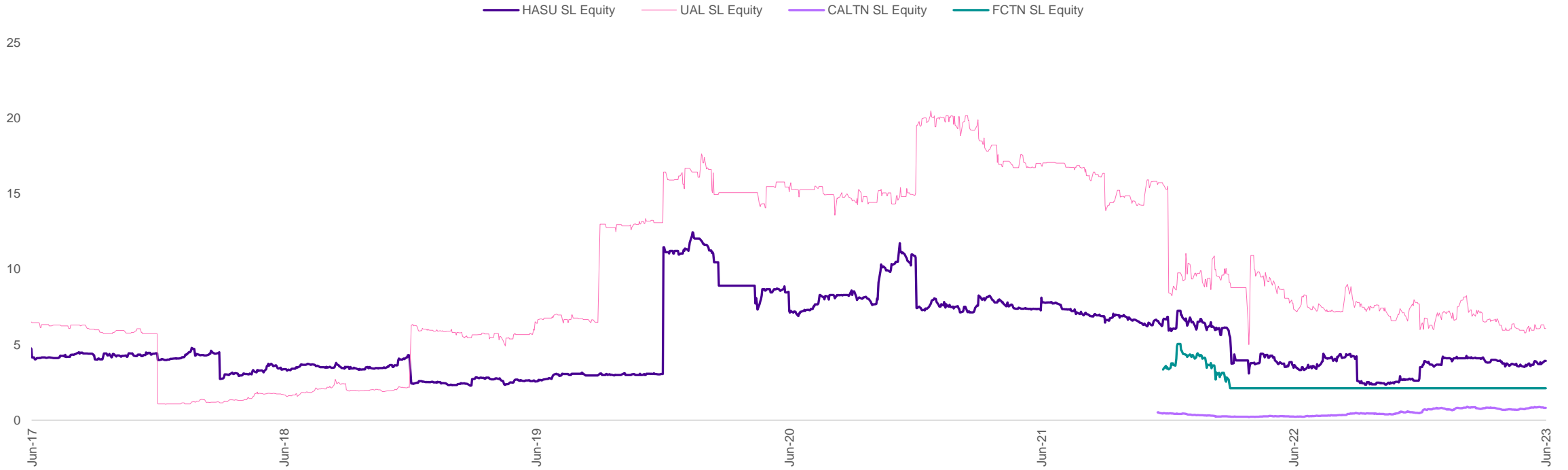
Source: Bloomberg, Acuity research



Avg. valuations for listed banks in our coverage universe are more than one standard deviation below their historical valuation multiples, indicating significant upside potential on multiple expansion as market interest rates and the economic conditions underlying the current low valuations gradually normalise.

Potential uptick is anticipated in share prices of insurance sector and primary dealer stocks...

P/E ratio movement - Insurance companies and Primary Dealers



Company	Ticker	Share Price *	Book Value per Share	Market Cap (LKR Bn)	Trailing EPS	Beta	Valuations *				Other Analysis				ASB Stock Rating	Rating Change	52W High Price	52W Low Price
							Sharpe ratio	Trailing PER (x)	PBV (x)	Sector PER (x)	Sector PBV (x)	ROE (%)	TTM EPS growth (%)					
BANKS											4.8	0.4		-				
COMMERCIAL BANK [V]	COMBN	68.10	156.18	84.2	12.44	0.51	-0.42	5.5	0.4	4.8	0.4	8%	-44%	Moderate Buy	▲	71.90	48.70	
COMMERCIAL BANK [NV]	COMBX	54.10	156.18	4.2	12.44	0.51	-0.42	4.3	0.3	4.8	0.4	8%	-44%	Moderate Buy	▲	62.00	39.40	
HNB [V]	HNB N	139.00	341.10	62.1	31.59	0.49	-0.26	4.4	0.4	4.8	0.4	9%	-8%	Moderate Buy	-	141.00	72.00	
HNB [NV]	HNB X	108.00	341.10	12.2	31.59	0.49	-0.26	3.4	0.3	4.8	0.4	9%	-8%	Moderate Buy	-	114.00	64.90	
SAMPATH BANK	SAMPN	55.90	114.77	65.6	10.42	0.64	-0.12	5.4	0.5	4.8	0.4	9%	-10%	Moderate Buy	-	59.30	26.00	
CAPITAL GOODS											4.0	0.7						
HAYLEYS	HAYLN	77.60	105.24	58.2	21.80	1.36	0.08	3.6	0.7	4.0	0.7	21%	-10%	Moderate Buy	-	125.00	59.00	
HEMAS HOLDINGS	HHL N	69.60	64.38	41.5	7.16	0.73	0.11	9.7	1.1	4.0	0.7	11%	0%	Hold	-	70.20	39.00	
JOHN KEELLS HOLDINGS	JKH N	150.00	246.24	207.7	13.12	0.40	-0.33	11.4	0.6	4.0	0.7	5%	-10%	Hold	-	157.00	118.50	
COLOMBO DOCKYARD	DOCKN	56.50	105.60	4.1	3.85	0.33	-0.59	14.7	0.5	4.0	0.7	4%	-47%	Hold	-	72.00	54.00	
CONSUMER DURABLES & APPAREL											9.0	0.9		Attractive				
HAYLEYS FABRIC	MGT N	23.50	22.84	9.8	1.00	1.07	0.33	23.6	1.0	9.0	0.9	4%	-85%	Moderate Buy	-	42.00	20.00	
TEEJAY LANKA	TJL N	30.40	44.71	21.8	2.97	0.39	0.23	10.2	0.7	9.0	0.9	7%	-16%	Hold	-	47.90	28.70	
HELA APPAREL	HELAN	6.80	10.70	8.9	-0.99	N/A	-1.94	N/A	0.6	9.0	0.9	-9%	-288%	Hold	-	14.40	5.70	
DIVERSIFIED FINANCIALS											3.3	0.9						
CENTRAL FINANCE	CFINN	74.30	249.83	16.9	28.93	1.51		2.6	0.3	3.3	0.9	12%	-19%	Moderate Buy	▲	84.00	56.00	
ENERGY											3.6	1.5						
LANKA IOC	LIOCN	130.00	115.00	69.2	70.79	2.54	0.38	1.8	1.1	3.6	1.5	62%	682%	Hold	-	296.00	67.10	
FOOD, BEVERAGE & TOBACCO											5.4	1.5						
MELSTACORP	MELSN	58.50	86.97	68.2	16.83	1.05	-0.09	3.5	0.7	5.4	1.5	19%	80%	Moderate Buy	-	61.60	35.00	
DISTILLERIES	DISTN	21.40	2.58	98.4	4.01	0.49	-0.14	5.3	8.3	5.4	1.5	156%	136%	Hold	-	23.20	12.70	

