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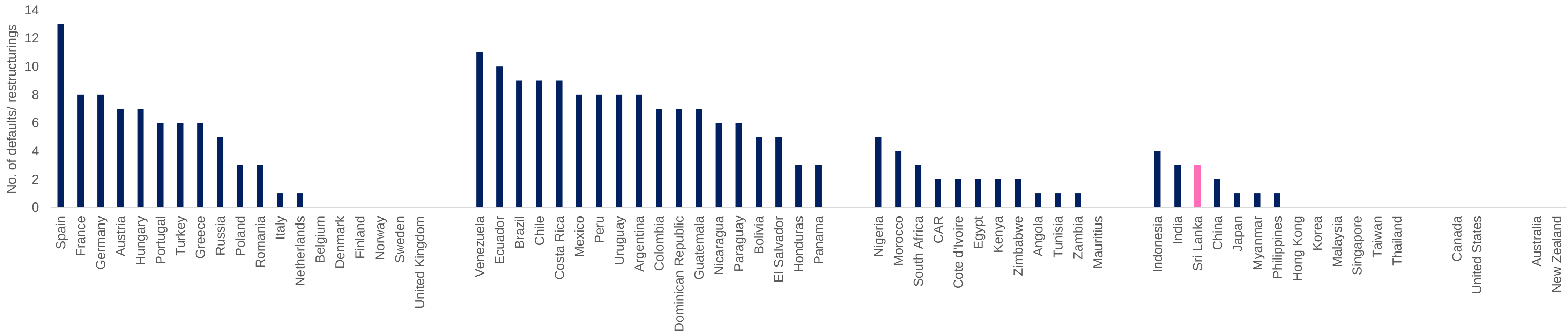
May 2023 | Sri Lanka | Economy & Strategy

Fixing the broken economy: Market impact of the IMF program & debt restructuring

The IMF program is an important endorsement of the corrective economic policies undertaken since the economic crisis. The EFF is a crucial first step towards restoring market access by facilitating a settlement with external creditors on foreign debt restructuring, and in setting out target debt sustainability parameters for both the external debt restructuring exercise and domestic debt optimisation. However, given the precarious fiscal situation and fragile political stability, we expect that the road to debt sustainability and sustained economic recovery will be long and arduous.

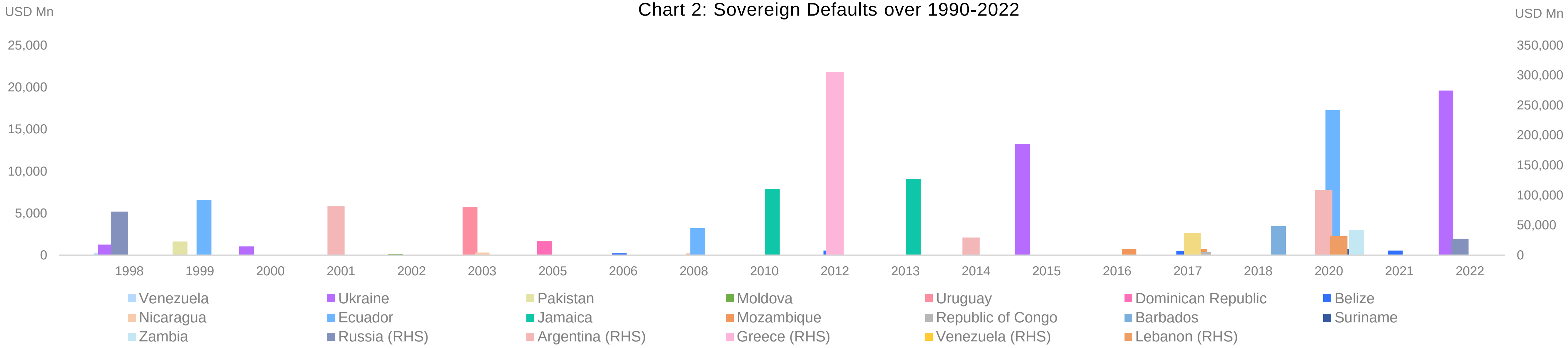
Sovereign debt defaults

Chart 1: Cumulative tally of default & rescheduling: 1800 or year of independence to date



Although many countries have defaulted their sovereign debt in the past, there have been fewer defaults by emerging market economies in recent times. Most of the defaults in the last three decades have been either very small economies or countries experiencing severe political and economic stress.

Chart 2: Sovereign Defaults over 1990-2022



Source: Moody's Investors Service, ReinHart and Rogoff (2010), Acuity Research

Sovereign debt defaults cont'd.

Table 1: Serial Defaults Following a Debt Crisis

Country	Year	External Debt/ GNP (%)	External Debt/ Exports (%)
Argentina	1982 2001	55.1 50.8	447.3 368.1
Chile	1972 1983	31.1 96.4	n.a. 358.6
Ecuador	1984 2000 2008	68.2 106.1 20.0	271.5 181.5 81.0
Peru	1978 1984	80.9 62.0	388.5 288.9
Russia	1991 1998	12.5 58.5	n.a. 109.8

Table 2: Recent Sovereign Defaults

	 Ghana 2021	 Zambia 2021	 Sri Lanka 2022
GDP (USD Bn)	77.59	22.15	77.1
Total Debt (% GDP)	77%	126%	114%
Foreign Debt	37%	65%	52%
Domestic Debt	40%	61%	62%
Total Revenue (% of GDP)	15%	24%	8%
Domestic Debt Restructuring	Yes	No	Yes

Source: Rheinhart & Rogoff (2010), World Bank, Bank of Ghana, IMF, Ministry of Finance, CBSL, Bank of Zambia

Sovereign debt defaults cont'd.

Emerging/ frontier market sovereign defaults in the past predominantly related to external foreign currency debt. Multilateral, bilateral and more recently commercial foreign currency debt traditionally comprised the main sources of debt financing available to developing economies. The growth of local currency government bond markets in developing economies is a more recent phenomenon spanning the last three decades in Sri Lanka and many other frontier economies. As reliance on domestic debt financing has increased, recent sovereign defaults such as Ghana and Sri Lanka, feature both foreign currency and local currency debt restructuring. Investors in local currency government debt often assume that such debt instruments entail zero default risk as the sovereign is endowed with the ability to monetise its local currency debt. However, its increasingly apparent that at high levels of government indebtedness, the ability to inflate away the local debt and/ or use monetary financing is not always viable without further destabilising the economy. Although an outright default on local currency government debt is unlikely in most cases, for sovereigns under high debt distress the local currency debt stocks may require periodic restructuring in the absence of debt sustainability.

The challenge for Sri Lanka is to ensure that it emerges from its worst economic crisis in recent memory with greater fiscal discipline and with a stronger institutional framework to manage its public finances. The alternative is that the country would continue to face debt distress and/ or serial debt defaults.

Source: Rheinhart & Rogoff (2010), World Bank, Bank of Ghana, IMF, Ministry of Finance, CBSL, Bank of Zambia

Sri Lanka Debt Summary

Fiscal slippage and government profligacy led to debt accumulation to an unsustainable level.

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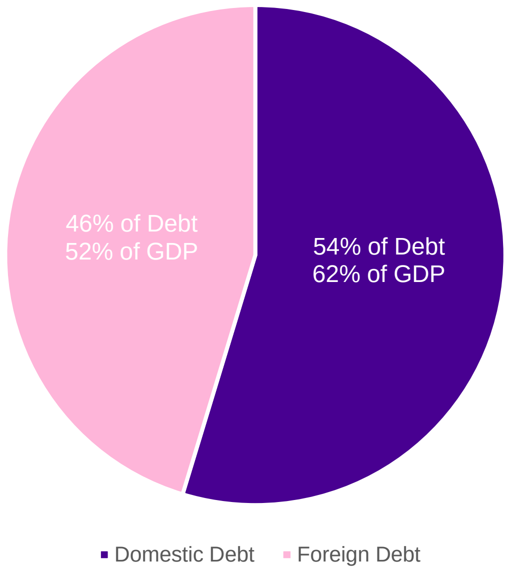
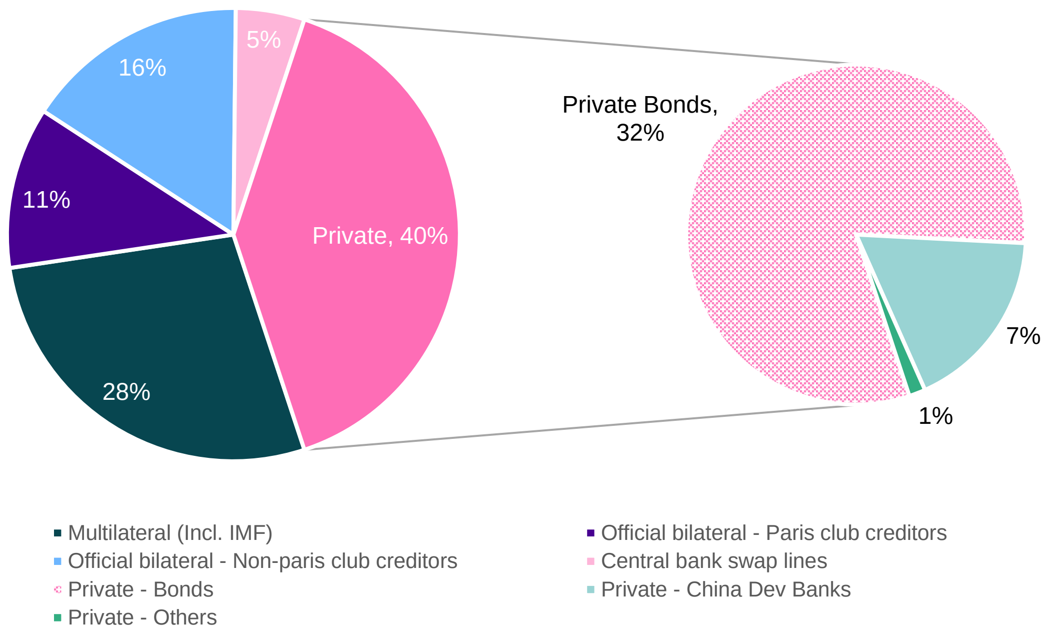
Sri Lanka debt composition

Chart 3a: Central Government Debt - as at end of 2022



LKR Bn	2022
Total debt	27,492
Domestic Debt	15,034
Foreign Debt	12,458

Chart 3b: Composition of Foreign-law Debt (LKR Bn)



LKR Bn	2022
Total foreign debt	12,458
Multilateral Debt	3,611
Bilateral and Commercial	8,846

Source: IMF, CBSL

LKR treasuries and ownership structure

Chart 4a: Treasury Bills

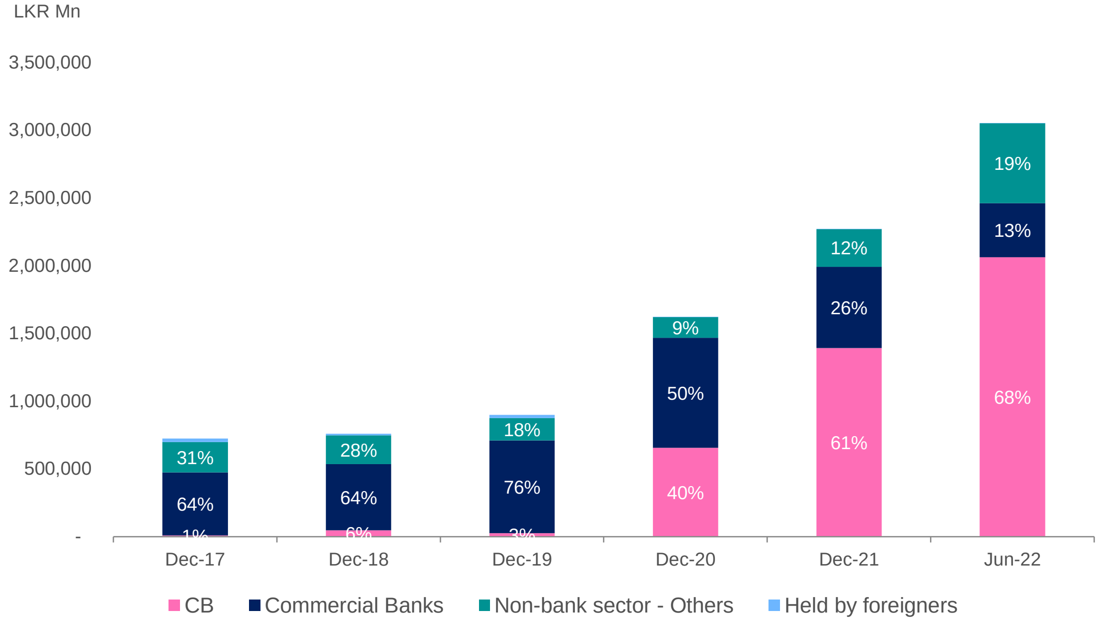
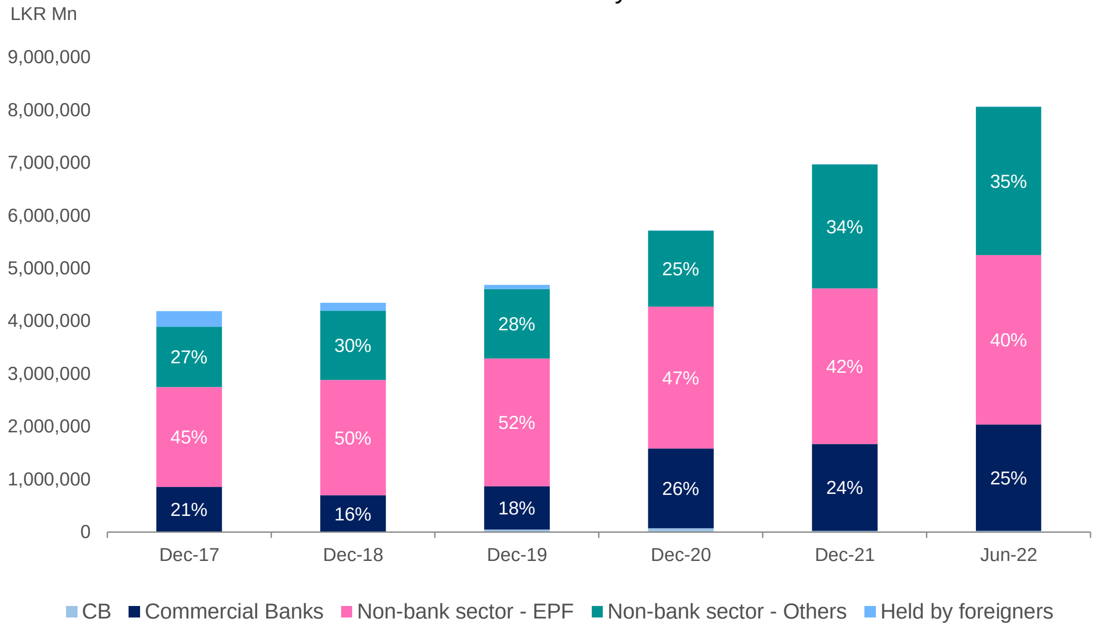


