

19 January 2023

Strategy Report 2023 - Summary

“Never let a crisis go to waste”

Sri Lanka | Economy & Strategy



Acuity: Stock Ratings Scale

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

Acuity: Industry View

Industry outlook	Cautious	In-Line	Attractive
	We view the performance of the industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.	We expect the performance of the industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.	We expect the performance of the industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.



Our previous Strategy Report published in January 2022, titled “**May you live in interesting times**” anticipated a very challenging year. The main predictions and outcomes were as follows:

Black swan events and increased geopolitical risks



Stagflationary conditions globally



Challenging external funding gap



High domestic inflation



Currency depreciation shock



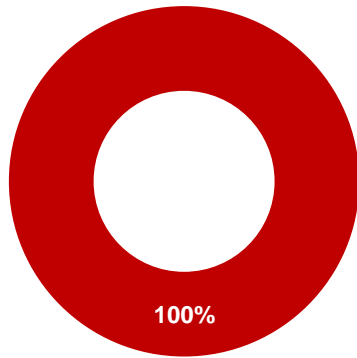
Rising interest rates



Review of last years Strategy Report cont'd

In 2022, we recommended clients to reduce risk by lowering the exposure to equity considering the growing economic and political crisis in Sri Lanka, as we felt it was better to possibly lose out to inflation than to lose capital by being overexposed to equity in a volatile market. Our recommended stocks and asset allocation framework outperformed the market by a wide margin.

100% Equity



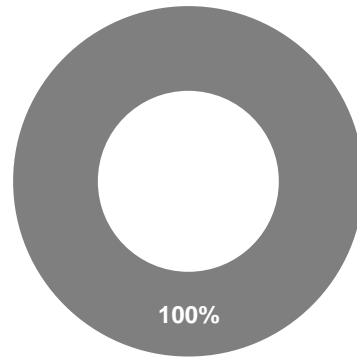
■ Equity

ASPI



32.6%

100% Fixed Income

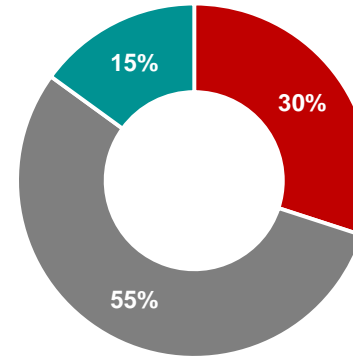


■ Fixed income



c. 21.5%

Acuity Recommended Asset Allocation in 2022



■ Equity ■ Fixed income ■ Alt. Inv



>22%*

Selected Key Stock Picks in 2022



33%

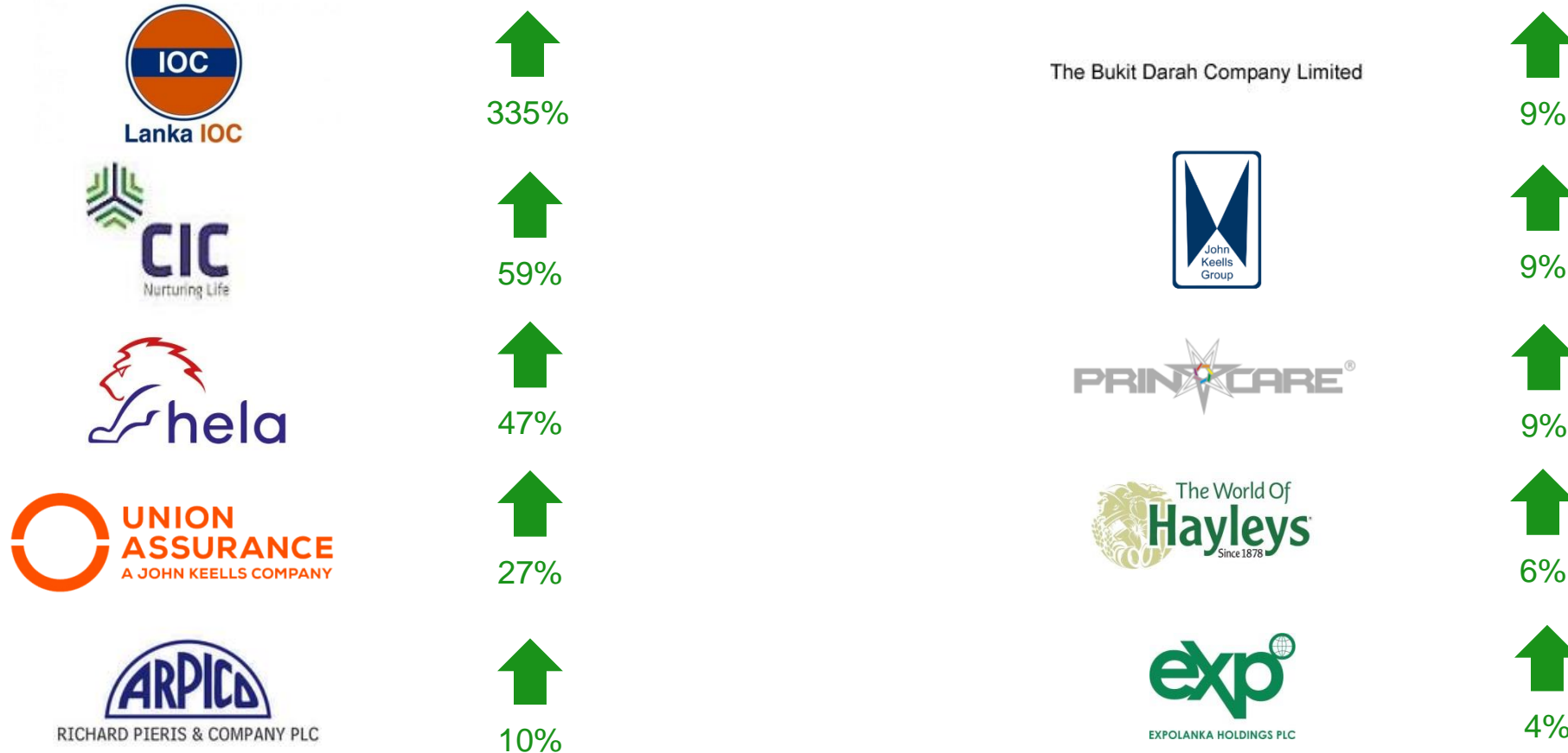


184%

* We have taken the return on gold as a proxy for alternative assets. The return calculation for equity assumes that investors had invested in the portfolio of stocks recommended by us in January 2022, weighted by market cap and held until end 2022.

Review of last years Strategy Report cont'd

2022 was a tough year for the CSE where the market peaked in January and share prices of most counters declined thereafter. However, our stock selection for the year allowed investors to significantly outperform the market as demonstrated by share price appreciation of selected stocks from our coverage universe from date of recommending in 2022 to the highest price for the year.



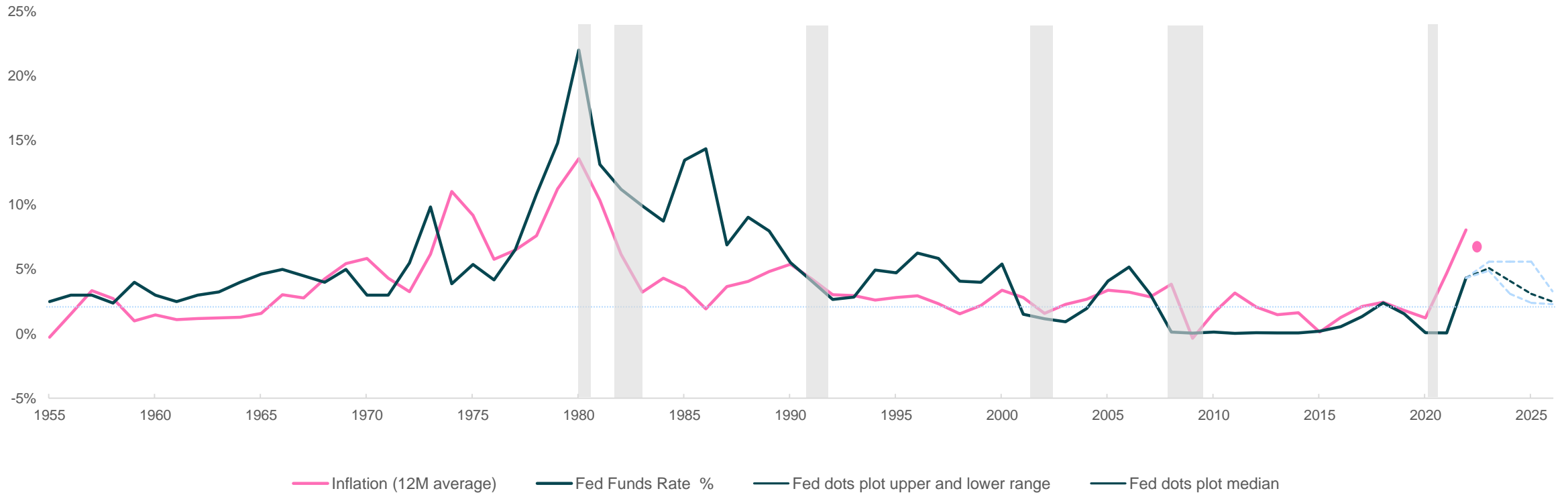
Global Headwinds

Outlook for 2023 is expected to remain challenging

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Policy rate hikes are behind the curve compared to previous cycles