Source : CSE, ASB Research Analysis

* Share price and company valuation is based on CMP as at 28th June 2023.

All figures are in LKR, unless specified.

Trailing (12 M) EPS for companies are based on 12 month ended as at 31-Mar-2023, except BPPL which is based on TTM as at 31-Dec-2022.

	Ticker	Share Price *	Book Value per Share	Market Cap (LKR Bn)	Trailing EPS	Beta	Valuations *				Other Analysis										
							Sharpe ratio	Trailing PER (x)	PBV (x)	Sector PER (x)	Sector PBV (x)	ROE (%)	TTM EPS growth (%)	ASB Stock Rating	Rating Change	52W High Price	52W Low Price				
INSURANCE											6.8	1.0									
UNION ASSURANCE	UALN	30.60	25.75	18.0	5.05	0.28	0.18	6.1	1.2	6.8	1.0	20%	46%	Moderate Buy	▲	39.50	20.10				
HNB ASSURANCE	HASUN	47.00	50.73	7.1	37.44	0.57		1.3	0.9	6.8	1.0	74%	285%	Moderate Buy	▲	53.80	31.50				
MATERIALS											4.7	1.2									
CIC HOLDINGS [V]	CICN	67.20	60.66	19.6	20.58	1.20	0.16	3.3	1.1	4.7	1.2	34%	112%	Moderate Buy	-	108.00	30.20				
CIC HOLDINGS [NV]	CICX	55.10	60.66	4.8	20.58	1.20	0.16	2.7	0.9	4.7	1.2	34%	112%	Moderate Buy	-	76.00	20.40				
DIPPED PRODUCTS	DIPDN	28.00	45.06	16.8	10.87	0.93	0.20	2.6	0.6	4.7	1.2	24%	21%	Hold	-	48.70	23.00				
CHEVRON	LLUBN	89.20	30.54	21.4	16.22	0.73	-0.19	5.5	2.9	4.7	1.2	53%	17%	Hold	-	116.25	68.00				
PGP GLASS CEYLON PLC	GLASN	23.30	9.27	22.1	3.27	0.99	0.19	7.1	2.5	4.7	1.2	35%	229%	Hold	-	23.60	8.90				
EX-PACK CORRUGATED CARTONS	PACKN	13.50	8.29	4.5	4.16	N/A	0.59	3.2	1.6	4.7	1.2	50%	126%	Hold	-	18.80	8.90				
HAYCARB	HAYCN	59.90	74.52	17.8	19.60	0.32	0.18	3.1	0.8	4.7	1.2	26%	77%	Hold	-	80.00	49.00				
REAL ESTATE											3.9	0.4									
PRIME RESIDENCIES	PLRN	7.50	10.01	7.0	3.57	N/A	-0.19	2.1	0.7	3.9	0.4	36%	99%	Hold	-	9.20	4.50				
SOFTWARE & SERVICES											5.2	1.6						Attractive	-		
HSENI BUSINESS SOLUTIONS	HBSN	12.10	7.20	3.3	0.67	N/A	0.19	18.0	1.7	5.2	1.6	9%	-60%	Hold	-	24.00	11.80				
HOUSEHOLD & PERSONAL PRODUCTS											4.7	1.8									
B P P L HOLDINGS	BPPLN	19.90	10.57	6.1	2.41	1.01	0.09	8.3	1.9	4.7	1.6	23%	49%	Hold	-	32.10	16.50				

Source : CSE, ASB Research Analysis

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