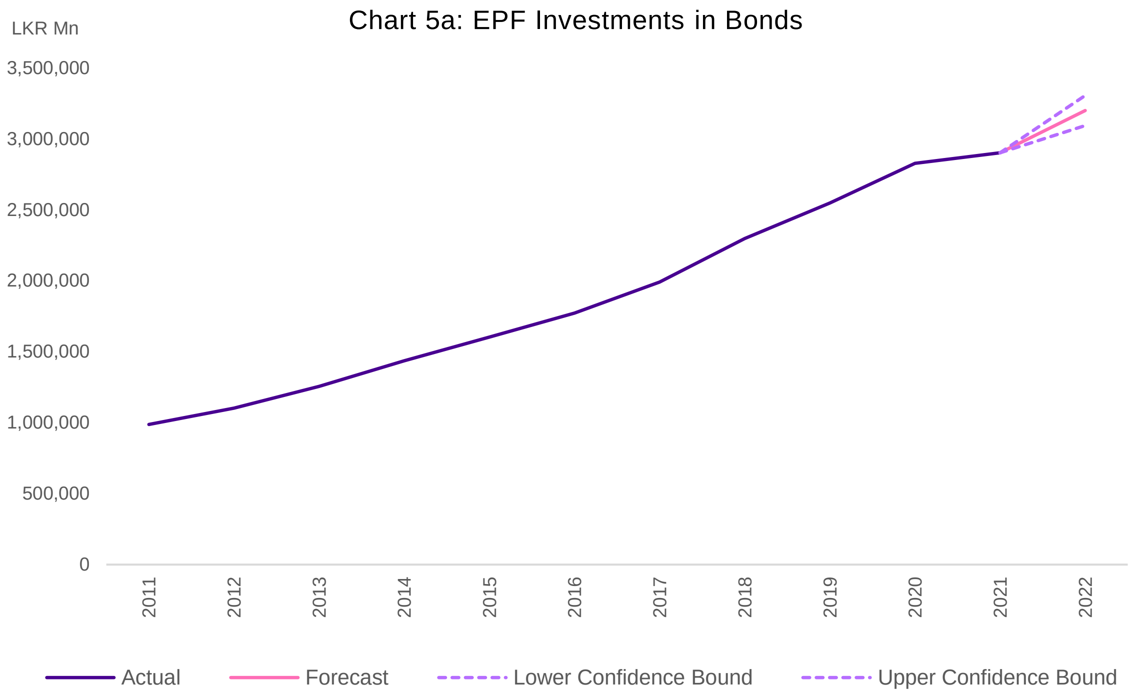
Chart 4b: Treasury Bonds

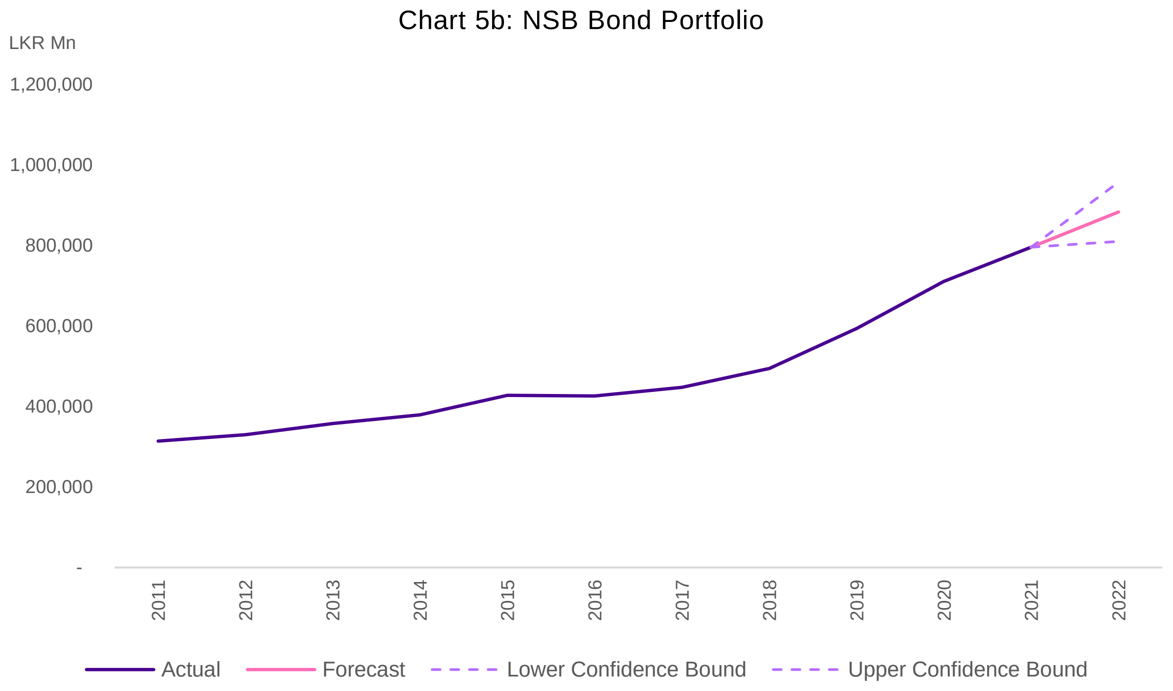


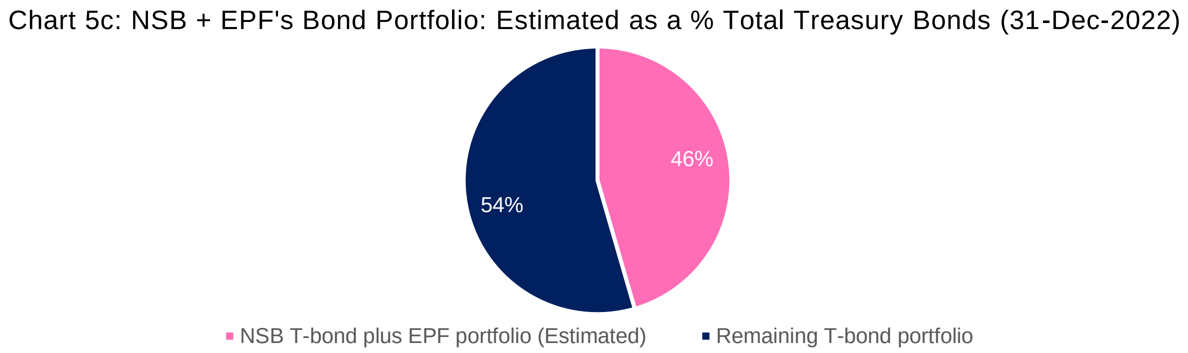
Sri Lanka has incurred significant fiscal deficits since 2020. The government relied heavily on monetary financing from 2020 until mid 2022, hence the CBSL share of the treasury bill stock has increased to c. 68%. The ownership structure of the treasury bond stock has remained more consistent with the EPF owning c. 40%.

Source : CBSL

EPF and NSB are the largest holders of Treasury Bonds







Source : CBSL

Significant part of deficit financing in 2022 came from CBSL

Chart 6a: Treasury Bill Stock Change

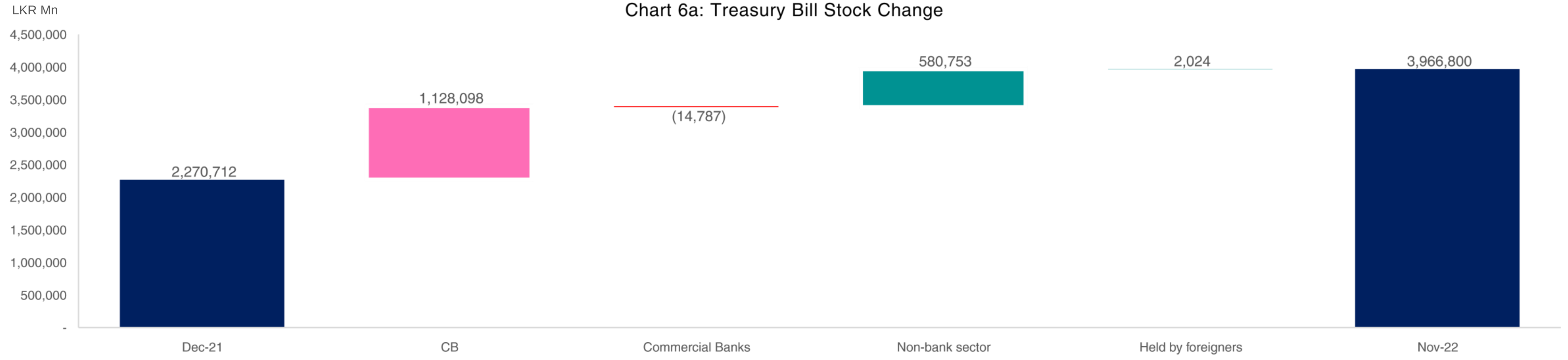
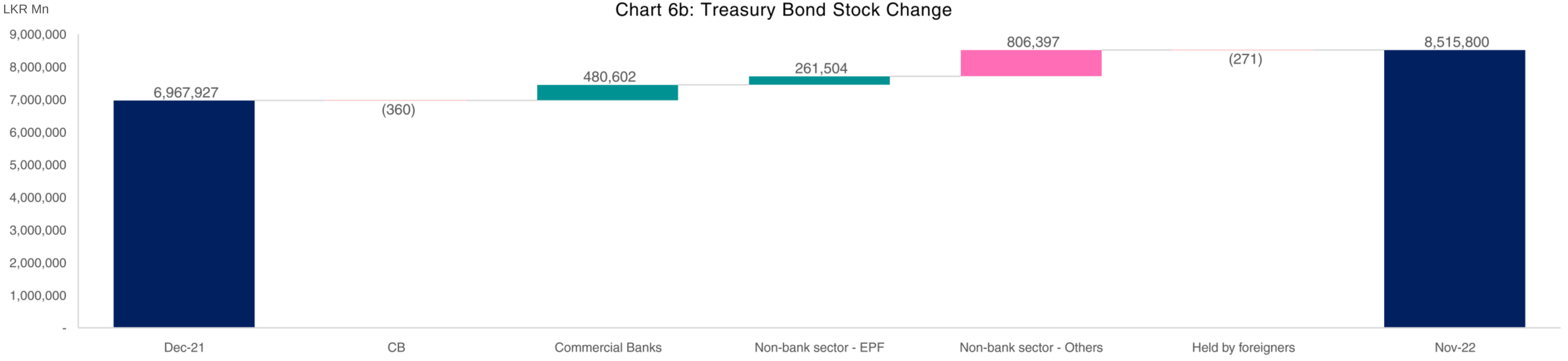


Chart 6b: Treasury Bond Stock Change



Source: CBSL

High level of bond maturities over the next few years

Chart 7a: Estimated Maturity Profile of Treasury Bonds

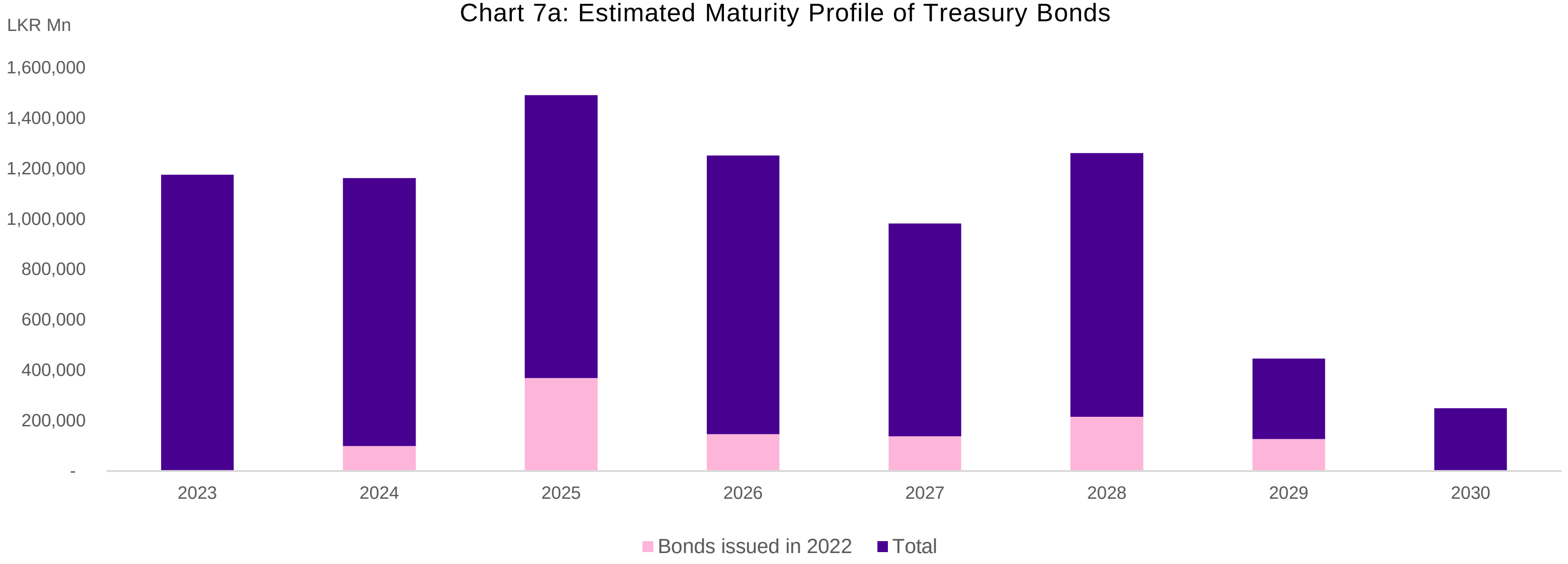
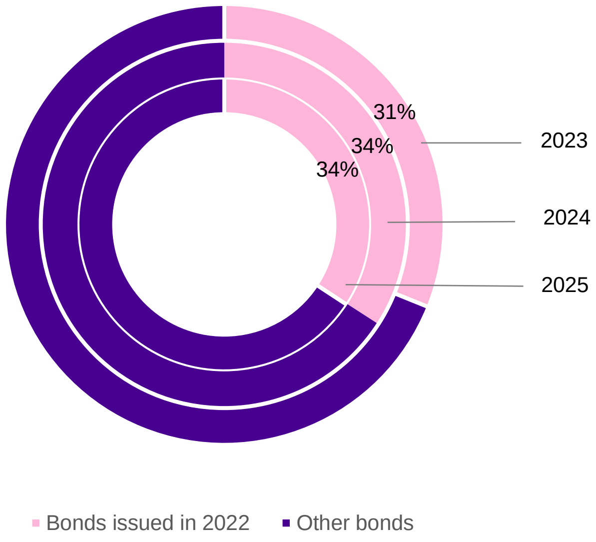


Chart 7b: Est. Interest Cost of Treasury Bonds



Treasury bonds amount to c. 65% of the domestic government debt, out of which high costs bonds (i.e., bonds issued in 2022) account for around c. 21% (by end of December 2022).

Out of the total treasury bonds maturing in the next 05-year period (2023 – 2027), maturity value of bonds issued in 2022 (high-cost bonds) only accounts to c. 17% of the total maturity value. However. over the next 05-years, out of the total interest cost estimated for the outstanding bond portfolio, on average c. 35% is resulting from high costs bonds (i.e., bonds issued in 2022).

Source: CBSL

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Structural Adjustments

Most of the painful adjustments in terms of fiscal consolidation, exchange rate adjustment and implementing cost reflective pricing to end circular debt have already been made as a precursor to the EFF.

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Cost reflective pricing to stem circular debt

Chart 8a: Household Electricity Prices in Sri Lanka Relative to Other Countries

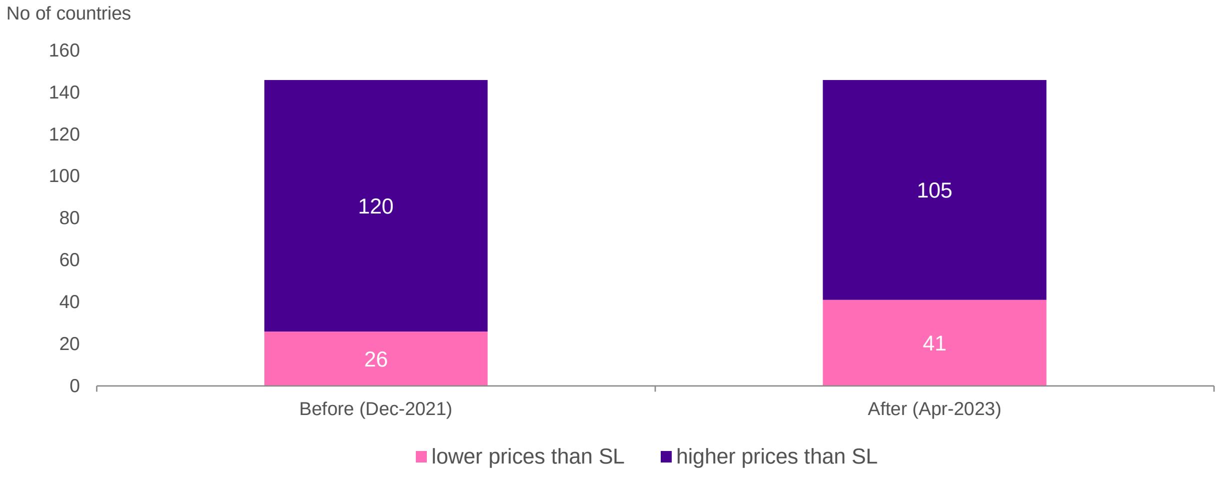
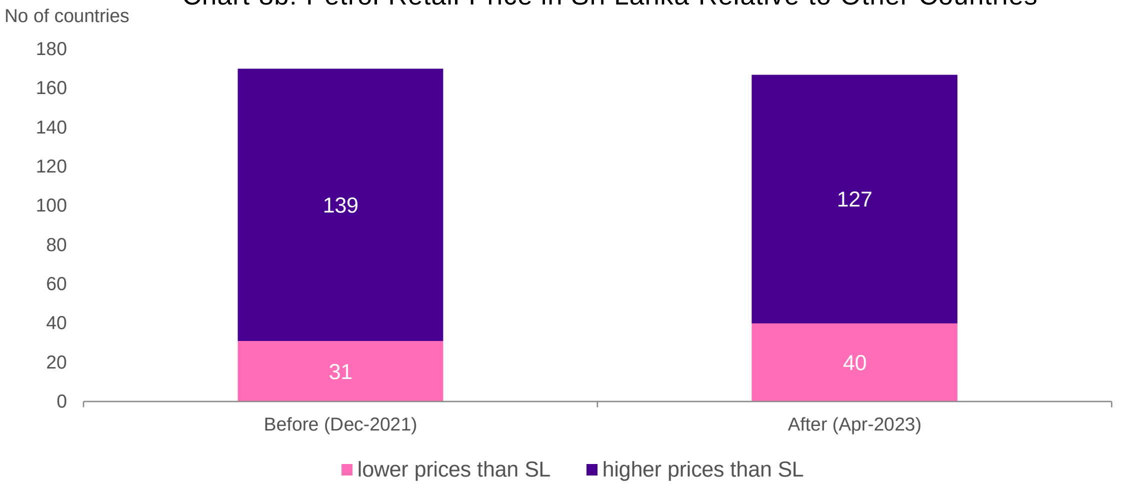
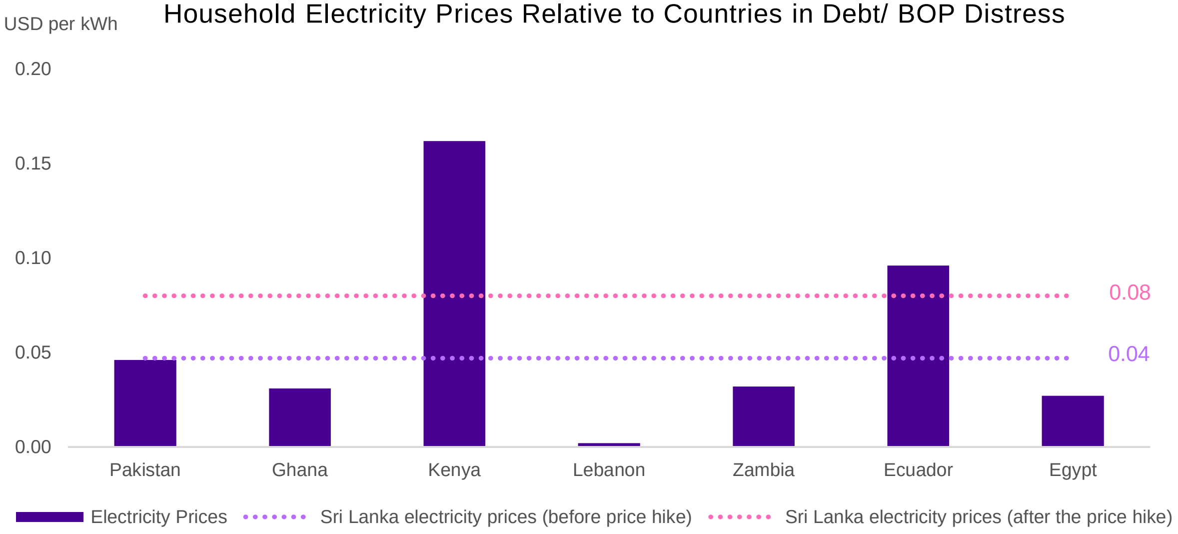