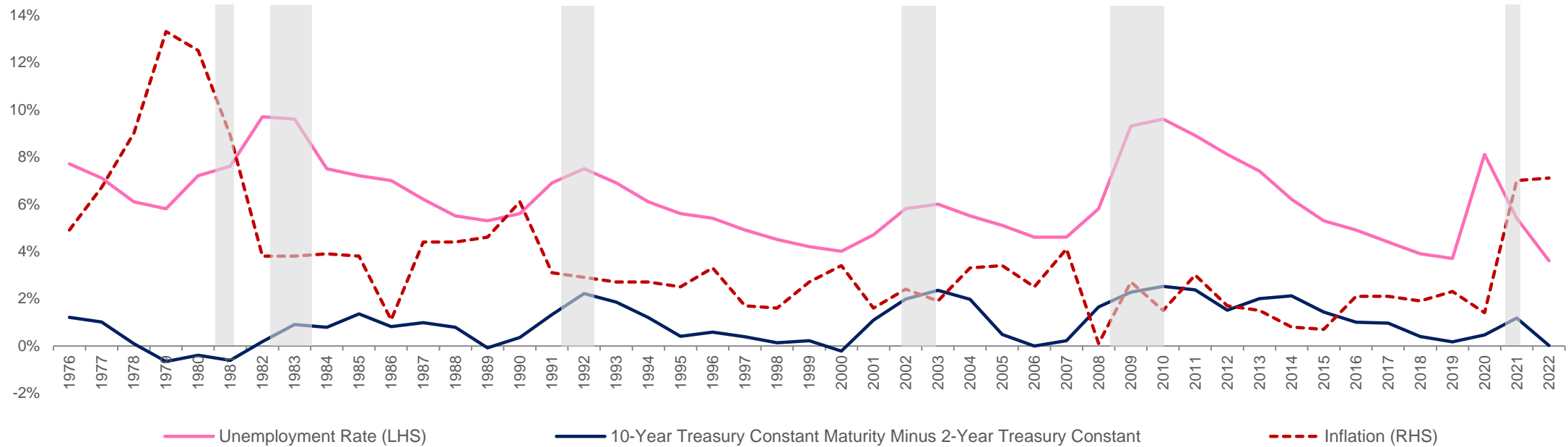
Chart 1: US Inflation and Fed Funds Rate



Whenever US inflation was above the target level of c. 2%, policy rates have generally needed to get ahead of inflation in order to tame inflationary pressure. The current expectation for US policy rates is for rates to peak c. 5% p.a. before gradually declining.

Tight labour markets amidst increasingly recessionary indicators ...

Chart 2: US: Phillips Curve and Yield Curve Inversion

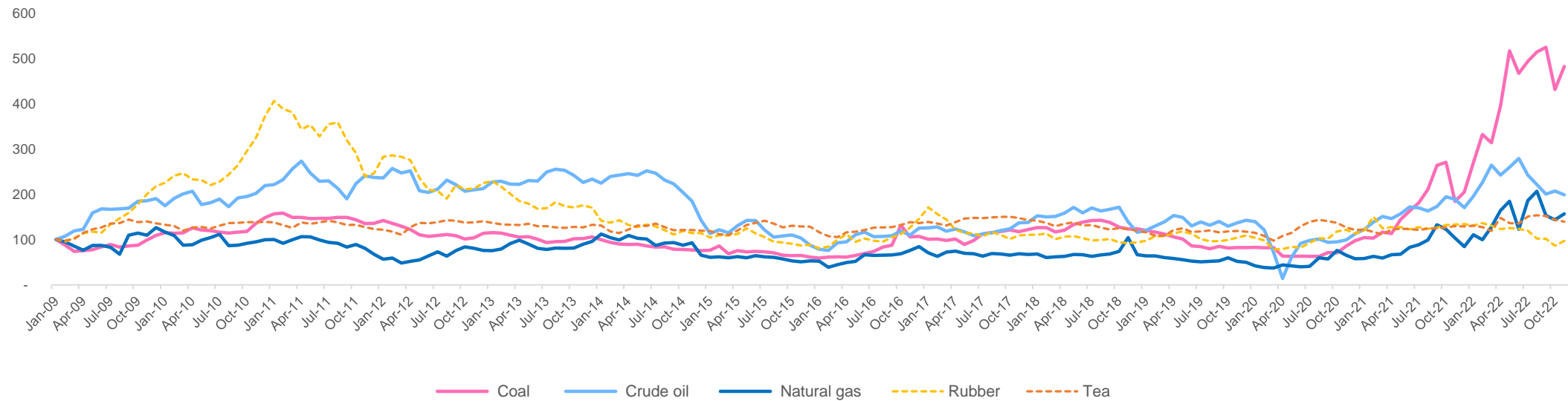


Yield curve inversion in the US (long term treasury rate minus short term treasury rate) has correctly predicted the last eight recessions. Despite recessionary indicators such as the yield curve inversion, a red-hot labor market might require interest rates to remain higher for longer, elevating the risk of a hard landing for the US economy.

... and higher energy prices could contribute to sticky inflation and elevated interest rates

Chart 3: Commodity Prices (since 2009)

Base year 2009 = 100



- Although key energy prices have declined from recent highs, energy policy in Europe, elevated geopolitical risks and further black swan events could contribute to structural inflation through high or elevated energy prices relative to pre-Covid levels.
- Sri Lanka's import prices of energy products have increased more than prices of its key export commodities. However, we don't anticipate a major terms of trade shock in the coming year, in the absence of any unforeseen geopolitical events.

High global debt levels pose a systemic risk if interest rates remain elevated

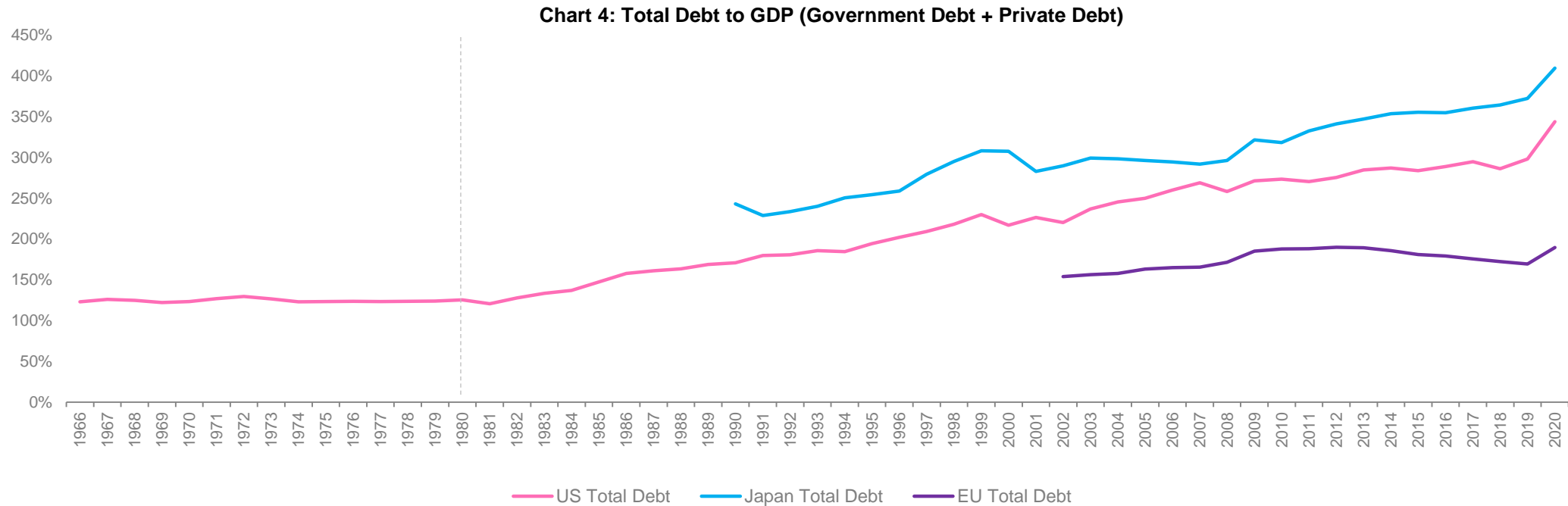


Table 1: No. Countries with Debt/ GDP > 100%

	1990	2000	2010	2020	2021
Developed Countries	2	3	4	8	8
Developing Countries	5	19	6	22	24

Higher global debt levels compared to previous decades increases sovereign default risk. For emerging and frontier market economies, the ability to fund current account deficits and rollover maturing foreign currency debt will be increasingly difficult given the prevailing risk premiums above the US risk free rate in view of elevated sovereign default risk for issuers with low sovereign credit ratings.

Sri Lanka Economy

The economy is at a critical juncture and the outcome of 2023 is likely to set the stage for sustained recovery or further distress in the future

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Economic hardship in 2022 was the worst in recent memory...