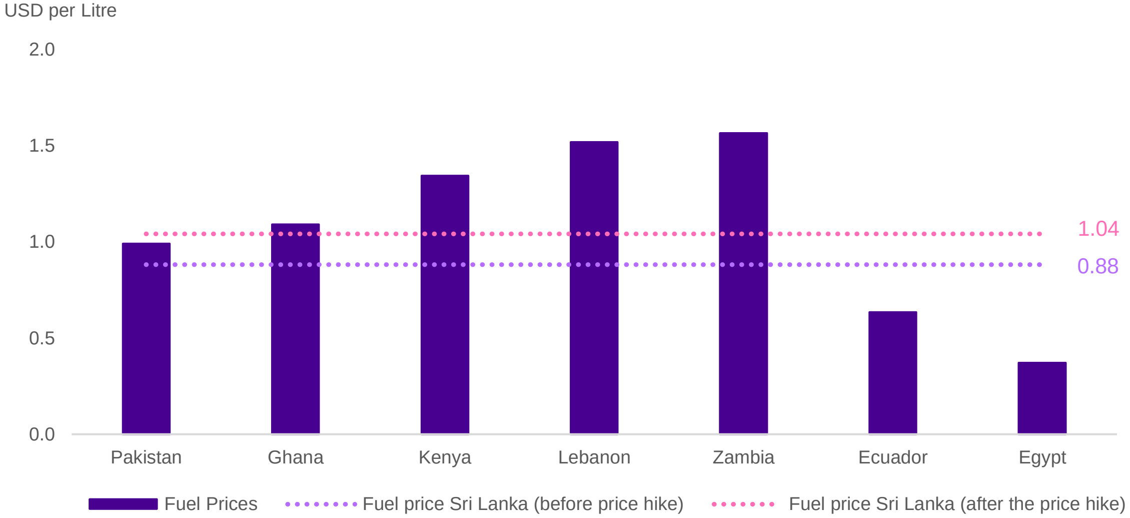
Chart 8b: Petrol Retail Price in Sri Lanka Relative to Other Countries



Household Electricity Prices Relative to Countries in Debt/ BOP Distress



Petrol Retail Price in Sri Lanka Relative to Countries in Debt/ BOP Distress

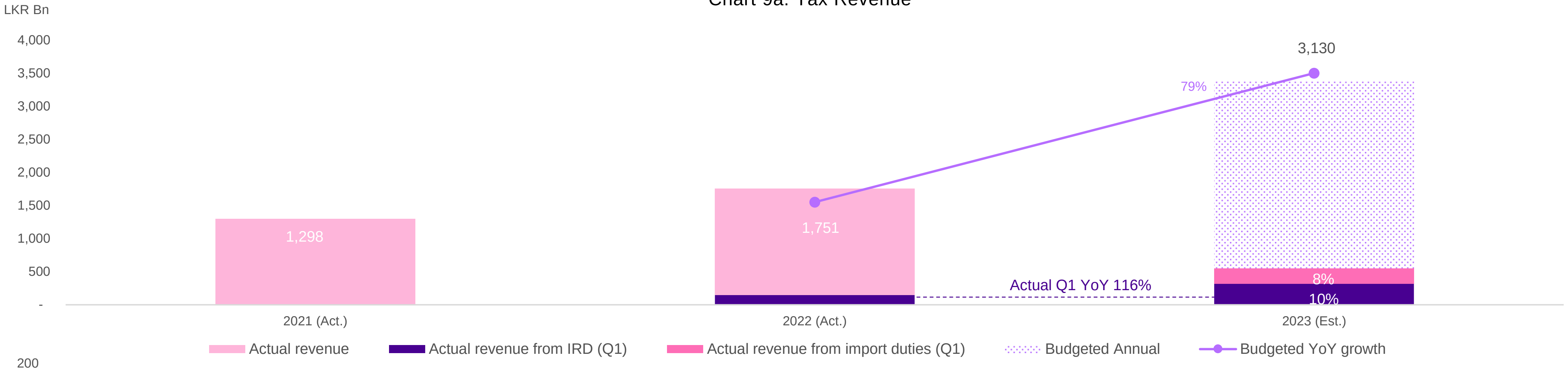


Source: Globalpetrolprices.com

Revenue based fiscal consolidation

Refer our previous report on the economic impact of the budget proposals for 2023. As highlighted therein the government has undertaken an ambitious fiscal adjustment process with higher tax rates and high nominal GDP growth supporting revenue collection. Based on the achieved 1Q 2023 numbers, revenue authorities seem to be on target to meet their full year objectives. Notably, the government achieved a primary balance surplus in 1Q 2023 against a budgeted deficit and will likely comfortably surpass the full year primary balance target.

Chart 9a: Tax Revenue



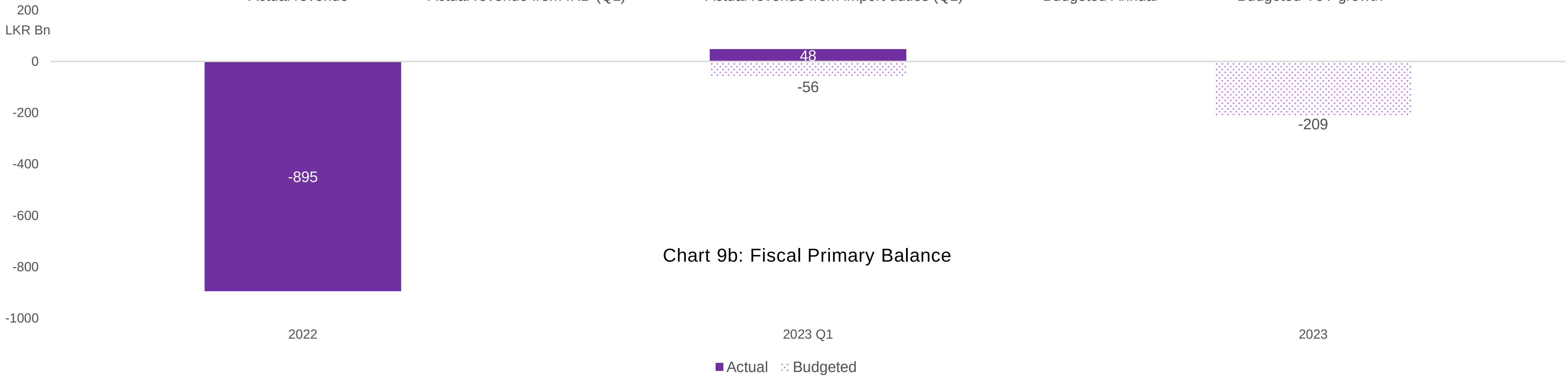


Chart 9b: Fiscal Primary Balance

Source: IRD, CBSL Annual report 2022, Economynext.com

Sri Lanka exchange rate adjustment

Chart 10a: Sri Lanka Currency Movement and Peer Countries (2017-2023 May)

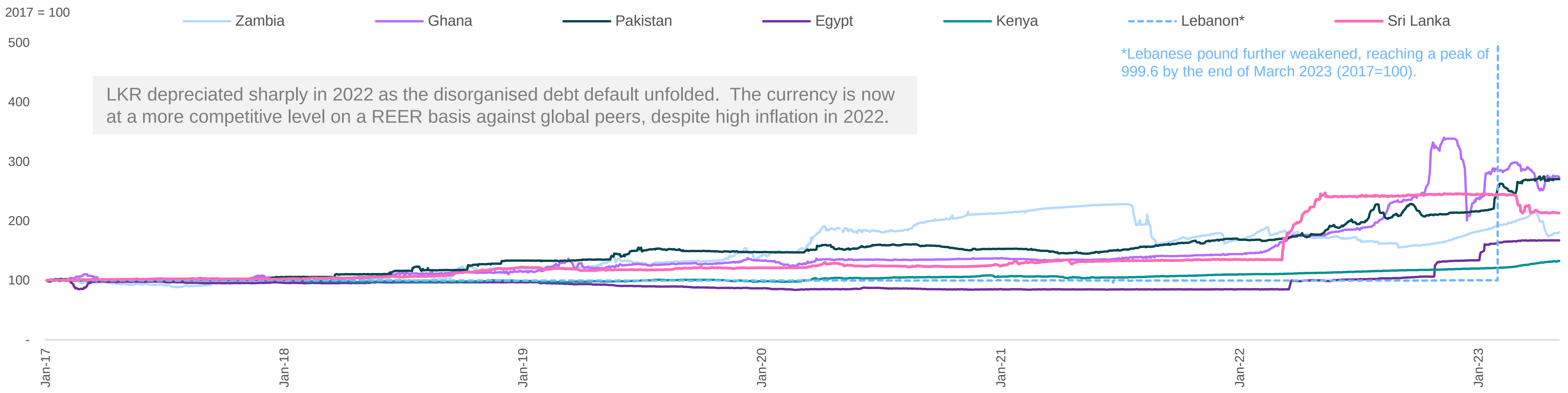
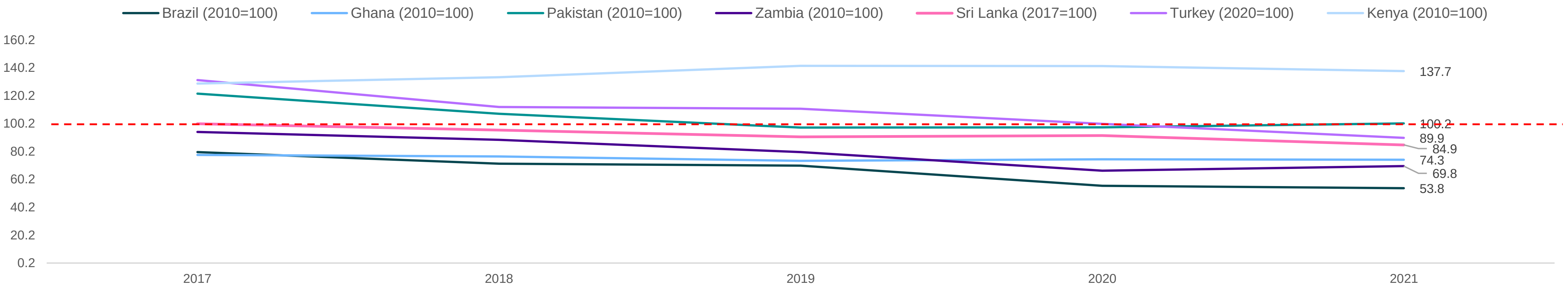


Chart 10b: Real Effective Exchange Rate: Sri Lanka and Peer Countries



Source: Bloomberg

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Extensive reforms required by the IMF as part of the EFF program

Initiation of the IMF Program

1st IMF Review – (Sept. 2023)*

2nd IMF Review – (Mar. 2024)*

3rd IMF Review – (Sept. 2024)*

4th IMF Review – (Sept. 2025)*

Q2-2023

- Parliamentary approval of welfare benefit payment scheme (Enhanced Social Safety Nets).
- Cabinet approval of a comprehensive strategy to restructure the balance sheets of key SOEs.
- Parliamentary approval of new anti-corruption legislation.
- Parliamentary approval of the new Central Banking Act.

Q3 and Q4-2023

- Revamping the VAT system by removing almost all product specific VAT exemptions.
- Submitting the Public Financial Management (PFM) Law to Parliament.
- Parliamentary approval for the full revision of the Banking Act.

2024

- Introduction of reforms making the Minister of Power and Energy responsible for implementing cost-recovery based fuel and electricity price adjustments.
- Introduction of a property tax, a gift and an inheritance tax.

IMF Pre-requisite	Measurements taken:
Revenue-based fiscal consolidation	Improving the primary balance through revenue-based consolidation (reaching a surplus of 0.8% of the GDP in 2024, and 2.3% of GDP from 2025 onwards) by, ▪ Revamping the VAT system. ▪ Introducing property/gift/inheritance tax.
Public debt sustainability	▪ Lowering public debt to below 95% of the GDP by 2032. ▪ Lowering gross financing needs to below 13% of GDP over 2027-2032. ▪ Managing FX debt servicing to less than 4.5% of the GDP over 2027-2032 and closing the fiscal and external financing gaps.

Source: Investor Presentation – March 2023, CBSL , Ministry of Finance, Economic Stabilization & National Policies

Market access is expected to be restored by c. 2027

IMF projections anticipate that Sri Lanka may be able to regain market access c. 2027, by which time internal reserves are expected to be around USD 10 billion. External funding requirements (including to build up international reserves) in the interim period is expected to be met from IMF and multilateral sources and debt relief from the external creditors.

Table 3: Sri Lanka External Financing Gap and IMF Program Financing 2022 to 2027

USD Mn	2022	2023	2024	2025	2026	2027	Total 2022-2027
Financing Gap (A)	-2,834	-4,939	-4,843	-5,018	-3,608	-3,911	-25,153
Program Financing (B) = (1+2+3+4+5)	2,834	4,939	4,843	5,018	3,608	3,911	25,153
IMF EFF (1)	-	663	665	663	662	329	2,982
IFI budget support (2)	-	900	850	700	700	600	3,750
World Bank		250	400	400	400	300	1,750
ADB		650	450	300	300	300	2,000
Other		-	-	-	-	-	-
Debt moratorium: External arrears accumulation (3)	2,834						2,834
Debt relief (4)		3,376	3,328	3,655	2,246	1,482	14,087
Sovereign bonds (market access) (5)		-	-	-	-	1,500	1,500
Shortfall (A+B)	-	-	-	-	-	-	
Memorandum:							
Gross International Reserves	1,898	4,431	6,128	8,520	10,888	14,208	
Project loans	1,473	1,400	1,542	1,585	1,633	1,682	

Source: IMF

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Debt Sustainability

The path to debt sustainability will require Sri Lanka to adhere to strict fiscal targets for the better part of a decade with minimal deviation. Failure to implement planned reforms and a return to fiscal profligacy are the biggest risk factors going forward which could precipitate another debt/ economic crisis over the next decade.