Chart 5a: Misery Index: Inflation + Unemployment

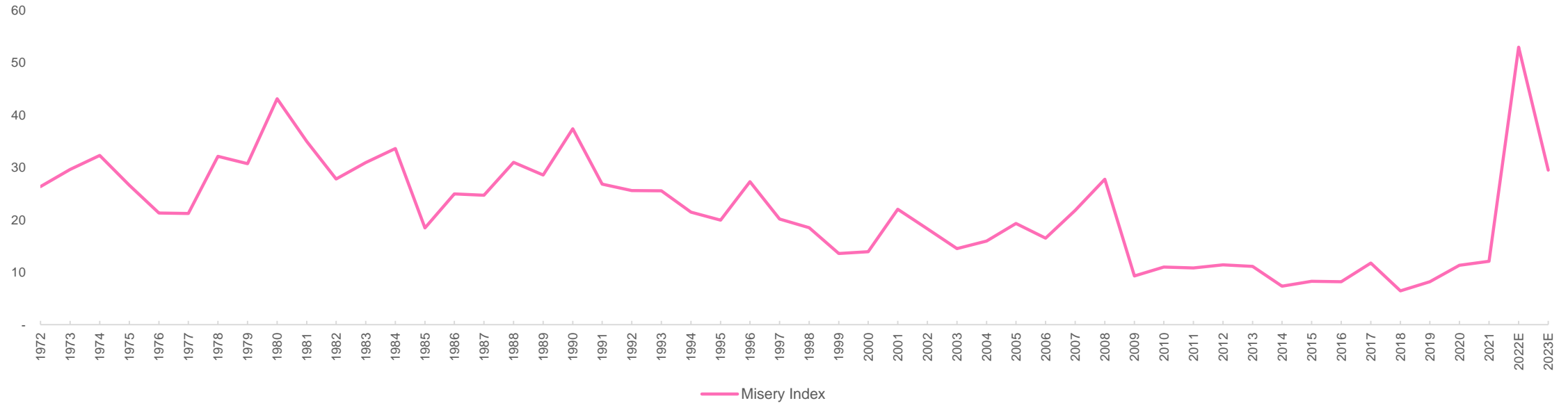
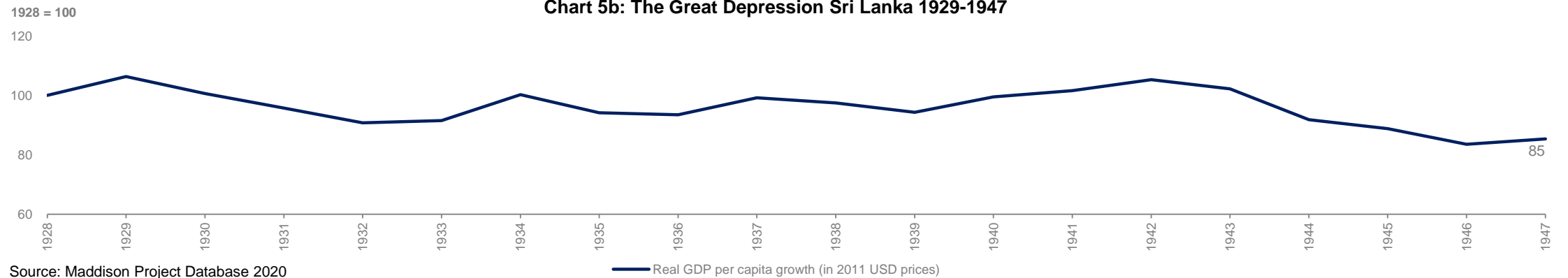


Chart 5b: The Great Depression Sri Lanka 1929-1947



Source: Maddison Project Database 2020

Twin deficit problem; persistent fiscal deficits leading to a structural current account deficit

Sri Lanka is a classic twin deficit economy where the direction of causality is from the fiscal deficit to the current account deficit. Fiscal and structural current account deficits have been largely debt funded. Debt funded growth has been inadequate to reduce debt/ GDP and the investments have largely flowed into non-tradeable sectors reflected in a declining trade/ GDP ratio, thus exposing the economy to a debt/ liquidity event which finally came to a head with the Covid pandemic when credit rating downgrades resulted in loss of market access to rollover maturing foreign debt.

■ Fiscal deficit as a % of GDP ■ S - I (Gap between savings and investments) as a % of GDP ■ Current account as a % of GDP

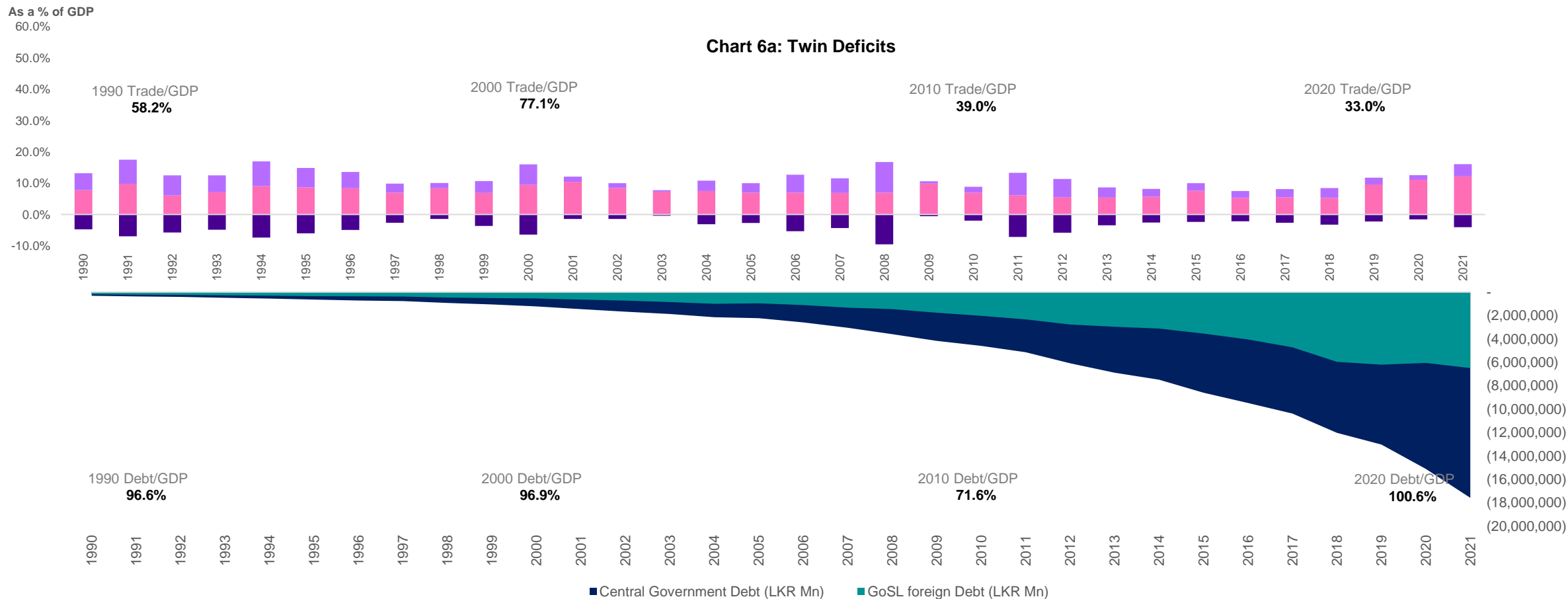


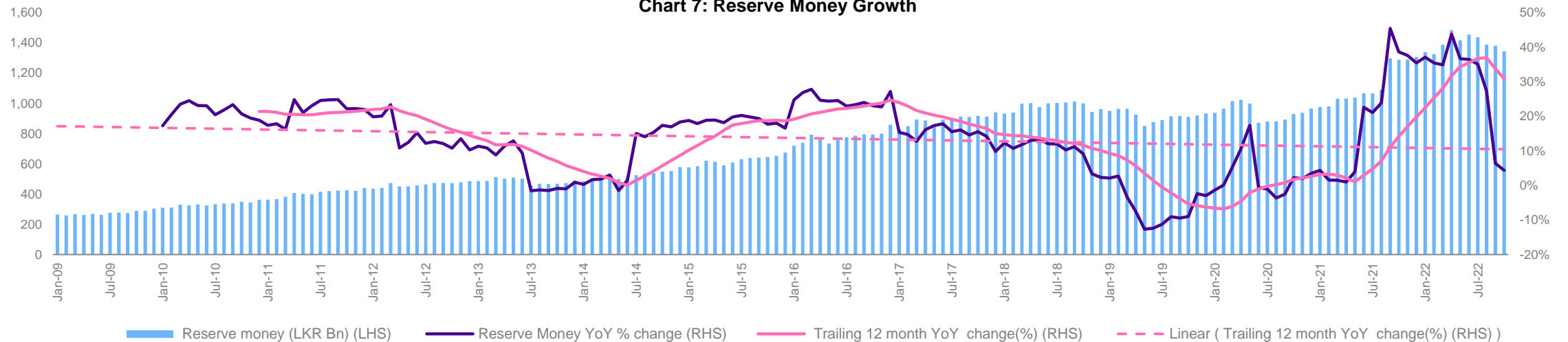
Chart 6b: Central Government Total Debt and Foreign Debt

Fiscal dominance of monetary policy has led to periodic balance of payments stress

Table 2: Correlation Matrix of Monetary Variables

	Reserve Money (M0)	Net Foreign Assets (NFA)	Net Credit to Govt (NCG)	Domestic Credit	Other Items (net)	Net Domestic Assets (NDA)	Broad Money (M2b)
Reserve Money (M0)	1.00						
Net Foreign Assets (NFA)	-0.66	1.00					
Net Credit to Govt (NCG)	0.94	-0.79	1.00				
Domestic Credit	0.98	-0.72	0.98	1.00			
Other Items (net)	-0.96	0.59	-0.95	-0.98	1.00		
Net Domestic Assets (NDA)	0.98	-0.74	0.99	1.00	-0.98	1.00	
Broad Money (M2b)	0.98	-0.68	0.98	1.00	-0.99	1.00	1.00

Chart 7: Reserve Money Growth



Periods of excessive monetary growth on account of fiscal dominance have usually led to strain on net foreign assets through higher credit/ import growth and reserve losses to maintain the currency peg, leading to crawling depreciation of the LKR.

Indicators show the economy is stabilising in response to corrective policy measures

Chart 8a: Overnight Liquidity (LKR Bn)

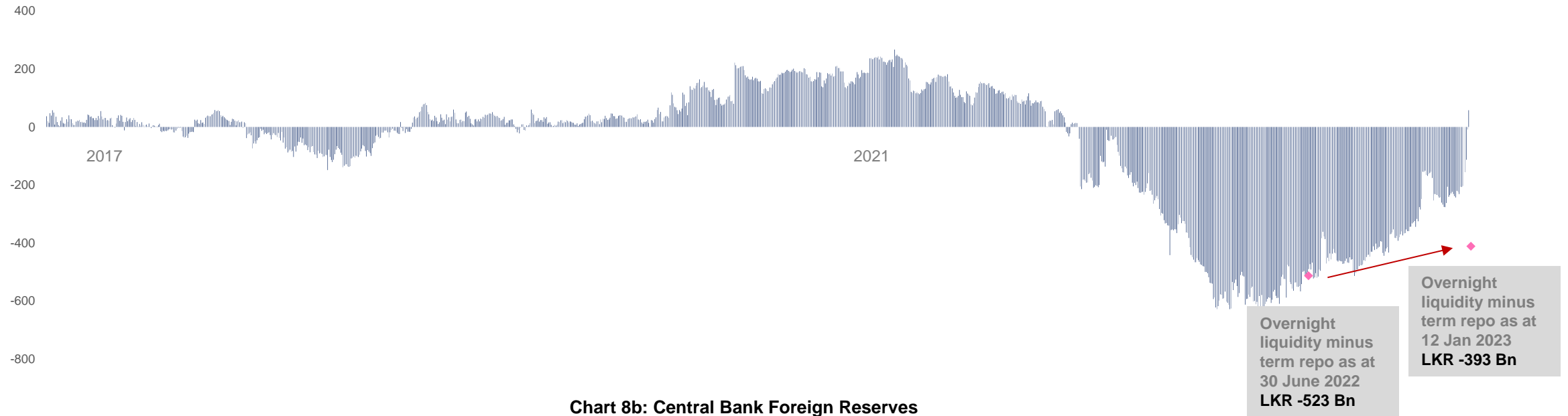
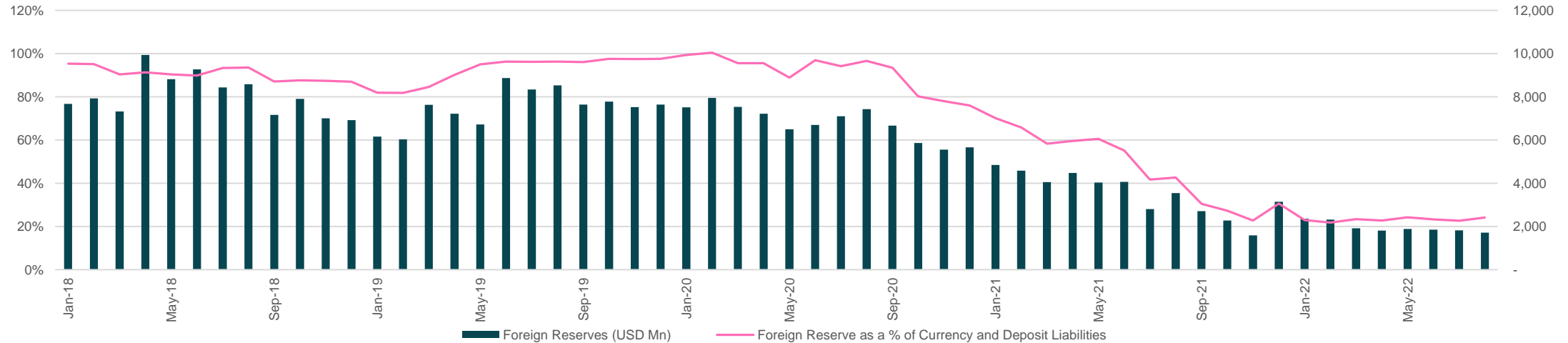
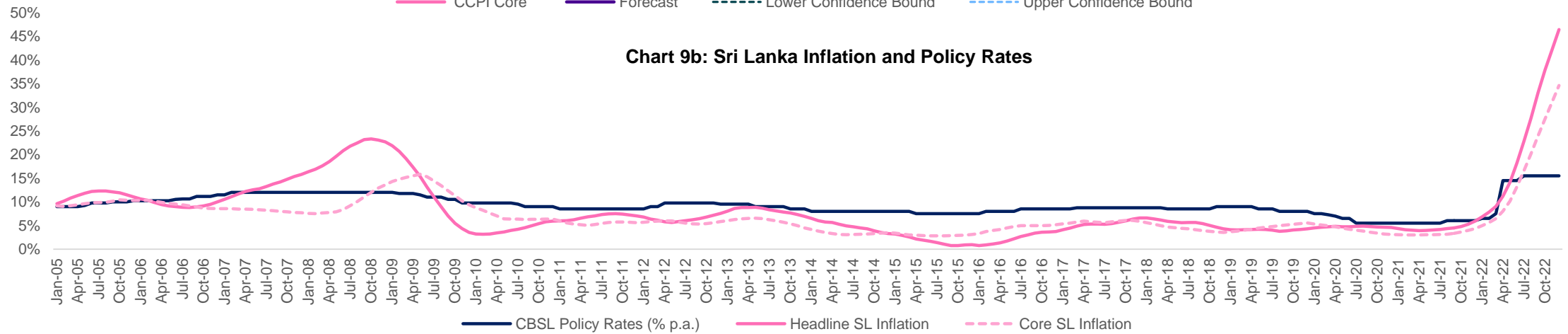
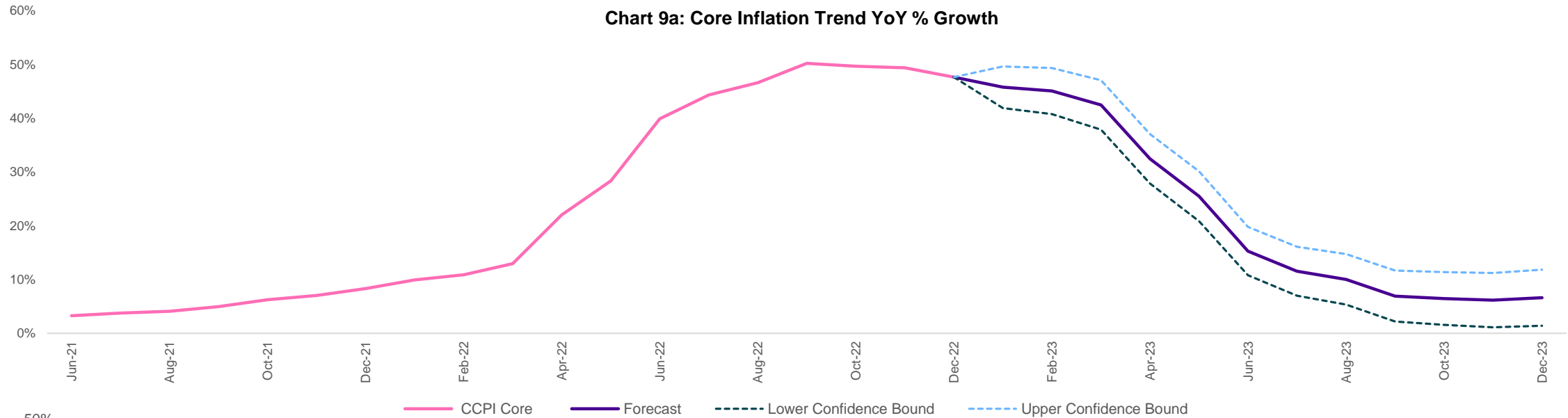


Chart 8b: Central Bank Foreign Reserves



Inflation is expected to revert to single digit levels by end of the year

Based on trend forecasts, core inflation is expected to revert to single digit levels by the end of the year, assuming there is no significant LKR depreciation during the year. We expect that policy rates will need to be maintained at around current levels throughout 2023 to get ahead of inflation and to keep inflation expectations anchored.



Yield curves need to pull back to historical levels for debt sustainability

Chart 10a: LKR Government Debt Historical Yield Curves

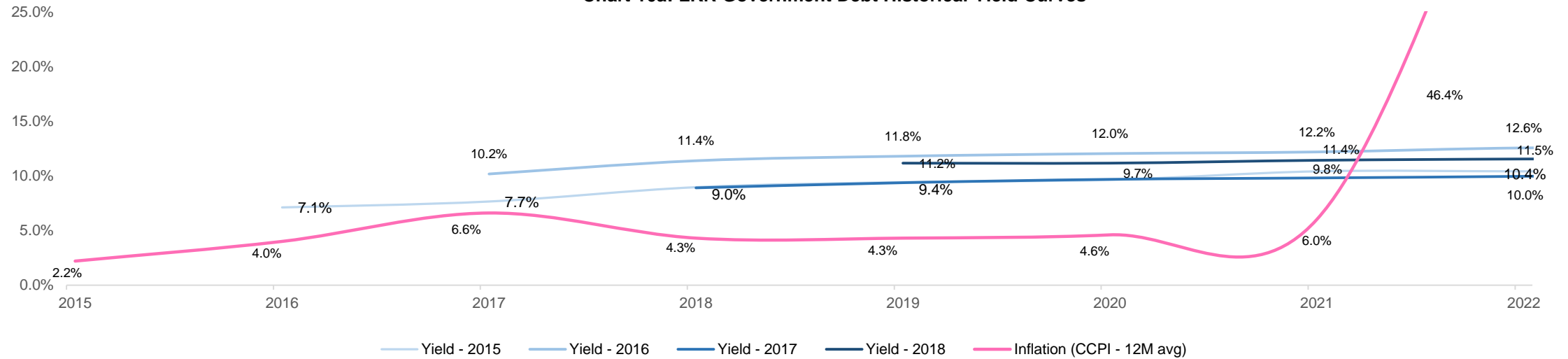
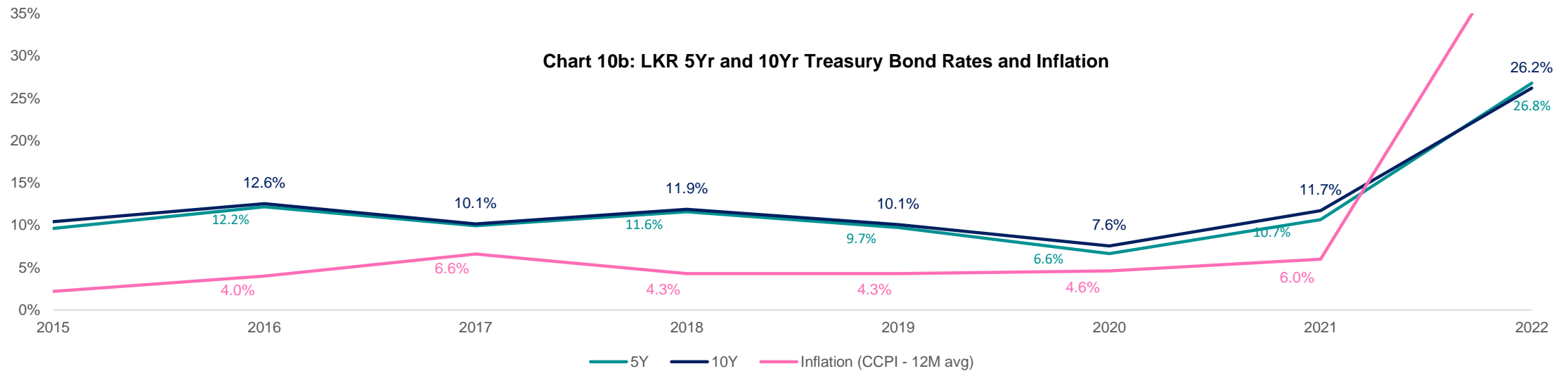