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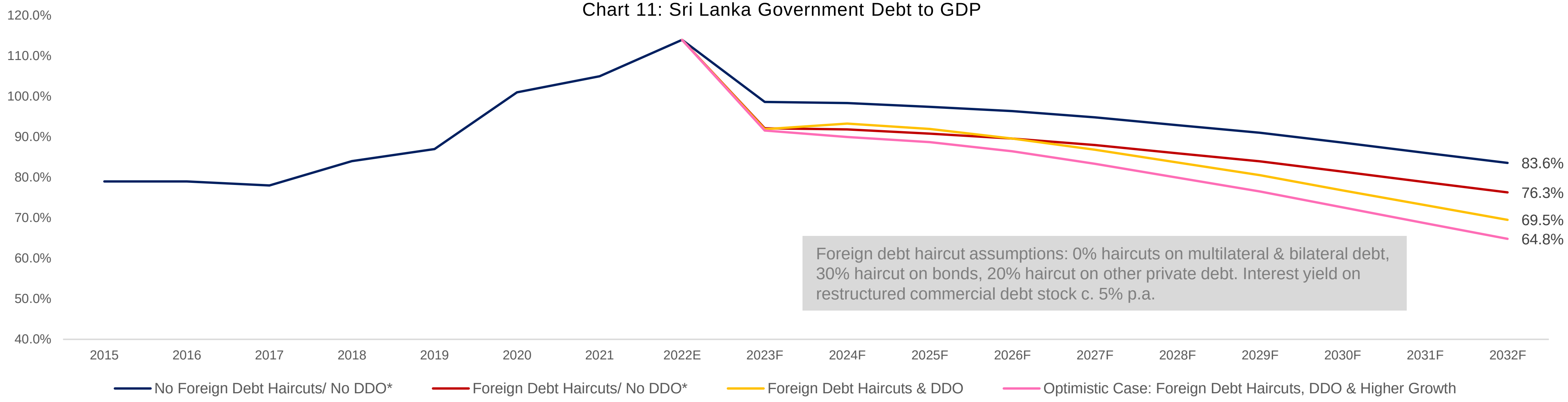
Debt sustainability will require sustained primary balance surpluses

Debt sustainability is a function of numerous variables including economic growth, inflation and real interest rates. Containing the fiscal deficit to targeted levels over the next few years is the primary determinant in returning to a sustainable growth path or facing recurring debt defaults and associated economic crises. There is minimal room for fiscal slippage for real/ nominal interest rates to return to levels consistent with debt sustainability.

Chart 11: Sri Lanka Government Debt to GDP



Scenario/ Assumptions	GDP Growth	Inflation	LKR Depreciation	Primary Balance % of GDP	LKR Interest Rates
No Foreign Debt Haircuts/ No DDO (except CBSL T Bill Stock)	4% p.a. from 2025	5% p.a. from 2025	5% p.a. from 2024 onwards	0% 2023; 0.8% 2024, 2.3% 2025 onwards	TB/ T Bond = inflation + 2.5% p.a./ +4.0% p.a. from 2024
Foreign Debt Haircuts/ No DDO (except CBSL T Bill Stock)	4% p.a. from 2025	5% p.a. from 2025	5% p.a. from 2024 onwards	0% 2023; 0.8% 2024, 2.3% 2025 onwards	TB/ T Bond = inflation + 2.5% p.a./ +4.0% p.a. from 2024
Foreign Debt Haircuts & DDO	5% p.a. from 2026	5% p.a. from 2025	5% p.a. from 2024 onwards	0% 2023; 0.8% 2024, 2.3% 2025 onwards	TB/ T Bond = inflation + 1.0% p.a./ +2.5% p.a. from 2025
Optimistic Case	5.5% p.a. from 2027	5% p.a. from 2025	5% p.a. from 2024 onwards	0.5% 2023; 2.0% 2024, 2.3% 2025 onwards	TB/ T Bond = inflation + 1.0% p.a./ +2.5% p.a. from 2025

Source: CBSL, Acuity research

Flow of debt

IMF program targets on debt sustainability place a heavy emphasis on the flow of debt as measured by gross financing needs. The GFN target of 13% of GDP by 2027 and beyond is far below Sri Lanka's historical levels. A lenient target of <95% of GDP on the stock of debt by 2027 with a more aggressive target on GFN may indicate that IMF views Sri Lanka's debt position as more of a debt flow problem. A lower GFN target combined with fiscal prudence could also help to reduce the interest cost structure going forward relative to historical levels.

Chart 12: Gross Financing Needs and Domestic Interest Rates

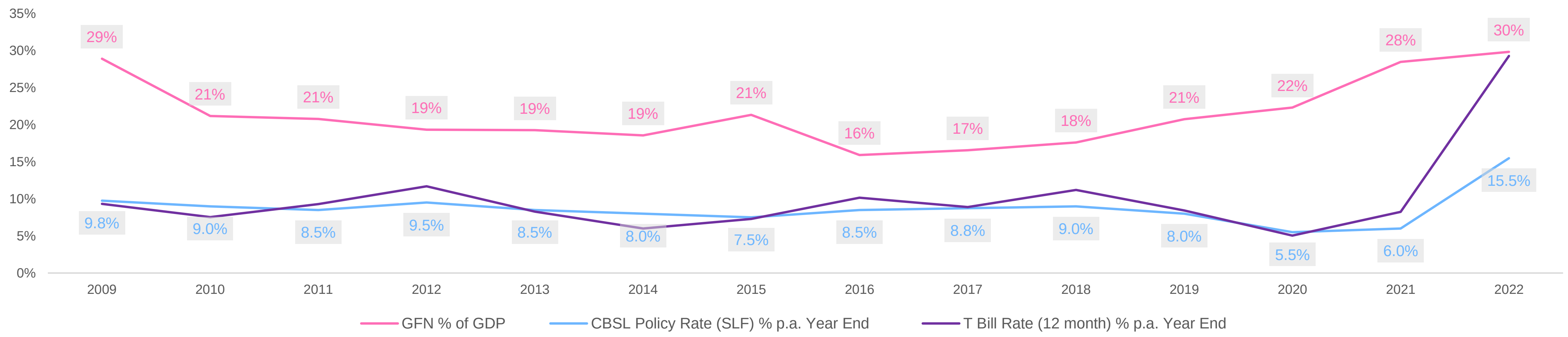


Table 4: Historical Correlation of GFN and Domestic Interest Rates (2009 to 2022)

	GFN % of GDP	CBSL Policy Rate (SLF) % p.a. Year End	T Bill Rate (12 month) % p.a. Year End
GFN % of GDP	1.00		
CBSL Policy Rate (SLF) % p.a. Year End	0.33	1.00	
T Bill Rate (12 month) % p.a. Year End	0.45	0.92	1.00

Source: CBSL, Acuity research

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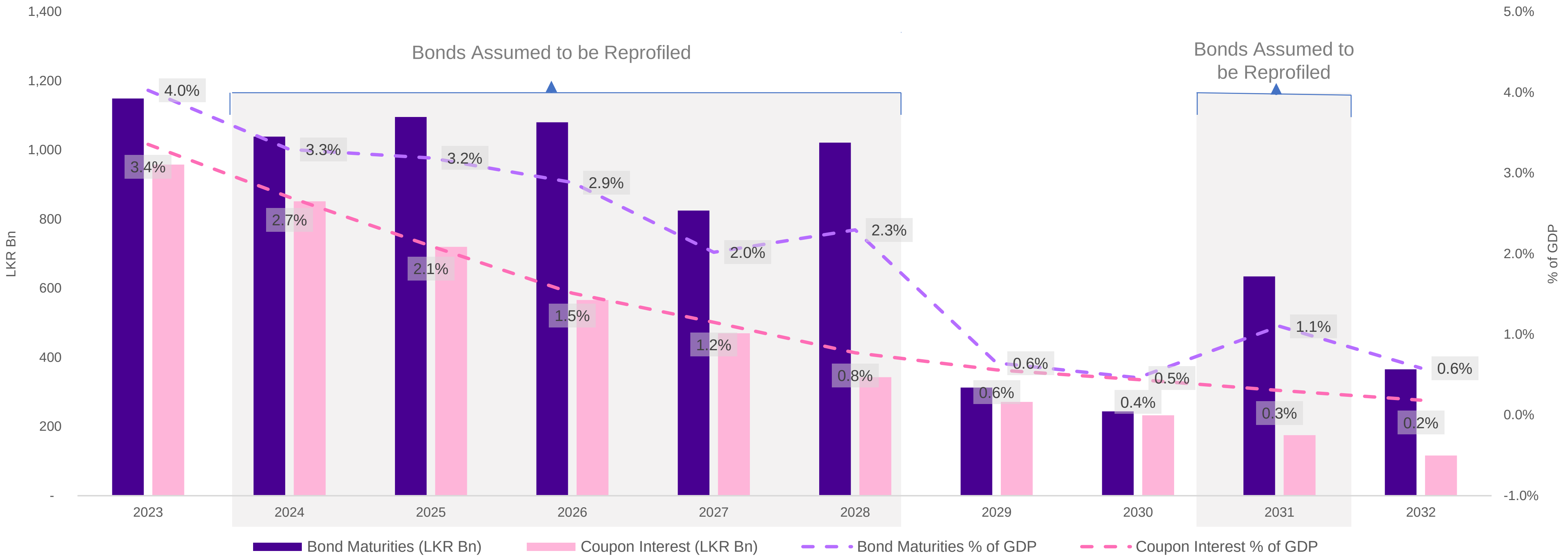
Bond maturities most likely to be reprofiled

Chart 13: Estimated Existing Bond Maturity Profile and Interest Cost



We have assumed that bonds maturing in 2024 through 2028 and in 2031 would be reprofiled in a DDO to lower the GFN as these bonds account for over 1-3% of GDP in the year of maturity.

Source: CBSL

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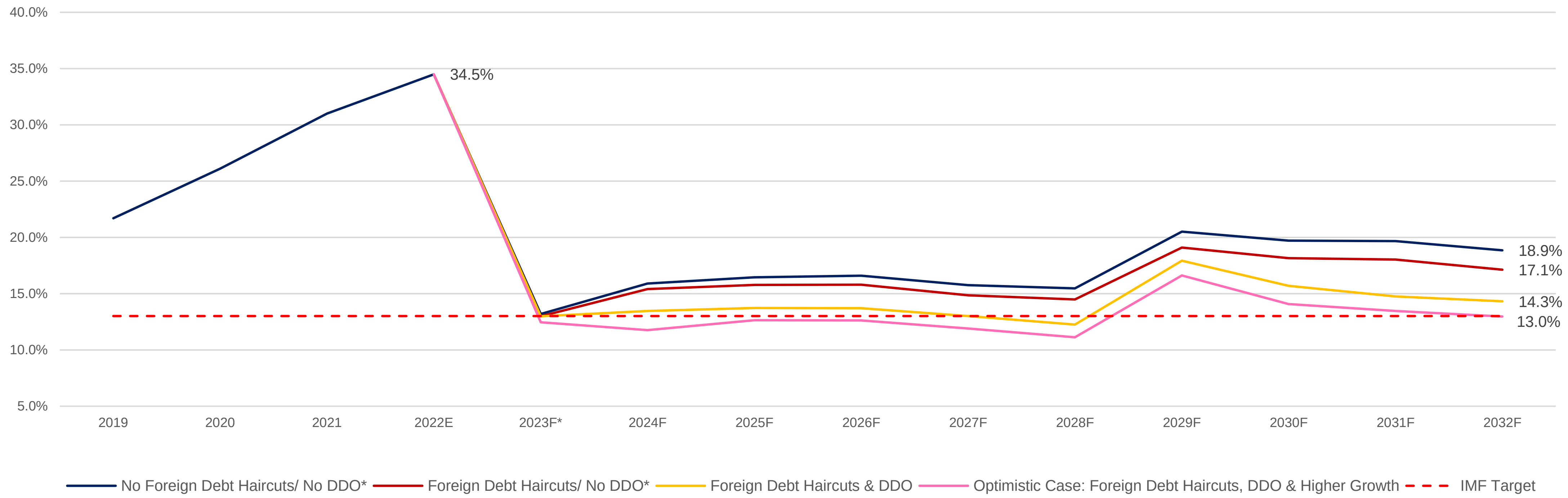
Meeting GFN targets may not be possible without a DDO

Our DSA projections indicate that meeting the GFN target of 13% of GDP by 2027 and beyond requires reprofiling of minimum c. 60% of the bond maturities highlighted in Chart 13.

Chart 14: Sri Lanka Gross Financing Needs to GDP



* Treasury Bills of c. LKR 3.2 Tn held mostly by CBSL are assumed to be reprofiled in 2023

Note: The temporary spike in GFN in 2029 is based on our simplified assumptions that part of the deficit financing in 2023 would be through bonds having an avg. maturity of 6 years and on the assumption that restructured external debt maturities would commence from 2028. Appropriate treatment of those maturities could ensure that there's no temporary bunching up of debt maturities in 2028 - 2029.

Source: CBSL, Acuity research

Simplified visualisation of potential DDO scenarios

	Year	0	1	2	3	4	5	6	7	8	9	10	11	PV @ Current Interest Rate/ PV @ Expected Rate 'Exit Yield'		PV gain/ (loss) on FSV
Original	Original Maturity		100											25%	PV (FSV) of original bond at current yield	
	Original Coupon (13% p.a.)		13												LKR 90	
Reprofiled (Scenario 1)	Extended Maturity (10 year)												100	15%	PV of reprofiled bond at new exit yield	LKR 73 – LKR 90 = LKR (17)
	New Coupons (10% p.a.)		10	10	10	10	10	10	10	10	10	10	10		LKR 73	
Reprofiled (Scenario 2)	Extended Maturity (05 year) & 5% Haircut							95						15%	PV of reprofiled bond at new exit yield	LKR 79 – LKR 90 = LKR (11)
	New Coupons (10% p.a.)		10	10	10	10	10	10							LKR 79	
Reprofiled (Scenario 3)																
	Extended Maturity (5 years) & Capital Repayment (05 years)							20	20	20	20	20		15%	PV of reprofiled bond at new exit yield	LKR 77 – LKR 90 = LKR (13)
	New Coupons (10% p.a.)		10	10	10	10	10	10	8	6	4	2			LKR 77	

Source: Acuity research

Simplified visualisation of potential DDO scenarios cont'd

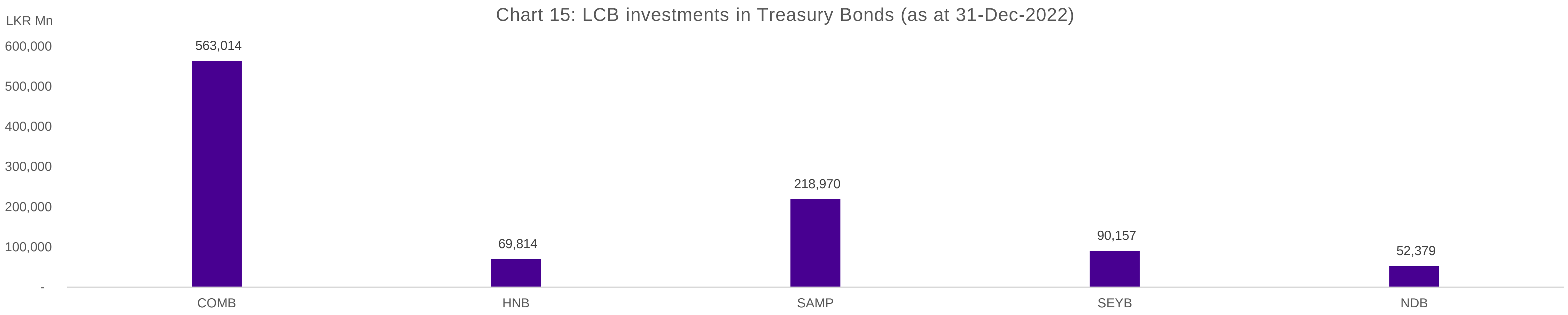
Potential Unrealized Profit/ (Loss) % for Bond of LKR 100 Face Value, Maturity of 1Y and 13% Coupon					
			Post DDO Market Interest Rate/ Exit Yield		
Scenario 1	10Y Maturity Extension 10% Coupon		10% p.a.	15% p.a.	20% p.a.
		CV	5% Profit	-21% Loss	-38% Loss
		FSV	10% Profit	-17% Loss	-34% Loss
Scenario 2	5Y Maturity Extension 10% Coupon 5% Haircut on Face Value		10% p.a.	15% p.a.	20% p.a.
		CV	2% Profit	-16% Loss	-30% Loss
		FSV	7% Profit	-11% Loss	-25% Loss
Scenario 3	5Y Maturity Extension & 5Y Amortizing Repayment 10% Coupon		10% p.a.	15% p.a.	20% p.a.
		CV	5% Profit	-17% Loss	-33% Loss
		FSV	10% Profit	-13% Loss	-28% Loss

Note: CV (Carrying Value) – It is assumed that bonds are typically bought at a discount to face value. The discount is assumed to be c. 5%. As such, the CV is LKR 95 for bond of LKR 100 Face Value.