Chart 10b: LKR 5Yr and 10Yr Treasury Bond Rates and Inflation

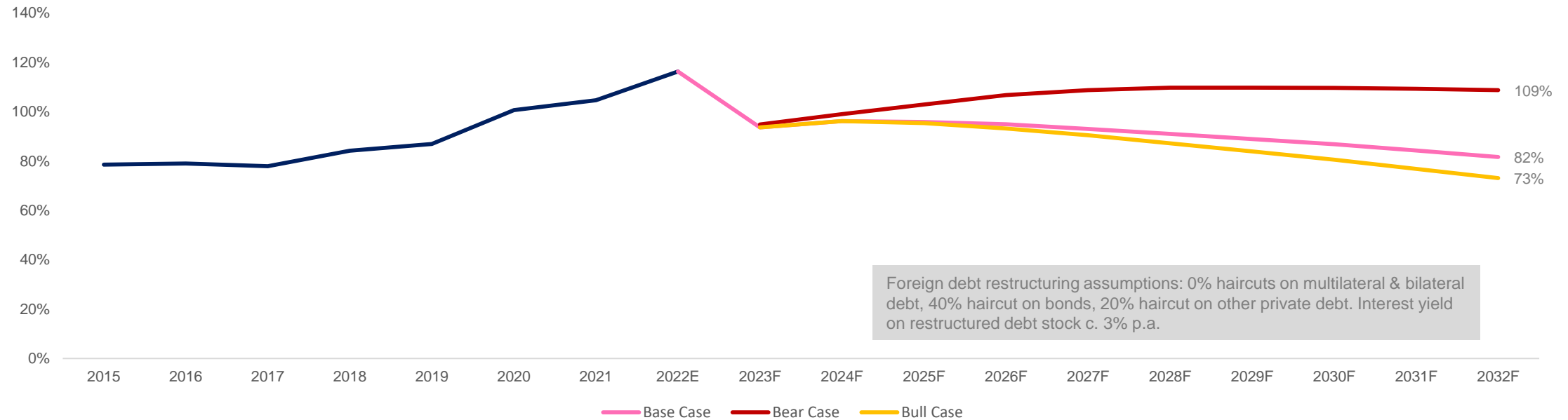


Despite significant and ongoing progress on fiscal consolidation (refer to our [budget 2023 review](#)), higher interest cost is currently driving the fiscal deficit as yields on government securities are elevated in response to the inflation shock and the risk of domestic debt restructuring. Yields need to revert to historical levels to prevent the fiscal situation spiraling out of control.

Debt sustainability will primarily depend on containing the primary balance deficit to target levels

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 defaults and possible domestic debt restructuring. There is no room for fiscal slippage if real/ nominal interest rates are to return to levels consistent with debt sustainability .

Chart 11: Sri Lanka Government Debt to GDP post Foreign Debt Restructuring



Assumptions	GDP Growth	Inflation	LKR Depreciation	Primary Balance % of GDP	LKR Interest Rates
Base Case	4% p.a. from 2025	5% p.a. 2024-26; 5.5% p.a. from 2027	5% p.a. from 2026 onwards	-1% 2023; 0% 2024, 2% 2025; 2.3% 2026 onwards	TB/ T Bond = inflation + 4% p.a./ +5% p.a. from 2027
Bear Case	3% p.a. from 2025	5% p.a. 2024-26; 5.5% p.a. from 2027	5% p.a. from 2026 onwards	-2% in 2023 to 0% in 2027; 1% in 2028; 2% from 2029	TB/ T Bond = inflation + 5% p.a./ +6% p.a. from 2027
Bull Case	5% p.a. from 2025	5% p.a. 2024-26; 5.5% p.a. from 2027	5% p.a. from 2026 onwards	-1% 2023; 0% 2024, 2% 2025; 2.3% 2026 onwards	TB/ T Bond = inflation + 3% p.a./ +4% p.a. from 2028

Policy measures have stabilised the BoP; restoring market access necessary to resume growth

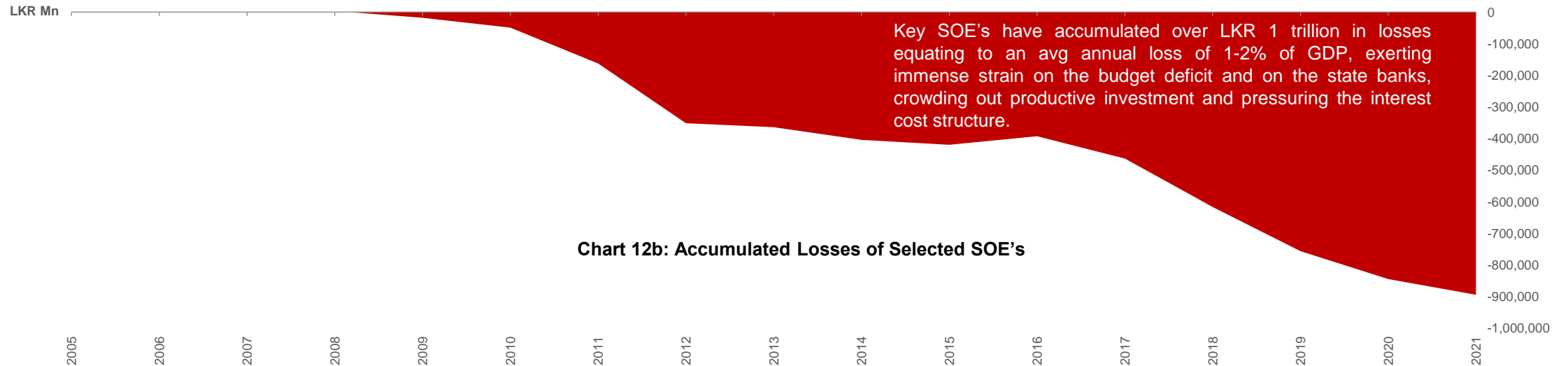
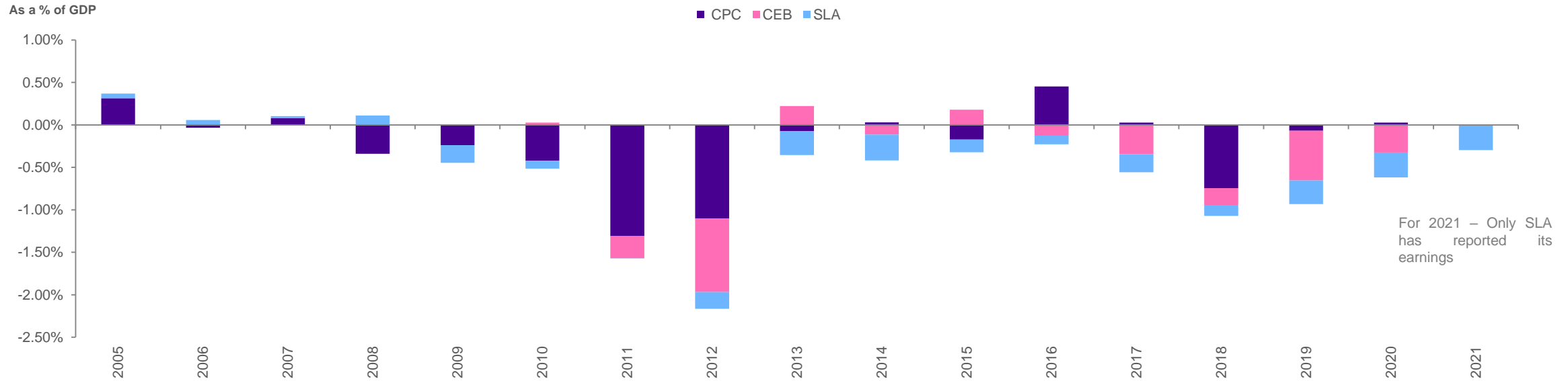
The current account of the balance of payments is expected to post a moderate surplus in 2023 based on current trends. Post foreign debt restructuring and with the expectation of receiving the IMF EFF and other bilateral/multilateral financing, the external funding situation is expected to be sufficient to meet foreign debt servicing in 2023 and for the CBSL to build up depleted reserves. Going forward, policy reforms will be required to maintain current accounts deficits at manageable levels and/or more FDI would be required to sustainably bridge external deficits.

Table 3: Projected Balance of Payments (USD Mn)	2023E	
Exports	11,932	
Imports	(18,000)	
Trade Balance	(6,070)	
Services Excl. Tourism	1,000	
Tourism	1,800	
Primary Income	(2,300)	
Secondary Income/ Remittances	6,000	
Current Account	430	
FDI	500	
Net Portfolio Investment	-	
Debt Servicing	(2,503)	Note 1
External Funding Gap	(1,573)	

Note 1: Incl. interest arrears, short term debt of central government and other sectors, loan maturities of LCB's. Excl. CBSL short term liabilities.