The primary outcome of a debt reprofiling will be the potential present value loss (or gain) to a bondholder. Its important to recognise that any PV loss will be an unrealised loss which will only materialise if a bondholder sells a reprofiled bond at a market price which may be below his investment/ carrying value. The bondholder would not incur a loss if the instrument is held to maturity. The quantum of the loss will depend on the length of the maturity extension, reduction in coupon and most importantly on the interest rates prevailing after the DDO exercise or the exit yield. A significant reduction in market interest rates in the aftermath of a DDO exercise would most probably lead to potential PV gains for bondholders.

Source: Acuity research

Bond holdings of major commercial banks



As at 31-Dec-2022	COMB	HNB	SAMP	SEYB	NDB
Treasury Bond portfolio (as a % of Total Assets)	23.2%	4.1%	17.1%	13.4%	6.3%

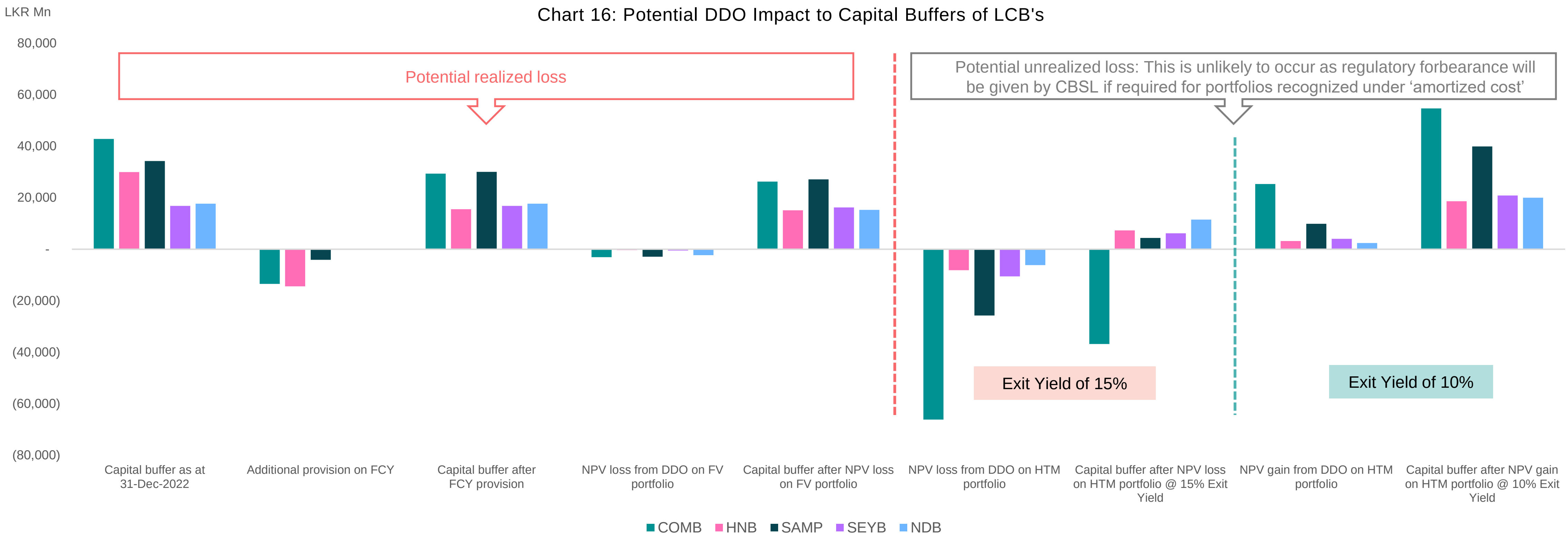
Source: Company financials, Acuity research

Bond reprofiling scenario applied on estimated bond portfolios of major LCB's

	Years to Maturity		1	2	3	4
Assumption for LCB Bond portfolios	Original Bond Portfolio Value	100				
	Original Bond Portfolio Maturity Profile		40%	30%	20%	10%
	Reprofiled		No	Yes		

- Total bond portfolio of banks (as at 31-Dec-2023) is assumed to mature over next 04 years (as depicted in the table to the left).
  - 40%, 30%, 20% and 10% in Y1, Y2, Y3 and Y4 respectively.
- Maturities assumed to be reprofiled such that End-to-End timeline will be within 10 years from its original maturity.
  - For example, Y2 maturity will be reprofiled with an End-to-End period over Y2 – Y11, with the capital repayment starting in Y7.

Chart 16: Potential DDO Impact to Capital Buffers of LCB's



Source: Company financials, Acuity research

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Banks are trading at steep discounts on concerns related to DDO and NPAs

Chart 17a: Share Price of Major LCB's

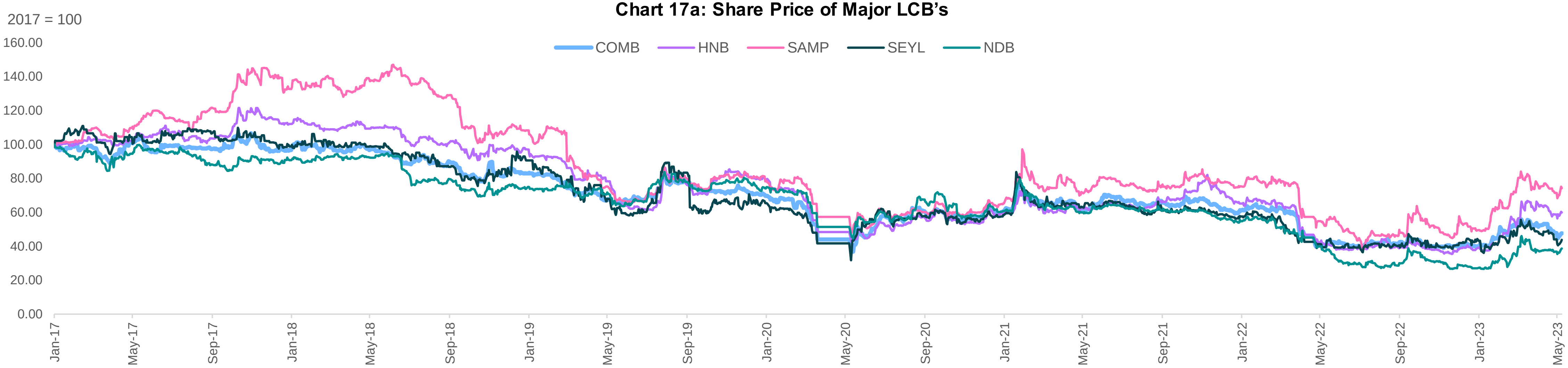
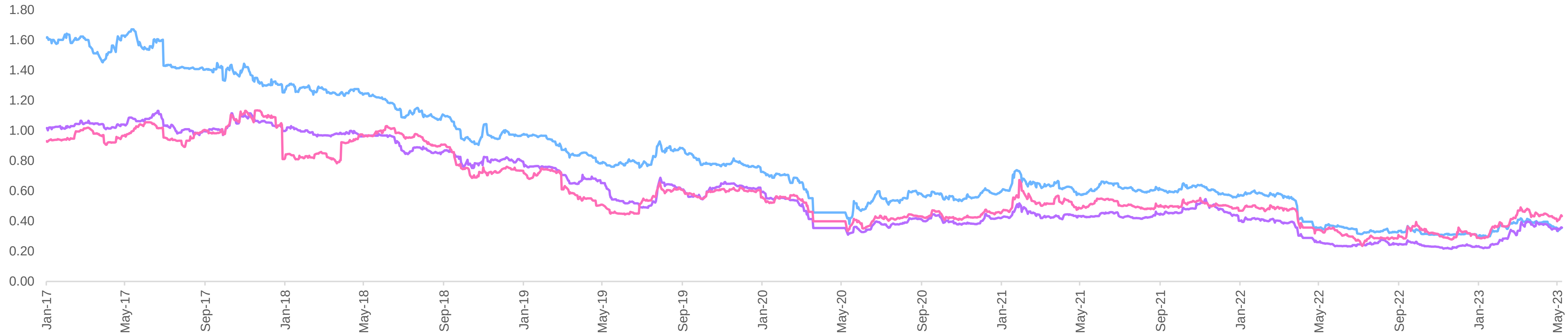


Chart 17b: PBV Multiple (x) of Major LCB's



Source: Bloomberg

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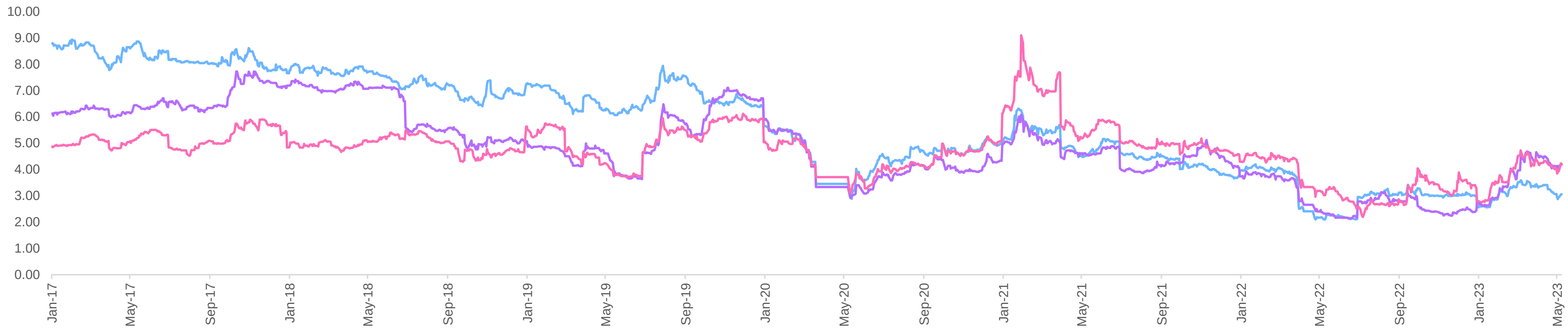
Banks are trading at steep discounts on concerns related to DDO and NPAs cont'd

Chart 17c: PER Multiple (x) of Major LCB's



Source: Bloomberg, Acuity research

Chart 17d: Banking Sector* Avg P/E Probability Distribution

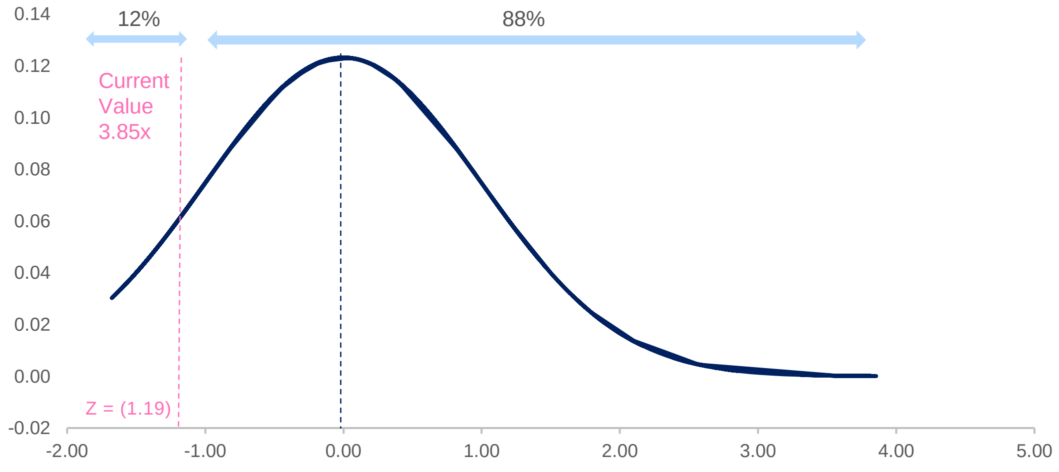
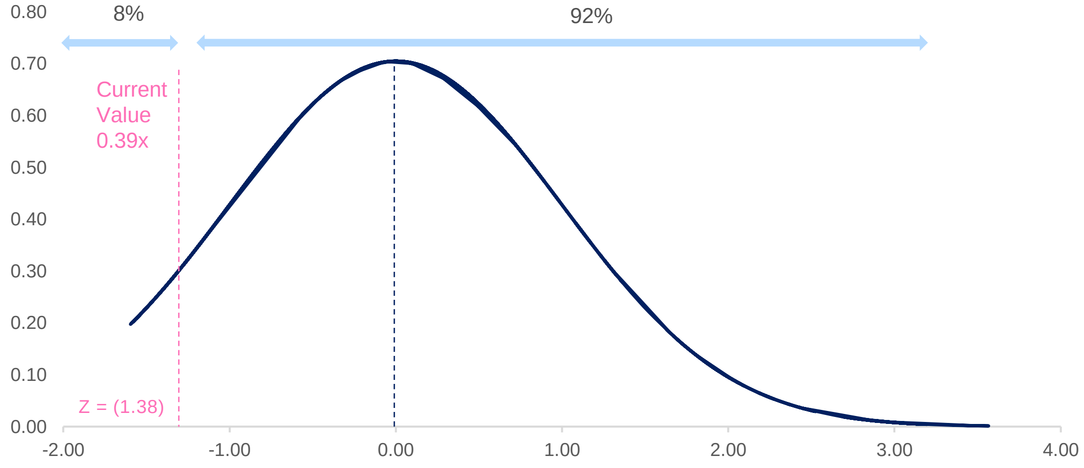


Chart 17e: Banking Sector* Avg PBV Probability Distribution



* Sector comprises COMB, HNB and SAMP

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.

Case Study

Jamaica stands out as a recent case study of a highly indebted economy which has substantially improved debt sustainability subsequent to two previous debt exchanges in the 2010’s and through sustained fiscal discipline thereafter.

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Jamaica debt and economic snapshot

Chart 18a: Debt Statistics - Jamaica (2022)

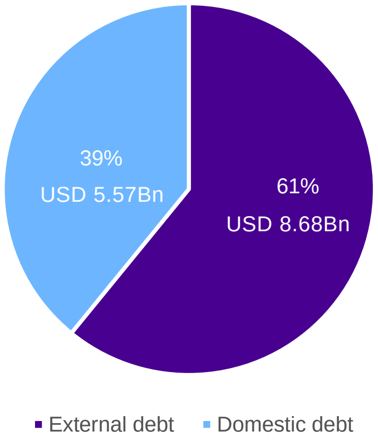


Chart 18b: Debt Profile - Sri Lanka (2022)

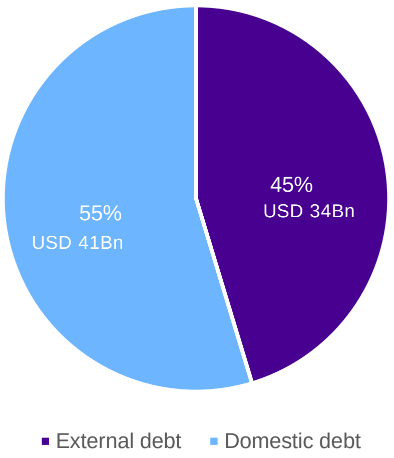


Table 5: Jamaica and Sri Lanka Debt & Economy Snapshot

Country and defaulted year	Period	GDP (USD Bn)	GDP growth	Inflation	Tax Revenue (% GDP)	Fiscal Deficit (% GDP)	Current Deficit (% GDP)	Debt to GDP	Remittances (% GDP)	Tourism Earnings (% GDP)
JAMAICA (2010)	2010	13.22	-1%	13%	24%	-6%	-7%	141%	15%	16%
	5 years after default (2015)	14.19	0.6%**	3.7%	25%	-0.29%	-3.0%	120%	17%	N/Av
	9 years after default (2019)	15.83	0.9%**	3.9%	28%	0.92%	-2.2%	94%	16%	N/Av
SRI LANKA (2022)	2022	77.1	-8%	59%	7%	-10%	-2%	114%	8% *	5% *

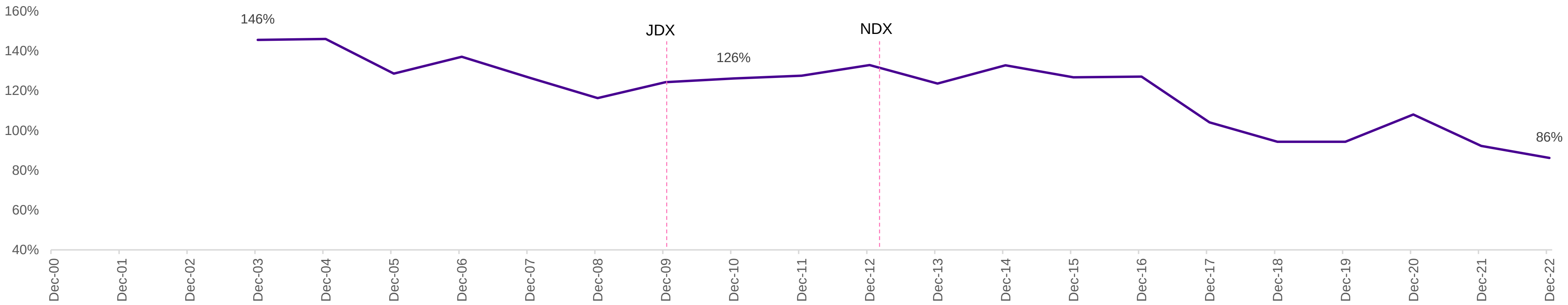
Note* : Remittances and Tourism earnings for Sri Lanka is for 2018.
Note** : GDP growth for Jamaica are the 5 & 9 years' average for respective periods.