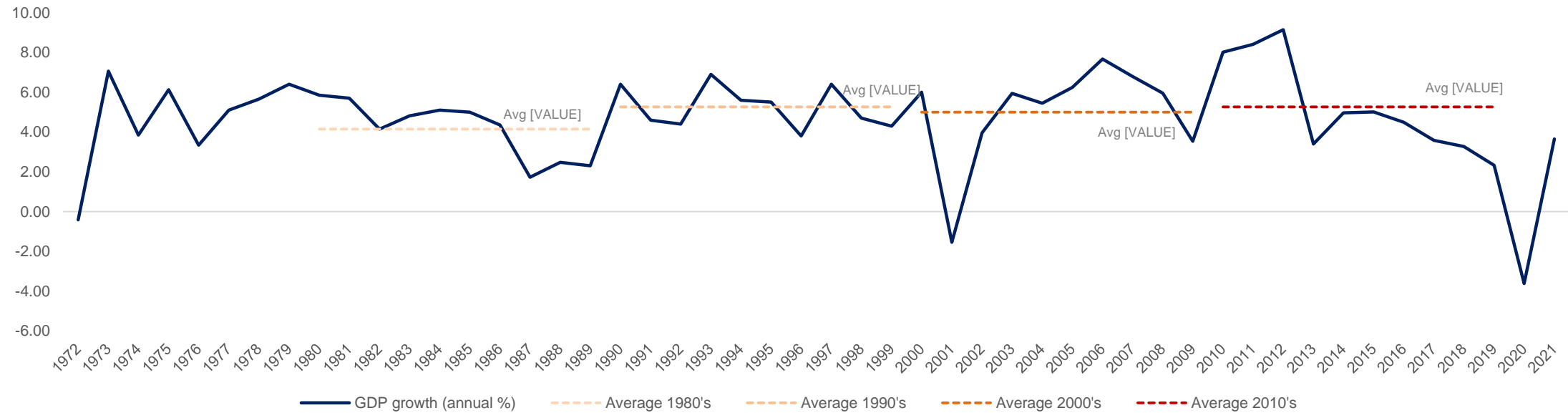
Golden opportunity for SOE reforms to spur economic growth

Chart 12a: Annual Losses of Selected SOEs



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

Chart 13: Real GDP Growth (annual %)



Sri Lanka's post war economic growth rate is lower than its wartime growth rate during the 90'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.

Equity Markets

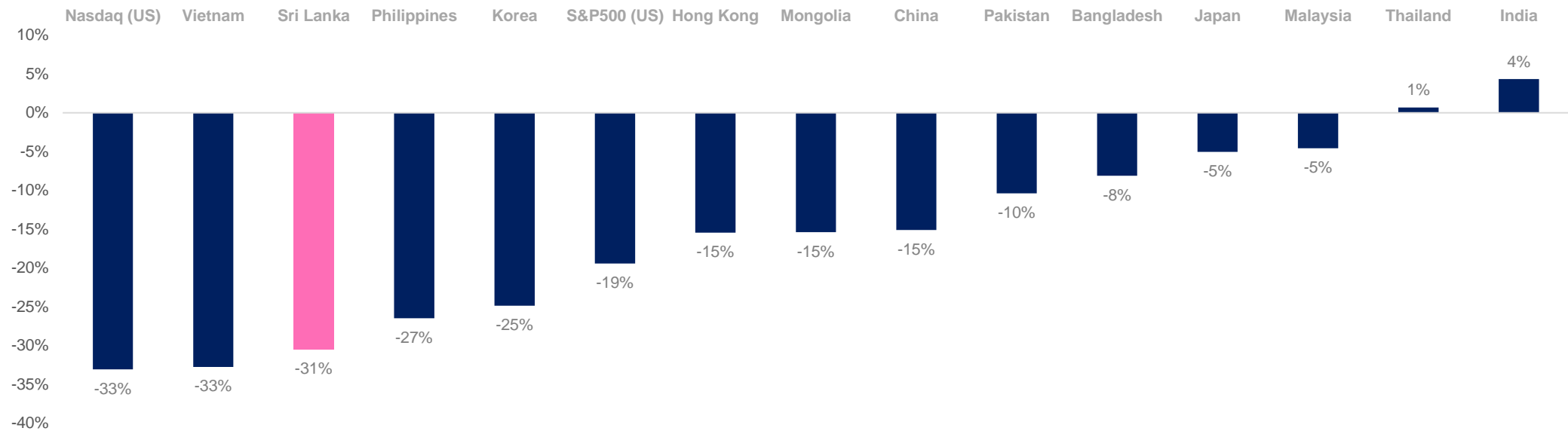
We expect markets to rerate on falling interest rates and improving financial conditions although earnings growth may remain subdued

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CSE underperformed its peer set in 2022 given the domestic economic challenges

2022 was one of the worst years in record for many equity markets. Sri Lanka's equity market performance was at the lower end of its peer set given the unfolding economic crisis during the year.

Chart 14: Market Performance in 2022



Notional market valuations appear to be cheap relative to historic averages

Although notionally valuations are at historic lows, the correct methodology would be to look at valuations relative to prevailing and expected interest rates.

Chart 15a: Market Capitalisation to GDP

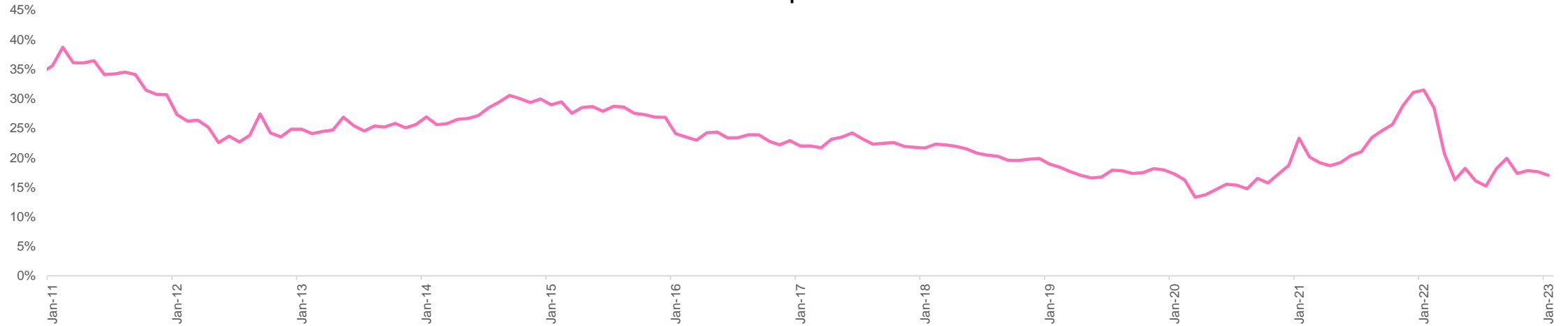
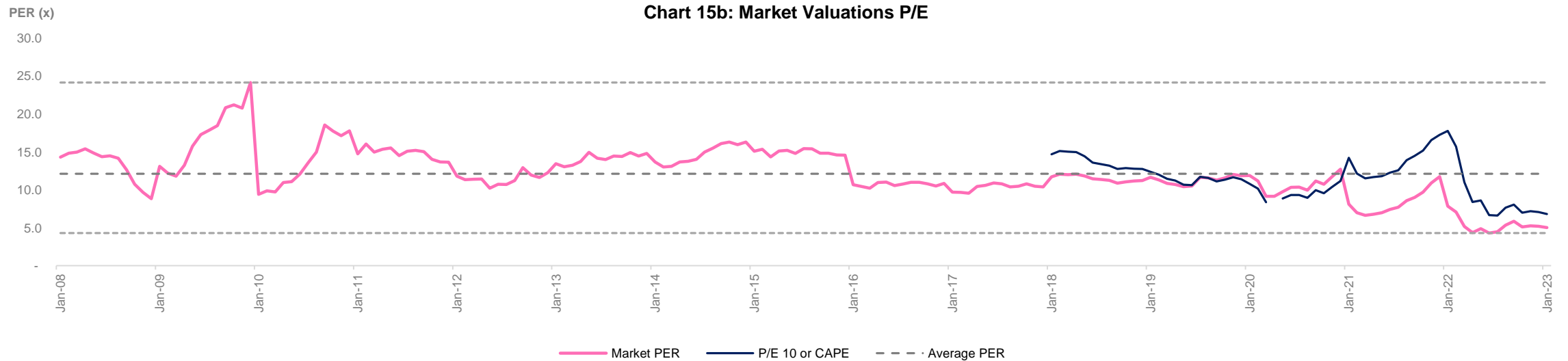


Chart 15b: Market Valuations P/E



Earnings yield relative to interest rates is a more relevant measure which explains current valuations

- The earnings yield (the inverse of the P/E ratio) has closely tracked the prevailing market interest rates.
- With interest rates expected to decline we expect the market P/E to re-rate upwards to around 6-7x on a trailing basis by the end of 2023 representing an earnings yield of 14-17%.
- The market has typically bottomed out before the economy during past periods of economic stress.

Chart 16: Market Earnings Yield and Interest Rates



In the absence of domestic debt restructuring, the banking sector could be one to watch

The banking sector is heavily discounted on concerns of growing NPA's and possible domestic debt restructuring on holdings of LKR government securities. NPA's have risen to c. 16% of gross assets during previous periods of economic stress before falling off on the back of stabilizing economic conditions. We would advise clients to stay on the sidelines with respect to the banking sector until there is more clarity on possible domestic debt restructuring.