Source: World Bank, Countryeconomy.com, IMF, CBSL

Debt sustainability has improved substantially from peak indebtedness

Jamaica had reduced its Government Debt/ GDP ratio by c. 40 percentage points from the time of its first debt exchange in 2010 to now. The improvement in debt sustainability over the period was mainly achieved through fiscal discipline as GDP growth rates have remained at a relatively modest levels.

Chart 19: Debt to GDP of Jamaica



Source: Bloomberg

Jamaica had one of the highest public Debt/GDP ratios in the world, which had contributed to subdued real GDP average annual growth of below 1.0% for over two decades prior to 2010. As a prior action to an IMF Standby Arrangement (SBA) in 2010 and then an Extended Fund Facility (EFF) in 2013, the Government of Jamaica (GOJ) was required to complete a voluntary debt exchange with 100% participation from eligible creditors. The GOJ completed two successful debt exchanges (JDX in 2010 and NDX in 2013) whereby domestic debt bondholders were asked to voluntary swap their existing bonds for new bonds with lower coupons and extended maturities. The second debt exchange, NDX, was launched after failing to capitalize on the fiscal space created by the JDX which was needed to underpin sustained improvement in debt sustainability.

"The key strategy for both exchanges was to convince the creditors that the voluntary debt swap would be transformative on the path to public debt sustainability through improved economic growth and fiscal consolidation, thereby increasing the market value of the **'New'** GOJ bonds.

Fitch and S&P ratings agencies initially downgraded **Jamaica's** sovereign long-term foreign and local currency bonds to **'RD'** (Restricted Default) and **'SD'** (Selective Default), respectively, as they considered the JDX a **'distressed exchange'**. The ratings agencies later reversed its actions and after GOJ secured the approval of the IMF for the SBA facility raised the ratings on **Jamaica's** sovereign bonds to grades that were higher than pre-JDX.**"** – Policy Lessons from Post-mortems of *Jamaica's* Two Recent Debt Exchanges, Bank of Jamaica 2013

Game theory and potential motivations for voluntary debt exchange

In a game theoretic model of a non-cooperative debt exchange with ‘Prisoners Dilemma’ type payoffs*, the dominant outcome is suboptimal. Holdout bondholders can expect to profit from “freeriding” as the market value of their Old Bonds will also increase in the event of a successful debt exchange that lowers the yield curve. Advisors in a debt exchange can use carrot and stick features to modify the payoffs to induce a more optimal outcome. (* payoff values shown are purely for illustrative purposes)

Chart 20a: Payoffs to (Government / Bondholders) in a Non-Cooperative Debt Exchange

		Domestic Bondholders	
		Participate	Hold Out
Government	Voluntary Exchange	50 / 50	20 / 60
	Mandatory Exchange	60 / 20	40 / 40

Dominant outcome: Mandatory Exchange / Hold Out (40 / 40)
Optimal outcome: Voluntary Exchange / Participate (50 / 50)

Chart 20b: Payoffs to (Government / Bondholders) in a Cooperative Debt Exchange

		Domestic Bondholders	
		Participate	Hold Out
Government	Voluntary Exchange	90 / 90	10 / 10
	Mandatory Exchange	10 / 10	10 / 10

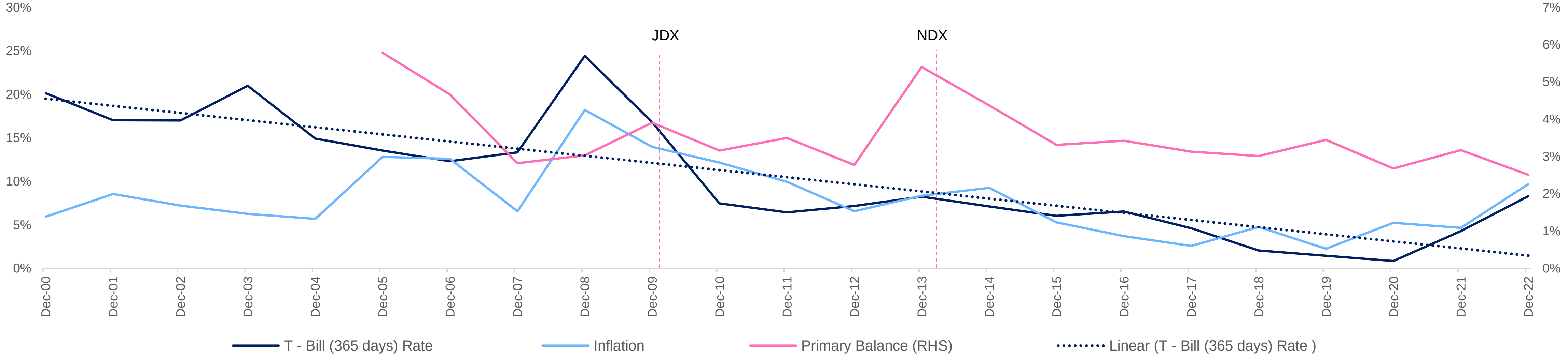
Source: Based on Policy Lessons from Post-mortems of Jamaica’s Two Recent Debt Exchanges, Bank of Jamaica 2013

Carrots	Sticks
Financial sector consultation on exchange structure	Negative market perception of institutional holdouts
Access to Financial Sector Support Fund for liquidity and solvency support/ increased liquidity support for New Bonds	Lower coupon instruments on offer post-exchange relative to coupon offered in exchange
Fair value gains and lower interest expense from reduction in Central Bank policy rate	Deep haircuts on collateral for liquidity support from Central Bank for holdout institutions/ Old Bonds
Greater public sector burden relative to private sector bondholders	
Put option embedded in New ‘Special’ Bonds for large bondholders	

Source: Bank of Jamaica

Jamaica: market interest rates significantly reduced after debt exchange

Chart 21: Jamaica Market Interest Rates and Fiscal Primary Balance: Before/ After Debt Exchange



High nominal and real interest rates prior to the debt exchanges

Low nominal and real interest rates after the debt exchanges

Jamaica's experience shows that domestic debt restructuring when combined with sustained fiscal discipline can lead to successful outcomes for debt sustainability, financial sector stability and potential gains for bondholders who participate in the dept optimisation exercise based on the lower market interest rates post debt exchange.

Source : Bloomberg, Bank of Jamaica

The Long Road to Recovery

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Early signs of an economic recovery led by the services sector

We expect service PMI's to further improve throughout the year supported by a recovery in the hospitality and related sectors as evidenced by the highly positive values recorded in the expectations for activity subcategory of the services PMI in first two months of 2023. Manufacturing PMI's are likely to move to positive territory by 2H 2023 on the back of falling inflation, higher remittances and a recovery in the agricultural sector which would allow for an uptick in manufacturing for domestic consumption.

Table 6a: Sri Lanka Manufacturing PMI

	2016	2017	2018	2019	2020	2021	2022	2023
Jan	51.9	56.2	51.7	54.4	54.0	60.2	58.7	40.8
Feb	55.3	57.1	55.6	50.6	53.6	59.4	52.5	42.3
Mar	60.7	66.5	65.6	66.9	30.0	67.0	57.8	51.4
Apr	41.6	41.8	45.5	41.0	24.2	44.3	36.4	
May	47.9	57.9	60.6	50.7	49.3	42.1	50.3	
Jun	55.1	56.1	57.6	53.9	67.3	50.4	44.1	
Jul	50.6	54.3	57.2	55.7	64.6	57.8	41.4	
Aug	53.5	54.4	58.2	56.6	57.9	45.1	49.6	
Sep	57.7	59.0	54.1	54.7	59.8	54.3	42.6	
Oct	56.5	54.8	58.2	57.6	40.3	60.4	38.4	
Nov	58.4	58.8	54.3	56.0	57.6	61.9	42.1	
Dec	58.3	59.1	53.7	54.3	61.2	58.1	44.8	

Table 7a: Sri Lanka Services PMI

	2016	2017	2018	2019	2020	2021	2022	2023
Jan	58.0	57.5	56.6	55.8	57.0	56.2	57.5	50.2
Feb	59.3	57.3	58.4	53.0	50.2	56.5	51.8	48.7
Mar	61.6	60.8	58.0	56.3	32.0	62.1	51.3	55.1
Apr	54.7	54.2	53.2	45.3	29.8	48.9	43.8	
May	58.1	55.3	56.9	44.7	43.1	39.5	42.4	
Jun	56.3	59.2	58.7	53.1	50.4	51.3	40.3	
Jul	57.8	59.1	57.8	57.1	51.4	55.7	43.0	
Aug	61.2	60.1	57.0	52.9	56.0	46.2	51.7	
Sep	57.7	57.0	53.0	52.7	54.3	52.2	51.2	
Oct	59.3	55.3	55.5	56.9	41.8	57.9	47.9	
Nov	59.7	57.4	52.6	57.4	48.8	62.1	49.0	
Dec	59.8	61.2	54.7	60.2	55.6	62.4	51.6	

Table 6b: Manufacturing PMI New Orders

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2022	62.2	59.0	66.5	32.0	47.5	38.3	39.0	49.0	37.5	33.0	38.0	45.5
2023	38.0	41.5	55.9									

Table 7b: Services PMI Expectations for Activity

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2022	68.5	54	44.8	34.7	37.4	32.3	48	57.2	57.8	57.9	59.2	59
2023	60.1	63.5	70.4									

Table 6c: Manufacturing PMI Production

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2022	59.8	45.0	56.9	19.0	44.5	36.2	32.0	49.0	39.0	32.5	35.5	40.5
2023	37.5	40.0	55.8									

Source: CBSL

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Quarterly GDP expected to post YoY growth from 2H 2023

Chart 22a: Sri Lanka Quarterly GDP

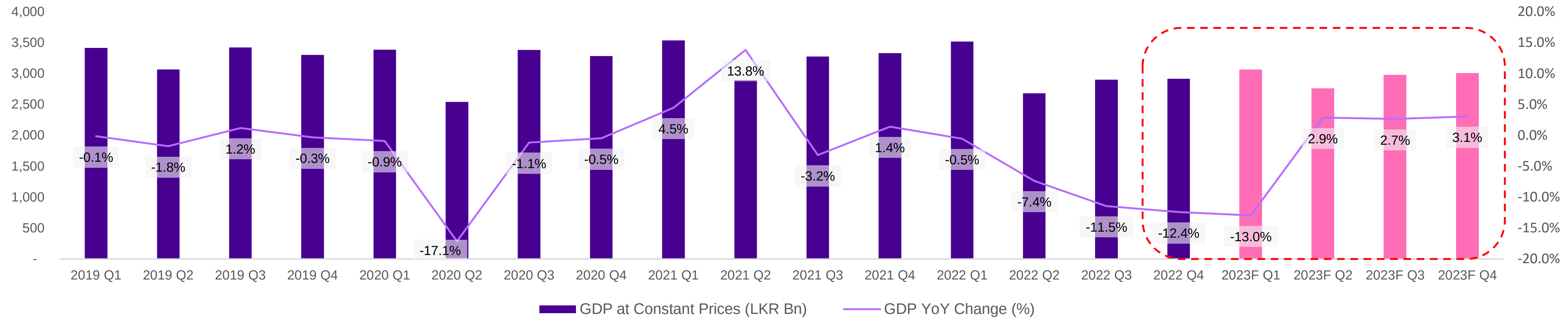


Chart 22b: Si Lanka Annual GDP

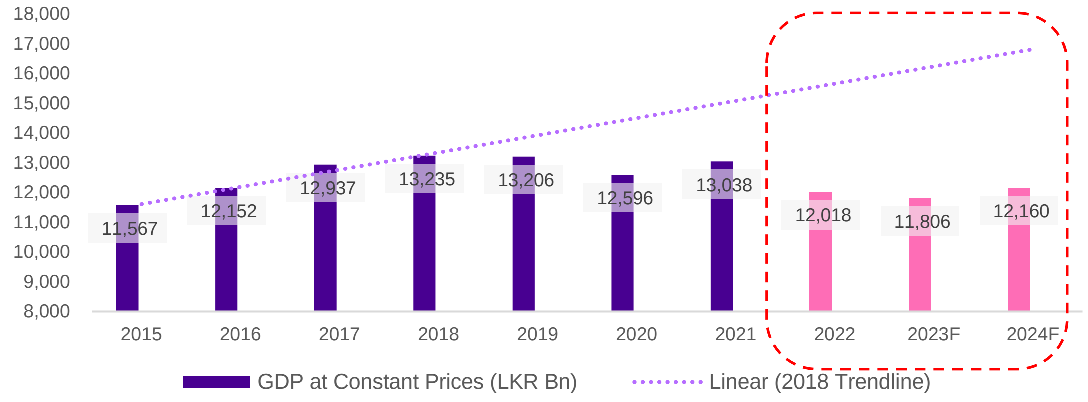
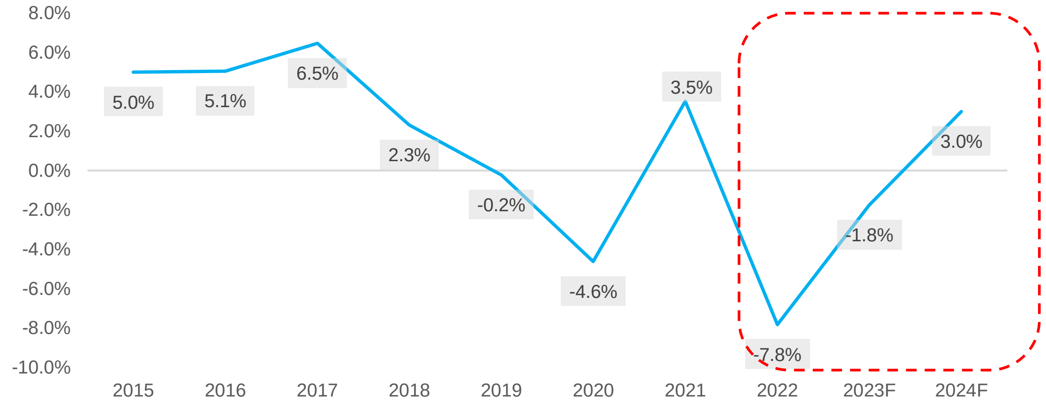


Chart 22c: Sri Lanka Annual GDP Growth



Source: CBSL

IMF projections for Sri Lanka and post default experience of previously distressed economies

IMF baseline projections for Sri Lanka seem to indicate a recovery generally in line with other previously distressed economies, with marginally lower GDP growth and a slower fiscal adjustment expectation.