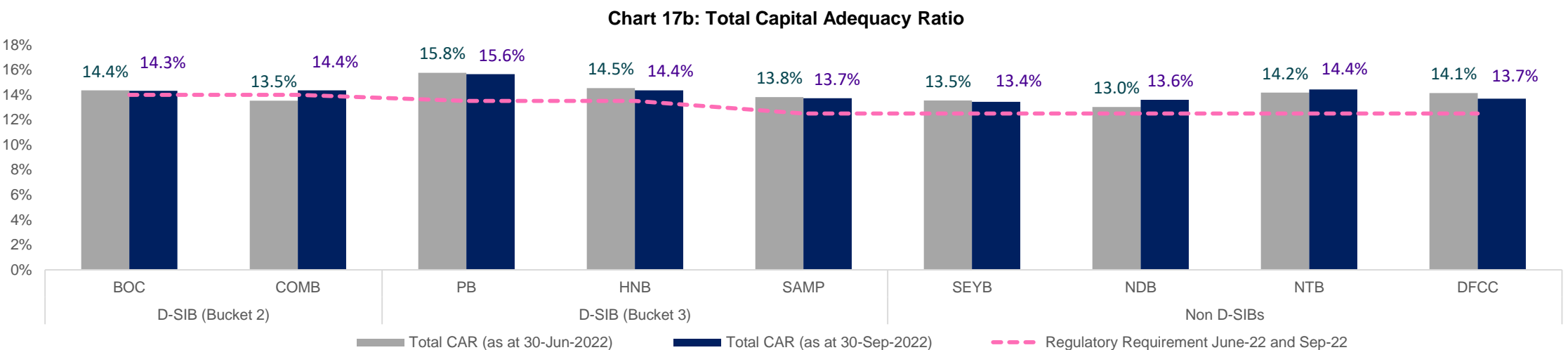
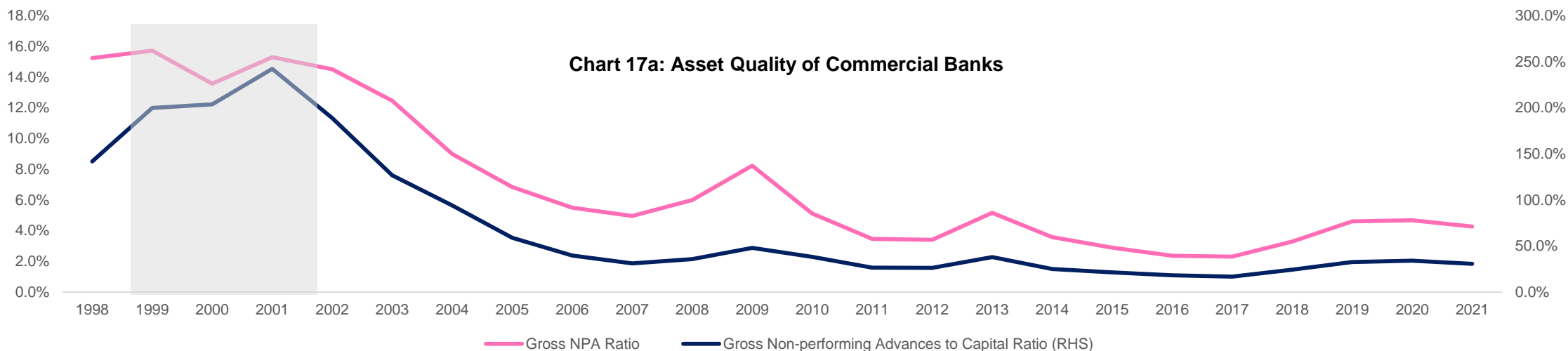
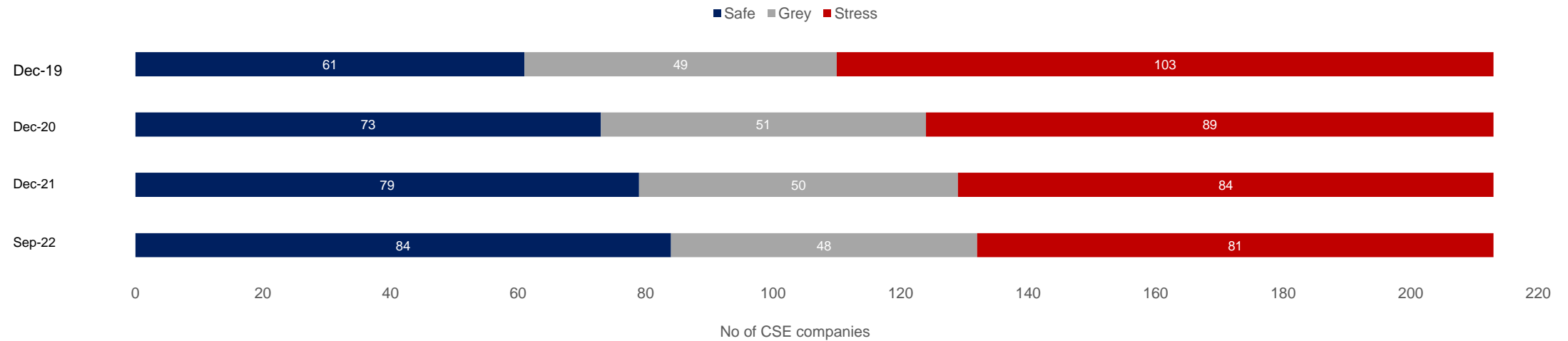


Chart 18: Altman's Z Score of Non-Financial Companies



Source: Bloomberg
Note: Excluding telcos

- Sri Lanka has historically had higher levels on leverage than developed markets, with even blue-chip conglomerates highly geared by international standards.
- Improving measures of financial stress for (for nonfinancial companies) shows that corporates have deleveraged in the last few years.
- Financial stress will however remain elevated for a handful of entities which have very high levels of leverage relative to their cashflow generation in a high interest rate environment.

Earnings growth is mostly correlated with lag of monetary liquidity and nominal GDP growth

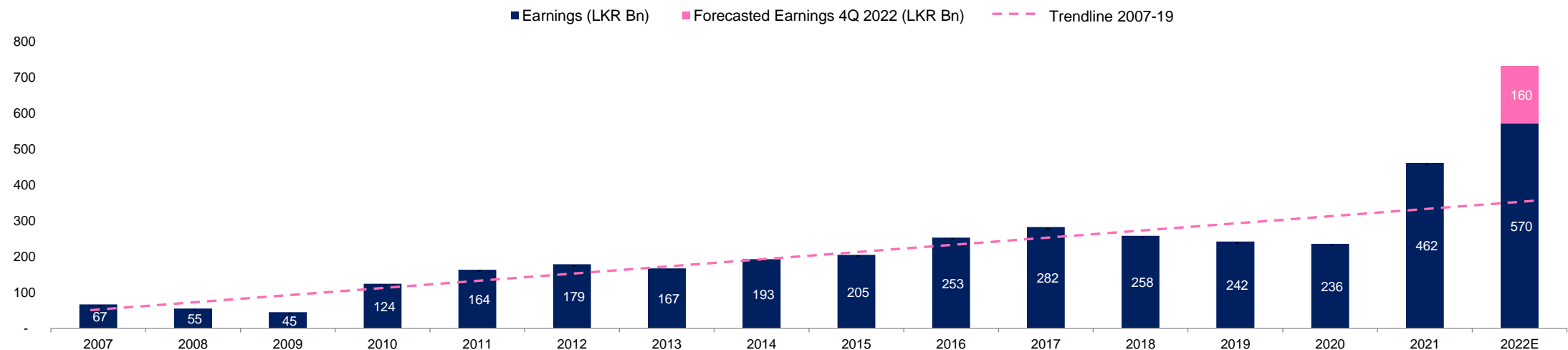
Correlation analysis of ASPI and CSE earnings growth shows the highest correlations with nominal GDP growth and with lagging financial liquidity. This is reflected in the chart below showing CSE earnings growth has closely followed its 2007 to 2019 trendline. Below trend earnings in 2019 and 2020 is explained by the Easter attack and the covid pandemic, respectively. Above trendline earnings in 2021 and 2022 despite subpar and negative GDP growth is explained by high nominal GDP growth in 2022 and the lagged effect of high financial liquidity in 2020 and 2021. The effect of tightening liquidity from 2H 2022 will impact earnings in 2023.

Table 4: Correlation Matrix of ASPI Index/ Earnings Growth

	<i>Growth in ASPI</i>	<i>Growth in CSE Earnings</i>	<i>Growth in GDP at Constant Prices</i>	<i>Growth in GDP at Market Prices</i>	<i>Inflation</i>	<i>Monetary Liquidity</i>	<i>Monetary Liquidity (t-1)</i>	<i>Change in Fx Rate (LKR/USD)</i>
Growth in ASPI	1.00							
Growth in CSE Earnings	0.53	1.00						
Growth in GDP at Constant Prices	0.26	-0.23	1.00					
Growth in GDP at Market Prices	-0.35	0.50	-0.38	1.00				
Inflation	-0.38	0.46	-0.76	0.88	1.00			
Monetary Liquidity	0.25	-0.49	0.31	-0.93	-0.79	1.00		
Monetary Liquidity (t-1)	0.71	0.69	0.33	-0.08	-0.24	0.00	1.00	
Change in Fx Rate (LKR/USD)	-0.45	0.43	-0.71	0.89	0.97	-0.84	-0.21	1.00

Monetary Liquidity = M2b growth – nominal GDP growth
(t-1) = lag period of one year

Chart 19: CSE Annual Earnings (LKR Bn)



We expect the market to re-rate upwards on lower interest rates despite subdued earnings

Chart 20a: CSE Quarterly Earnings (LKR Bn) 4Q 2019 to 3Q 2022

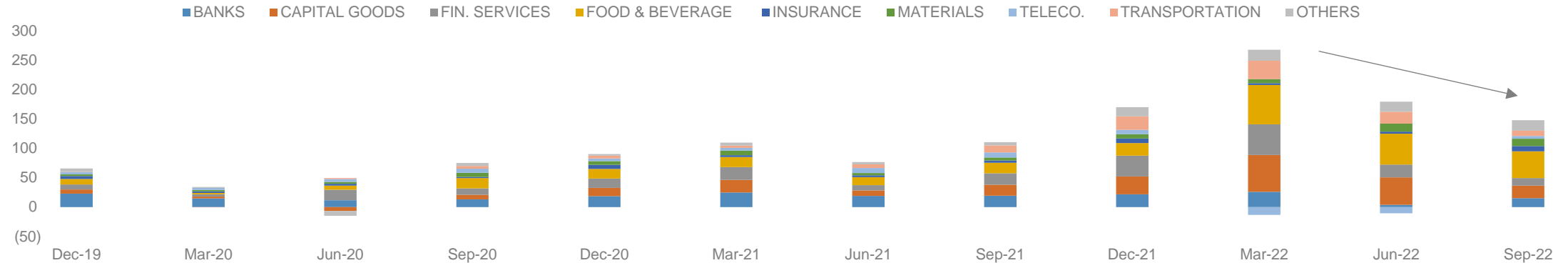
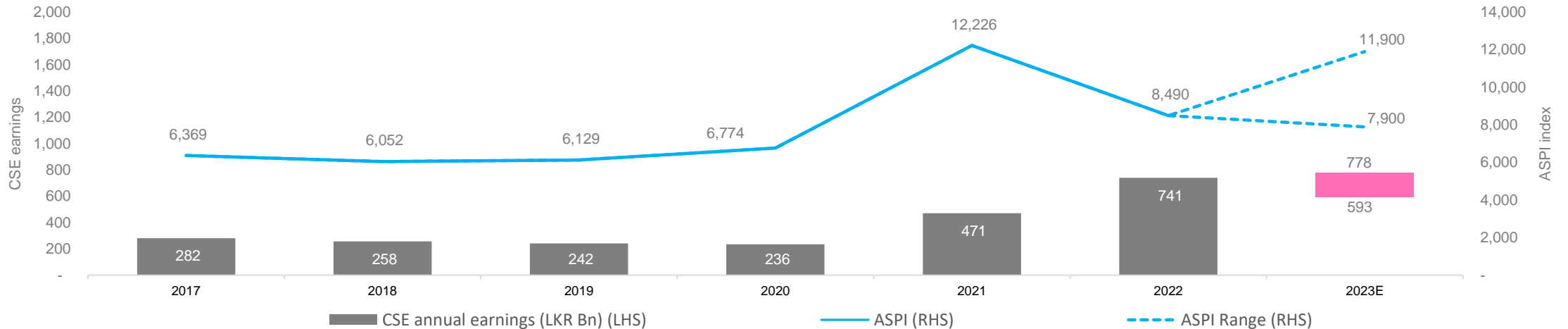


Chart 20b: CSE Annual Earnings, ASPI Index and ASPI Forecast Range for 2023



We expect CSE market earnings growth to range between +5% and -20% for 2023. With the expectation that the market will re-rate to a trailing P/E of 6-7x on the back of falling interest rates, our ASPI target for the end of 2023 is a range between c. 7900 points (-7%) to 11,900 points (+40%).

Strategy & Recommendations

We cautiously recommend a slightly higher allocation to equity with portfolios constructed around counters that have exposure to foreign currency revenues and/ or inflation hedging potential

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Sector and stock selection strategy for 2023

In the context of elevated inflation, high nominal interest rates expected to prevail throughout much of the year and lower demand in the domestic economy, 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 high 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, Essential Goods and Pricing Power: We would look 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, food & beverages, consumer staples, healthcare and other essential services are also likely to be able to both pass on costs to the end consumers and maintain revenue growth in a depressed economy.



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 the cost of capital will remain high. We would look for companies with strong operating leverage with limited capex requirements.



Foreign Currency Revenue Streams: Entities catering to larger addressable markets overseas with less reliance on domestic demand are best positioned to weather the current economic environment as well as providing a hedge against unexpected depreciation of the LKR.



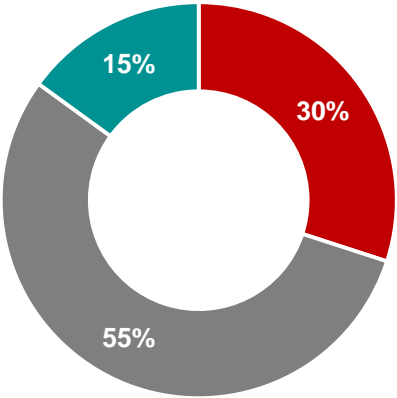
Moderate Financial Leverage: We would avoid highly leveraged companies with significant LKR or foreign currency denominated debt as high interest rates will negatively impact margins and earnings through higher interest costs and exchange losses.

Our preliminary stock selection for the current year based on the strategy and outlook for the year are as follows. We will periodically update our strategy and stock selection for the year based on macroeconomic outcomes, market conditions and earnings releases/ management guidance.

We would cautiously recommend a slightly higher allocation to equity in 2023

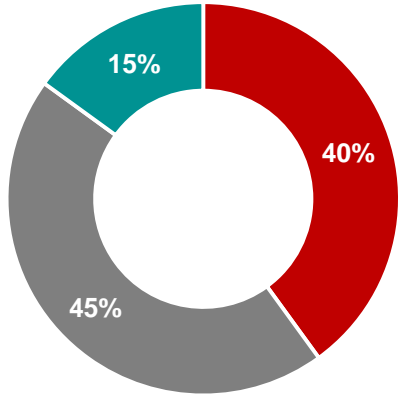
Based on expected challenging macro conditions going forward and potentially higher volatility, we maintain our recommendation for an asset allocation framework in line with an all-weather asset portfolio as follows.

Acuity Recommended Portfolio Allocation
2022



■ Equity ■ Fixed income ■ Alt. Investments

Acuity Recommended Portfolio Allocation
2023



■ Equity ■ Fixed income ■ Alt. Investments

Stock selection and upside potential

Stock	Share Price (13-Jan-2023)	Trailing PER (x)	PBV (x)	Potential upside		ASB rating
				Low PER (6.0 x)	High PER (7.0 x)	
Banks						
Commercial Bank [V]	50.20	3.1	0.3	95%	128%	Hold
Commercial Bank [NV]	41.00	2.5	0.3	139%	179%	Hold
HNB [V]	76.40	2.4	0.2	153%	195%	Hold
HNB [NV]	67.10	2.1	0.2	188%	236%	Hold
Sampath Bank	34.70	3.4	0.3	77%	107%	Hold
Capital Goods						
Hayleys	64.00	1.7	0.6	248%	306%	Moderate Buy
Hemas Holdings	57.30	7.0	1.0	-14%	0%	Hold
John Keells Holdings	136.75	6.6	0.5	-9%	6%	Hold
Richardpieris & Company PLC	22.10	4.8	1.7	25%	46%	Hold
Consumer Durables & Apparel						
						Attractive
Hayleys Fabric PLC	22.10	2.2	1.5	169%	213%	Moderate Buy
Teejay Lanka	31.60	5.8	0.6	3%	21%	Hold
Hela Apparel	8.60	12.4	0.7	-52%	-44%	Hold
Diversified Financials						
						Hold
Energy						
Lanka IOC	177.50	3.6	2.1	69%	97%	Hold
Food, Beverage & Tobacco						
Melstacorp	46.10	2.7	0.6	121%	157%	Moderate Buy
Distilleries	13.20	4.9	10.2	22%	42%	Hold

Stock selection and upside potential

Stock	Share Price (13-Jan-2023)	Trailing PER (x)	PBV (x)	Potential upside		ASB rating
				Low PER (6.0 x)	High PER (7.0 x)	
Insurance						
Union Assurance	29.30	8.0	1.4	-25%	-13%	Hold
Materials						
CIC Holdings [V]	76.90	4.4	1.4	37%	60%	Moderate Buy
CIC Holdings [NV]	52.00	3.0	1.0	103%	136%	Moderate Buy
Dipped Products	27.00	2.0	0.6	199%	249%	Hold
Chevron	95.20	5.5	3.3	9%	27%	Hold
Haycarb PLC	53.50	2.5	0.7	142%	182%	Hold
Real Estate						
Prime Residencies	6.50	1.5	0.7	294%	360%	Hold
Transportation						
Expolanka Holdings	172.00	4.0	2.1	49%	74%	Hold
Household & Personal Products						
B P P L Holdings Plc	23.00	8.0	2.2	-25%	-13%	Hold
Software & Services						
Hsenid Business Solutions	16.50	6.1	2.2	-2%	15%	Hold
Commercial & Professional Services						
Printcare PLC	53.10	1.3	0.8	359%	436%	Moderate Buy

Research Team

Shehan Cooray
(+94) 112 206 256
shehan@acuity.lk

Arun Sarweswaran
(+94) 112 206 251
arun@acuitystockbrokers.com

Sales Team

Prashan Fernando
(+94) 112 206 222
prashan@acuitystockbrokers.com
(+94) 772250609

Kapila Pathirage
(+94) 112 206 227/228
kapila.p@acuitystockbrokers.com
(+94) 777660131

Naren Godamunne
(+94) 112 206 225
naren@acuitystockbrokers.com
(+94) 772250603

Dhammika Wanniarachchi
(+94) 112 206 229
dhammika.w@acuitystockbrokers.com
(+94) 771063754

Kumar Dias Desinghe
(+94) 814 474 443
kumar@acuitystockbrokers.com
(+94) 777801713

Susil Fernando
(+94) 112 206 234
susil@acuitystockbrokers.com
(+94) 772432110

Auburn Senn
(+94) 112 206 239
auburn@acuitystockbrokers.com
(+94) 714943304

S. Vasanthakumar
(+94) 112 206 250/251
vasantha.k@acuitystockbrokers.com
(+94) 773613285

Prasanna Semasinghe
(+94) 814 474 443
prasanna@acuitystockbrokers.com
(+94) 773613284

Warana Sumanasena
(+94) 112206 231
warana@acuitystockbrokers.com
(+94) 719553617

Dinuk Subasinghe
(+94) 112206 237
dinuk@acuitystockbrokers.com
(+94) 775877878

Danuksha Koralage
(+94) 112206 233
danuksha@acuitystockbrokers.com
(+94) 777281221

Buddhenia Narangoda
(+94) 112206 248
buddhenia@acuitystockbrokers.com
(+94) 777453640

Thushintha Hettige
(+94) 112 206 232
thushintha@acuitystockbrokers.com
(+94) 78 102 5871

Dushan Senanayaka
(+94) 11 2 206 236
Dushan@acuitystockbrokers.com
+94 (76) 551 1456

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