Chart 23a. Real GDP growth (t = 0 is year of debt default/ restructuring event)

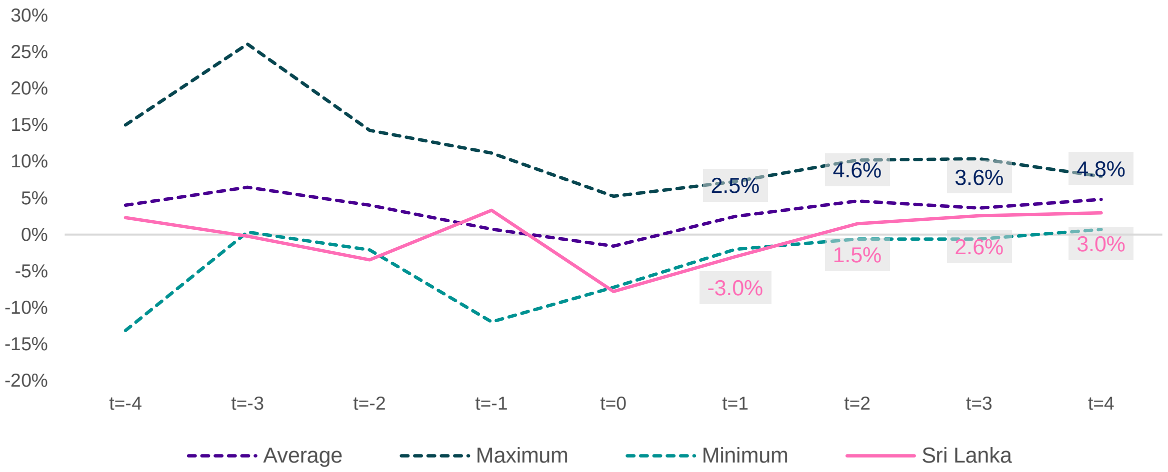


Chart 23b. Debt to GDP (t = 0 is year of debt default/ restructuring event)

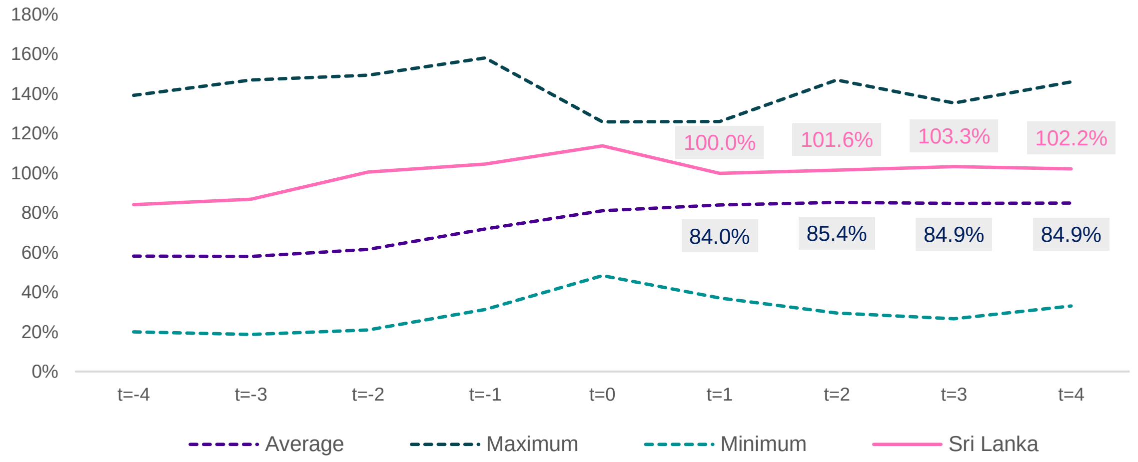


Chart 23c. Fiscal Deficit (t = 0 is year of debt default/ restructuring event)

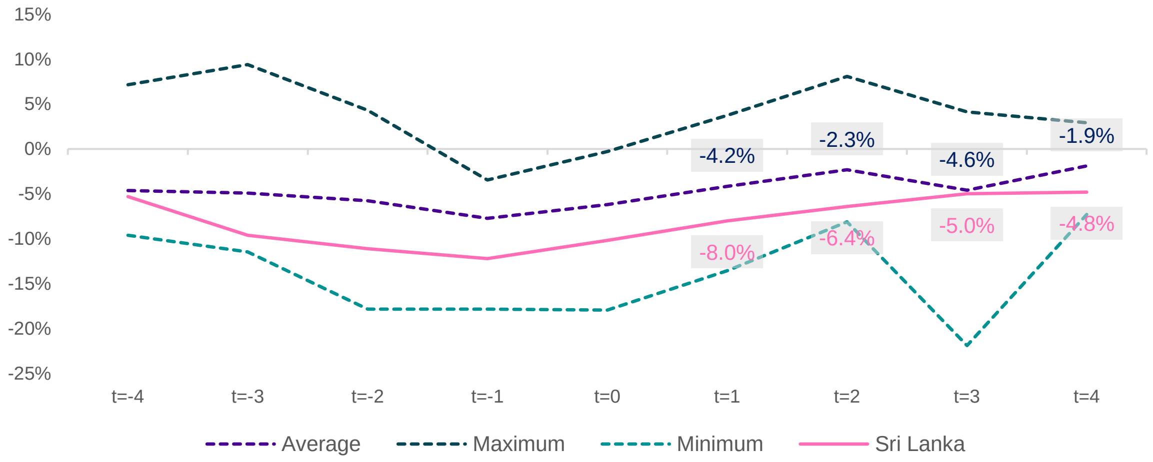
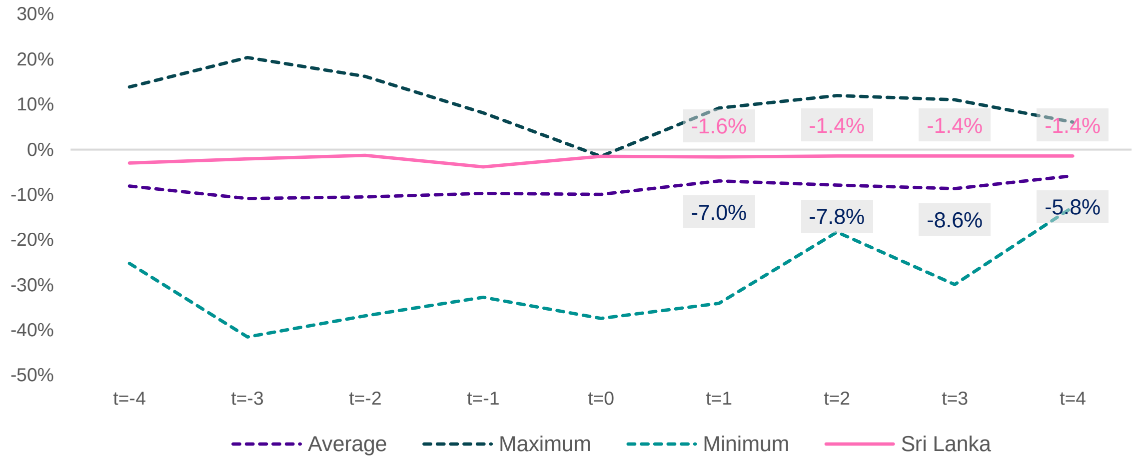


Chart 23d. Current Deficit (t = 0 is year of debt default/ restructuring event)



Source: World Bank, IMF

Note : 2020 excluded from the analysis of Real GDP growth, considering the negative impact from Covid-19 pandemic

Note : Barbados, Jamaica, Mozambique, Cyprus, Ghana, El Salvador, Ecuador, Argentina, Dominica, Suriname, Angola, Antigua and Barbuda, Carbo Verde, Maldives are considered for the analysis.

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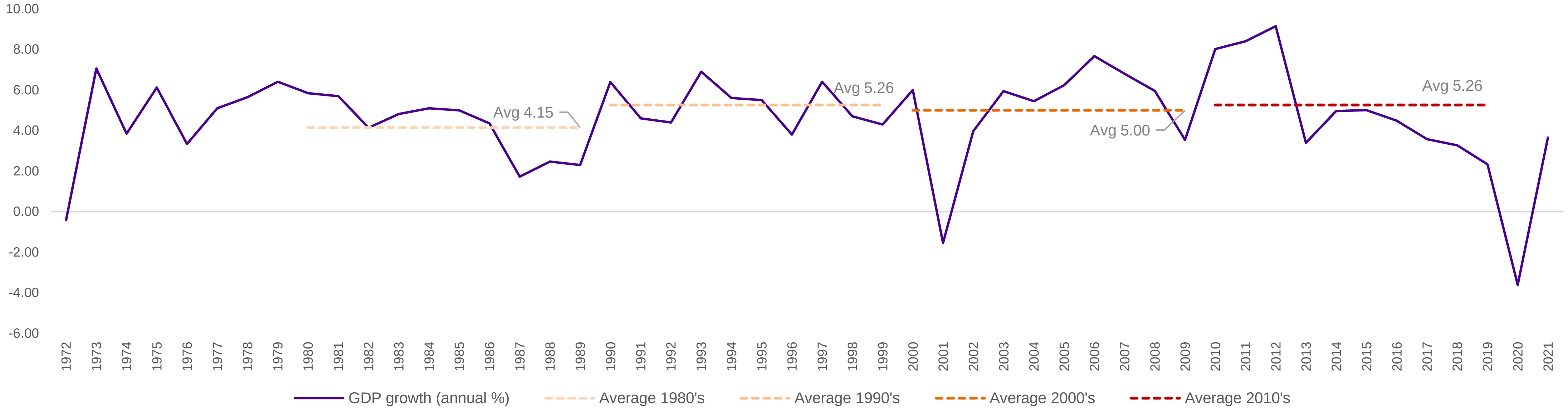
Economic reforms in the past decades produced higher GDP growth despite the war

Chart 24: Real GDP Growth (annual %)



We believe that based on its past track record and with sufficient reforms, Sri Lanka's post crisis GDP growth trajectory could potentially be higher than forecast. Sri Lanka's post war economic growth rate is lower than its wartime growth rate during the 1990's once we adjust for a few outliers in the immediate aftermath of the war. Lower economic growth coincides with the slowdown in economic reforms after the 1990's and early 2000's. Economic reforms and greater liberalization will be necessary to lift Sri Lanka's sagging growth rate if the country is to grow out of its debt more quickly.

Reduced GoSL/ SOEs' role in the economy through privatization

- The Cabinet of Ministers has approved, in principle, the divestiture of various companies, including Sri Lankan Airlines, Sri Lankan Catering, Sri Lanka Telecom (SLT), Sri Lanka Insurance Corporation (SLIC), Canwill Holdings (Grand Hyatt Colombo), Hotel Developers Lanka (Hilton Hotel Colombo), Litro Gas Lanka, Litro Gas Terminals and Lanka Hospitals.
- As part of restructuring loss-making Ceylon Petroleum Corporation (CPC), Sri Lanka decided to award licenses to three global oil companies to operate in the domestic fuel retail market.

Source: CBSL

Tailwinds for Economic Recovery

The tourism sector and foreign remittances could catalyse a faster recovery in the economy given the relative high share of USD earnings, large output gaps and potentially lower correlation with domestic supply side factors.

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Tourism recovery underway

Chart 25: Monthly Tourist Arrivals

Table 8: Monthly Tourist Arrivals as a % of Same Month in 2018

	2019	2020	2021	2022	2023
January	102%	96%	1%	34%	43%
February	107%	88%	1%	41%	46%
March	105%	31%	2%	46%	54%
April	93%	0%	2%	35%	58%
May	29%	0%	1%	23%	
June	43%	0%	1%	22%	
July	53%	0%	1%	22%	
August	72%	0%	3%	19%	
September	73%	0%	9%	20%	
October	78%	0%	15%	27%	
November	90%	0%	23%	31%	
December	95%	0%	35%	36%	

Source: SLTDA

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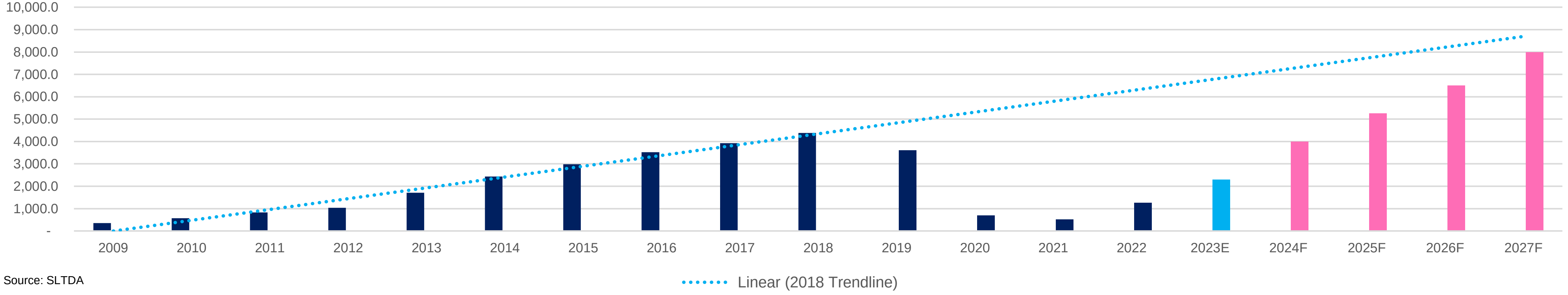
Significant output gap in the tourism sector

The tourism industry in Sri Lanka lost out on approx. USD 12.5 billion of earnings from 2020 to end 2022 based on its long-term trendline earnings minus the actual realized earnings during the period. The pandemic induced loss of foreign exchange earnings by the tourism sector and lower foreign remittances were both significant contributory factors leading up to the sovereign debt default in 2022.

Table 9: Tourism Earnings (USD Mn)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023E
January	30.0	44.7	72.0	88.9	148.8	233.3	259.0	333.3	406.8	448.5	460.3	307.0	4.4	151.7	161.8
February	26.7	50.4	63.8	84.9	153.4	225.9	274.4	339.2	366.3	442.3	475.0	278.9	8.8	169.4	169.9
March	26.6	46.1	72.9	92.9	152.4	211.8	260.3	330.8	348.8	438.1	460.5	95.9	11.9	161.2	198.1
April	20.3	33.7	61.9	73.1	108.7	179.3	202.6	234.0	297.2	338.7	314.7	-	10.9	108.7	
May	19.3	31.0	47.5	57.3	100.7	143.3	188.2	214.5	226.1	243.0	71.2	-	3.9	43.5	
June	23.6	39.4	52.0	62.8	121.5	164.2	191.4	202.5	228.8	275.6	118.9	-	4.2	45.0	
July	33.0	55.7	81.3	100.5	144.0	213.3	291.4	359.2	381.1	408.9	218.1	-	6.3	85.0	
August	32.2	49.2	70.3	81.8	165.9	223.4	276.1	319.6	354.1	376.1	270.6	-	13.1	67.9	
September	29.6	41.7	58.4	68.8	121.6	168.0	237.6	254.8	269.0	279.8	204.6	-	35.3	40.5	
October	29.3	46.1	67.5	79.5	144.1	193.5	219.2	258.1	282.7	287.4	223.8	-	59.3	54.9	
November	34.6	63.6	88.2	114.7	147.3	190.6	238.9	286.9	310.7	367.1	333.6	-	115.4	81.0	
December	44.4	74.5	94.6	133.5	207.2	284.4	341.6	385.7	453.5	475.2	455.5	0.5	233.3	127.4	
Total	349.6	575.9	830.3	1,038.7	1,715.5	2,431.1	2,980.7	3,518.5	3,924.9	4,380.6	3,606.9	682.4	506.9	1,136.3	

Chart 26: Tourism Earnings (USD Mn)



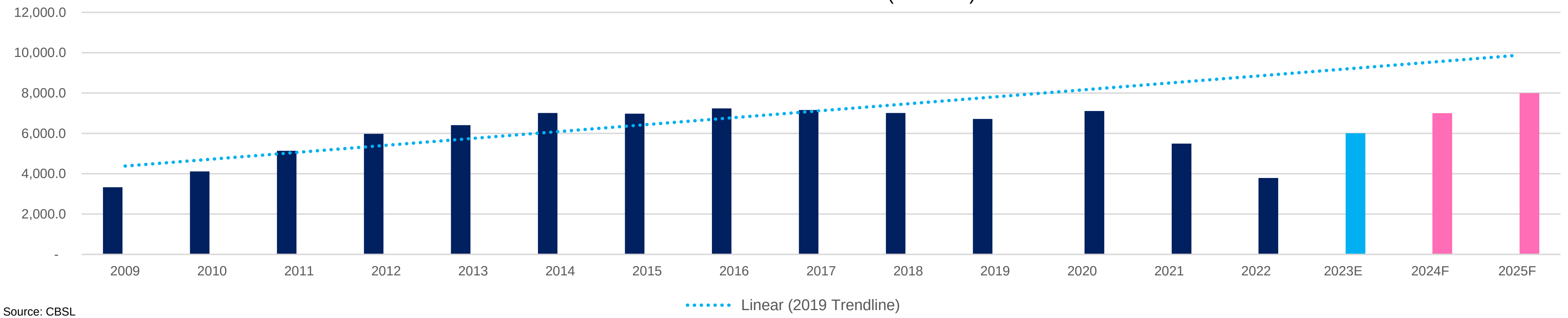
Source: SLTDA

Remittances also expected to recover to pre-Pandemic levels

Table 10: Worker Remittances (USD Mn)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023E
January	258.0	313.1	377.0	472.8	502.3	555.5	523.5	563.4	670.3	729.4	545.3	580.9	675.3	259.2	437.5
February	241.3	310.1	393.3	470.4	469.4	502.0	511.6	554.2	598.1	571.5	500.5	527.3	579.7	204.9	407.4
March	281.3	373.2	503.4	564.7	511.4	605.9	644.3	675.7	643.1	677.7	571.4	492.1	612.0	318.4	568.3
April	266.3	339.7	414.8	475.2	515.3	554.0	585.9	578.0	487.9	541.2	553.7	375.0	518.8	248.9	
May	275.5	303.0	414.5	507.1	512.4	557.5	537.7	597.2	600.7	580.4	562.1	431.8	460.1	304.1	
June	280.5	343.9	403.5	452.3	528.2	585.1	629.6	644.5	590.9	523.6	536.6	572.5	478.4	274.3	
July	300.1	343.0	415.4	475.0	526.6	606.7	599.3	572.8	629.3	619.3	625.7	702.1	453.3	279.5	
August	291.7	332.5	458.5	490.1	540.0	548.1	566.0	618.3	599.9	534.2	518.2	664.5	446.6	325.4	
September	286.6	345.7	401.6	511.2	557.8	575.0	584.2	577.9	537.8	499.6	516.3	702.7	353.2	359.3	
October	292.4	376.0	420.5	522.1	573.0	600.1	605.1	607.5	546.3	599.1	607.0	630.7	317.4	355.4	
November	261.6	365.9	436.0	491.3	567.8	619.3	574.5	567.4	588.4	555.0	515.3	611.7	271.4	384.4	
December	294.9	369.7	506.2	553.2	602.8	708.8	618.5	684.6	671.4	584.5	665.0	812.7	325.2	475.6	
Total	3,330.3	4,116.0	5,144.8	5,985.3	6,407.0	7,017.8	6,980.3	7,241.5	7,164.0	7,015.4	6,717.2	7,103.9	5,491.5	3,789.5	

Chart 27: Workers Remittances (USD Mn)



Source: CBSL

Despite challenging external environment, exports expected to maintain long term momentum

Chart 28a: Sri Lanka Exports (USD Mn) and Global Recessions

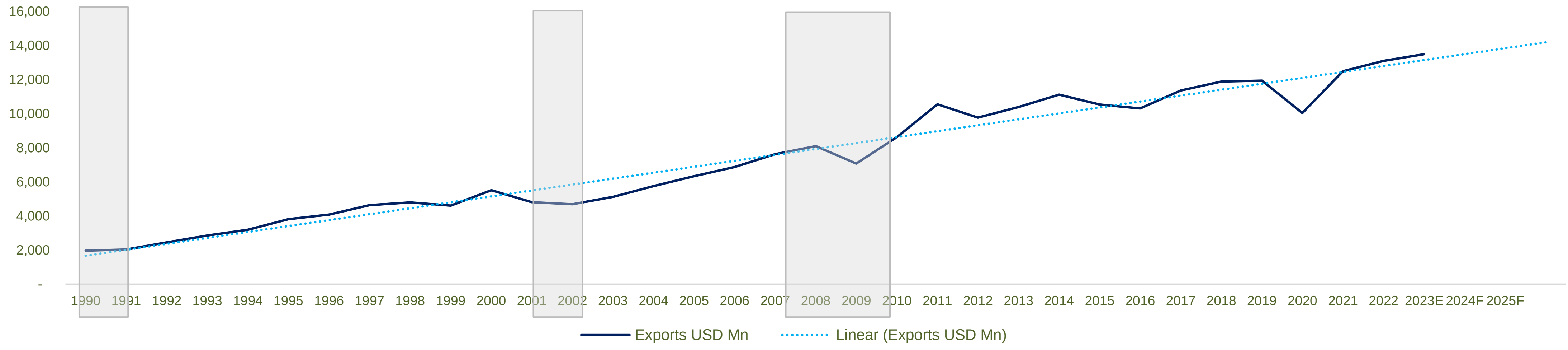
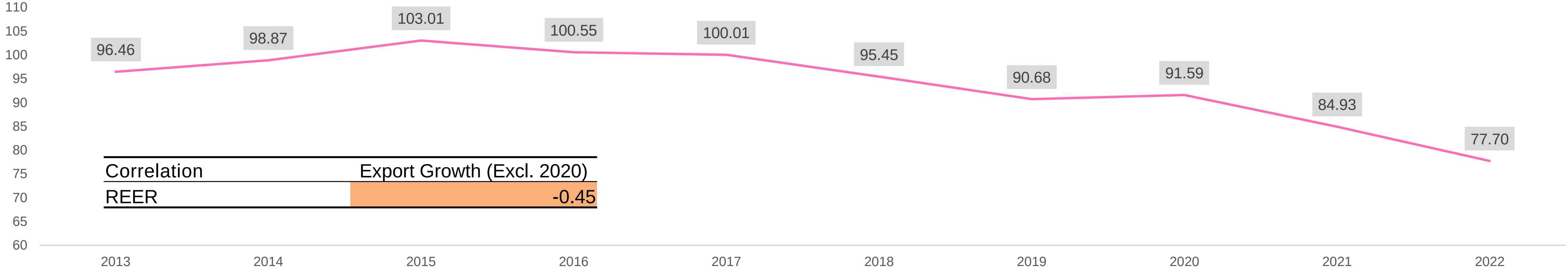


Chart 28b: Real Effective Exchange Rate



Correlation	Export Growth (Excl. 2020)
REER	-0.45

Source: CBSL

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Higher share of tourism & remittances in Sri Lanka may support a faster economic recovery

Chart 29a: Remittances as a % GDP

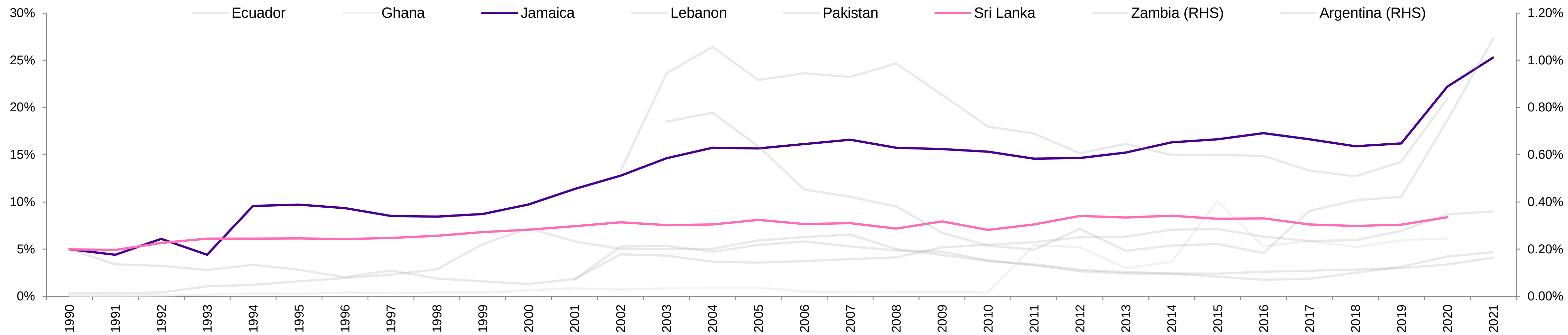
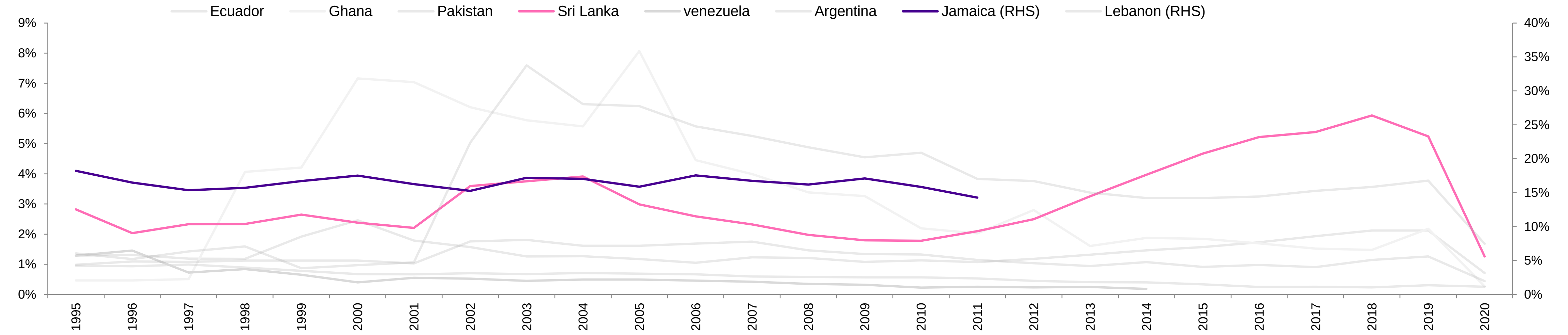


Chart 29b: Tourism earnings as a % GDP



Source: World Bank, Worlddata.info

Stock rating changes

Company	Ticker	Share Price *	Book Value per Share	Market Cap (LKR Bn)	Valuations *							Other Analysis		ASB Stock Rating	Rating Change	52W High Price	52W Low Price
					Trailing EPS	Beta	Sharpe ratio	Trailing PER (x)	PBV (x)	Sector PER (x)	Sector PBV (x)	ROE (%)	TTM EPS growth (%)				
BANKS										4.1	0.4				-		
COMMERCIAL BANK [V]	COMBN	**56.40**	156.18	69.7	12.44	0.51	-0.42	4.5	0.4	4.1	0.4	8%	-44%	Hold	-	71.90	48.70
COMMERCIAL BANK [NV]	COMBX	**46.50**	156.18	3.6	12.44	0.51	-0.42	3.7	0.3	4.1	0.4	**8%**	-44%	Hold	-	62.00	39.40
HNB [V]	HNB N	**118.25**	341.10	52.8	31.59	0.49	-0.26	3.7	0.3	4.1	0.4	**9%**	-8%	Moderate Buy	▲	138.00	72.00
HNB [NV]	HNB X	**85.30**	341.10	9.6	31.59	0.49	-0.26	2.7	0.3	4.1	0.4	**9%**	-8%	Moderate Buy	▲	114.00	64.90
SAMPATH BANK	SAMPN	**49.00**	114.77	57.5	10.42	0.64	-0.12	4.7	0.4	4.1	0.4	**9%**	-10%	Moderate Buy	▲	59.30	26.00
CAPITAL GOODS										3.7	0.6						
HAYLEYS	HAYLN	**67.80**	105.24	50.9	21.80	1.36	0.08	3.1	0.6	3.7	0.6	**21%**	-10%	Moderate Buy	-	125.00	56.10
HEMAS HOLDINGS	HHL N	**63.50**	64.38	37.9	7.16	0.73	0.11	8.9	1.0	3.7	0.6	**12%**	6%	Hold	-	70.00	39.00
JOHN KEELLS HOLDINGS	JKH N	**135.75**	246.24	188.0	13.12	0.40	-0.33	10.3	0.6	3.7	0.6	**7%**	83%	Hold	-	157.00	118.50
RICHARDPIERIS & COMPANY	RICHN	**18.00**	12.86	36.6	3.58	1.13	0.12	5.0	1.4	3.7	0.6	**28%**	17%	Hold	-	34.40	13.00
COLOMBO DOCKYARD	DOCKN	**57.50**	105.60	4.1	3.85	0.33	-0.59	14.9	0.5	3.7	0.6	**4%**	-47%	Hold	▲	74.00	54.00
CONSUMER DURABLES & APPAREL										8.7	0.9			Attractive			
HAYLEYS FABRIC	MGT N	**23.60**	22.84	9.8	1.00	1.07	0.33	23.7	1.0	8.7	0.9	**4%**	-85%	Hold	-	42.00	20.00
TEEJAY LANKA	TJL N	**30.90**	44.71	22.1	2.97	0.39	0.23	10.4	0.7	8.7	0.9	**7%**	-16%	Hold	-	47.90	30.80
HELA APPAREL	HELAN	**6.50**	11.24	8.5	-0.94	N/A	-1.94	N/A	0.6	8.7	0.9	**-8%**	-188%	Hold	-	14.90	6.50
DIVERSIFIED FINANCIALS															-		
ENERGY										3.9	1.7						
LANKA IOC	LIOCN	**138.00**	115.00	73.5	70.79	2.54	0.38	1.9	1.2	3.9	1.7	**62%**	682%	Hold	-	296.00	39.70
FOOD, BEVERAGE & TOBACCO										5.2	1.5						
MELSTACORP	MELSN	**53.50**	83.98	62.3	19.33	1.05	-0.09	2.8	0.6	5.2	1.5	**23%**	176%	Moderate Buy	-	61.60	35.00
DISTILLERIES	DISTN	**17.80**	1.46	81.9	3.46	0.49	-0.14	5.1	12.2	5.2	1.5	**236%**	113%	Hold	-	22.00	12.70

Source : CSE, ASB Research Analysis

* Share price and company valuation is based on CMP as at 19th May 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 CIC, HELA, MELS, DIST, RICH, EX-PACK, PLR, HBS and BPPL which are based on TTM as at 31-Dec-2022.

Stock rating changes… cont'd

Company	Ticker	Share Price *	Book Value per Share	Market Cap (LKR Bn)	Valuations *							Other Analysis		ASB Stock Rating	Rating Change	52W High Price	52W Low Price
					Trailing EPS	Beta	Sharpe ratio	Trailing PER (x)	PBV (x)	Sector PER (x)	Sector PBV (x)	ROE (%)	TTM EPS growth (%)				
INSURANCE										6.3	0.9						
UNION ASSURANCE	UAL N	**30.60**	25.75	18.0	5.05	0.28	0.18	6.1	1.2	6.3	0.9	**22%**	34%	Hold	-	39.50	20.10
MATERIALS										4.3	1.1						
CIC HOLDINGS [V]	CIC N	**61.40**	56.93	17.9	20.05	1.20	0.16	3.1	1.1	4.3	1.1	**35%**	116%	Moderate Buy	-	108.00	30.00
CIC HOLDINGS [NV]	CIC X	**43.10**	56.93	3.8	20.05	1.20	0.16	2.1	0.8	4.3	1.1	**35%**	116%	Moderate Buy	-	76.00	20.00
DIPPED PRODUCTS	DIPDN	**26.60**	45.06	15.9	10.87	0.93	0.20	2.4	0.6	4.3	1.1	**24%**	21%	Hold	-	48.70	23.00
CHEVRON	LLUBN	**82.80**	30.54	19.9	16.22	0.73	-0.19	5.1	2.7	4.3	1.1	**53%**	17%	Hold	-	116.25	68.00
PGP GLASS CEYLON PLC	GLASN	**19.90**	9.27	18.9	3.27	0.99	0.19	6.1	2.1	4.3	1.1	**35%**	229%	Hold	▲	22.00	8.90
EX-PACK CORRUGATED CARTONS	PACKN	**13.40**	7.60	4.5	4.51	N/A	0.59	3.0	1.8	4.3	1.1	**59%**	243%	Hold	▲	18.80	8.90
HAYCARB	HAYCN	**55.80**	74.52	16.6	19.60	0.32	0.18	2.8	0.7	4.3	1.1	**26%**	77%	Hold	-	80.00	49.00
REAL ESTATE										3.8	0.4						
PRIME RESIDENCIES	PLR N	**7.50**	1.00	7.0	4.10	N/A	-0.19	1.8	7.5	3.8	0.4	**411%**	160%	Hold	-	9.20	4.50
SOFTWARE & SERVICES										5.6	1.7			**Attractive**	-		
HSENID BUSINESS SOLUTIONS	HBS N	**13.00**	7.54	3.6	2.29	N/A	0.19	5.7	1.7	5.6	1.7	**30%**	112%	Hold	-	24.00	12.90
HOUSEHOLD & PERSONAL PRODUCTS										4.7	1.8				-		
B P P L HOLDINGS	BPPLN	**19.50**	10.57	6.0	2.41	1.01	0.09	8.1	1.8	4.7	1.7	**23%**	49%	Hold		32.10	16.50

Source : CSE, ASB Research Analysis

* Share price and company valuation is based on CMP as at 19th May 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 CIC, HELA, MELS, DIST, RICH, EX-PACK, PLR, HBS and BPPL which are based on TTM as at 31-Dec-2022.

Glossary of terms

2022 Q1	Year 2022 Quarter 1
2023E / 2024F	Year 2023 Estimated / Year 2024 Forecasted
2H 2023	2nd Half of Year 2023
c.	Approximately
Act.	Actual
ADB	Asian Development Bank
BOP	Balance of Payments
CB/ CBSL	Central Bank of Sri Lanka
CV	Carrying Value
DDO	Domestic Debt Optimization
DSA	Debt Sustainability Analysis
EFF	IMF Extended Fund Facility
EPF	Employees Provident Fund
Est.	Estimate
FCY/ FX	Foreign Currency
FDI	Foreign Direct Investment
FOREX	Foreign Exchange
FSV	For Sale Value
FV	Fair Value
GDP	Gross Domestic Product
GFN	Gross Financing Needs
GNP	Gross National Product
GOJ	Government of Jamaica
GOSL	Government of Sri Lanka
HTM	Held To Maturity
IFI	International Financial Institution
IMF	International Monetary Fund
IRD	Inland Revenue Department
JDX	Jamaica Debt Exchange
kWh	Kilowatt Hour
LCB	Licensed Commercial Banks
LKR	Sri Lankan Rupee
n.a.	Not Available
NDX	National Debt Exchange
NPA	Non-Performing Advances
NPV	Net Present Value
NSB	National Savings Bank
p.a.	Per Annum
PBV	Price-to-book value
PE or P/E	Price-to-earnings ratio
PMI	Purchasing Managers Index
PV	Present Value
REER	Real Effective Exchange Rate
RHS	Right-hand-side
SL	Sri Lanka
SLF	Standard Lending Facility
SLTDA	Sri Lanka Tourism Development Authority
SOE	State-owned Enterprises
T Bill	Treasury Bill
T Bond	Treasury Bond
USD	United States Dollar
VAT	Value Added Tax
WB	The World Bank
Y1	Year-1
YoY	Year-on-Year

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