CEYLON ASSET MANAGEMENT RESEARCH

Sri Lanka, the Contrarian Investment Opportunity of 2021

CSE Offers Negative Correlation Benefits to Global Investors

Contrarian investing

"A strategy that involves going against the grain of investor sentiment... The contrarian believes the value of the market or stock is below its intrinsic value and thus represents an opportunity..."

Source: www.investopedia.com

Key Highlights

1. **Sri Lanka equities emerged world's best performing stock market in 2021 YTD**
2. **Global equity interest in Emerging Markets expected to trickle down to CSE**
3. **Global Negativity offers "contrarian" profit opportunity on Sri Lanka Sovereign Bonds**
4. **New ECT terms with a FDI of USD 500Mn favourable for Sri Lanka**
5. **Return of Pension funds to the CSE at prevailing valuations imperative**
6. **UBS has upgraded emerging market equities to the most preferred global asset class**

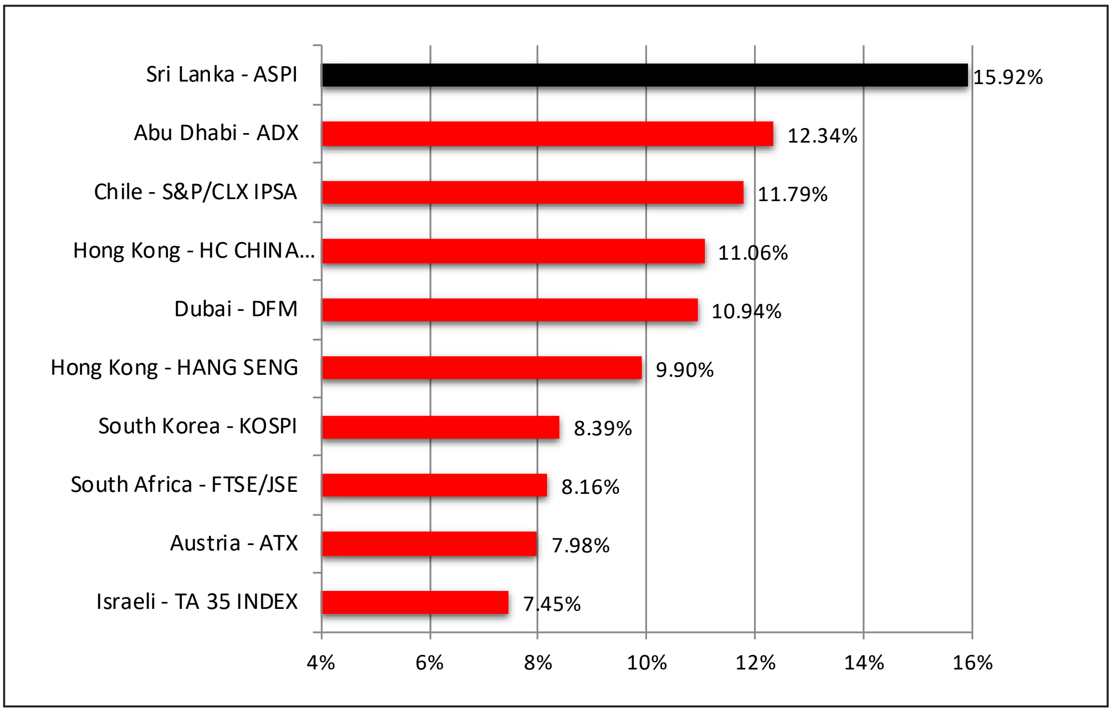
Colombo Stock Exchange (CSE) the Best Performing Stock Market in the World in 2021 YTD

Despite global negativity, the CSE has emerged the best performing stock market in the world as of 19th January 2021 due to local positivity.

The CSE has outperformed the major indices for the period between 11th May 2020 and 31st December 2020 despite the lack of confidence displayed by foreign investors on Sri Lanka. During this period the All Share Price Index (ASPI) recorded a return of 54.2% while S&P 500 (US) recorded 28.2%, NIFTY 50 (India) recorded 51.3% and MSCI Frontier market index reported 27.4%.

Top 10 Best Performing Equity Markets

YTD as at 19th January 2021

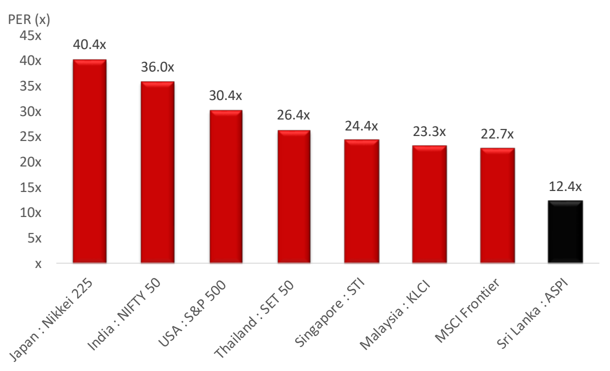


Emerging Markets appear to be the primary interest of global investors in 2021. UBS has upgraded Emerging Market Equities to the most preferred Global Asset Class. Within Emerging Markets, UBS recommends exposure to a diversified set of segments that lagged the top performing stocks and sectors in 2020. Many analysts expect global equity market growth to move away from the US to favour the rest of the world. The capital flow into Emerging Markets can also be expected to flow into Frontier Markets as well as the CSE during 2021.

The CSE has the potential to outperform other frontier equity markets during 2021 since it is trading at attractive valuations. The ASPI is trading at a discount of 54% PER (Price to Earnings Ratio) and 33% PBR (Price to Book Ratio) compared to its peer frontier market countries.

Valuation Comparison of Global Market Indices vs. Sri Lanka

Comparison of Price to Earnings Ratio



Comparison of Price to Book Ratio

Source: www.bloomberg.com

CSE's Negative Correlation offers a unique risk reduction opportunity to foreign investors

Global Investors seek markets that perform conversely to their primary markets in order to mitigate volatility risk. Due to the Colombo Stock Exchange's inverse relationship with major equity markets such as United States, India & Japan, Sri Lanka has the potential to offer the most advantageous risk reduction opportunity to global investors in 2021. Despite the low market capitalization of the Colombo Stock Exchange, it has historically offered negatively correlated returns to investors.

5 Year Correlation Comparison Table (2016 to 2020)

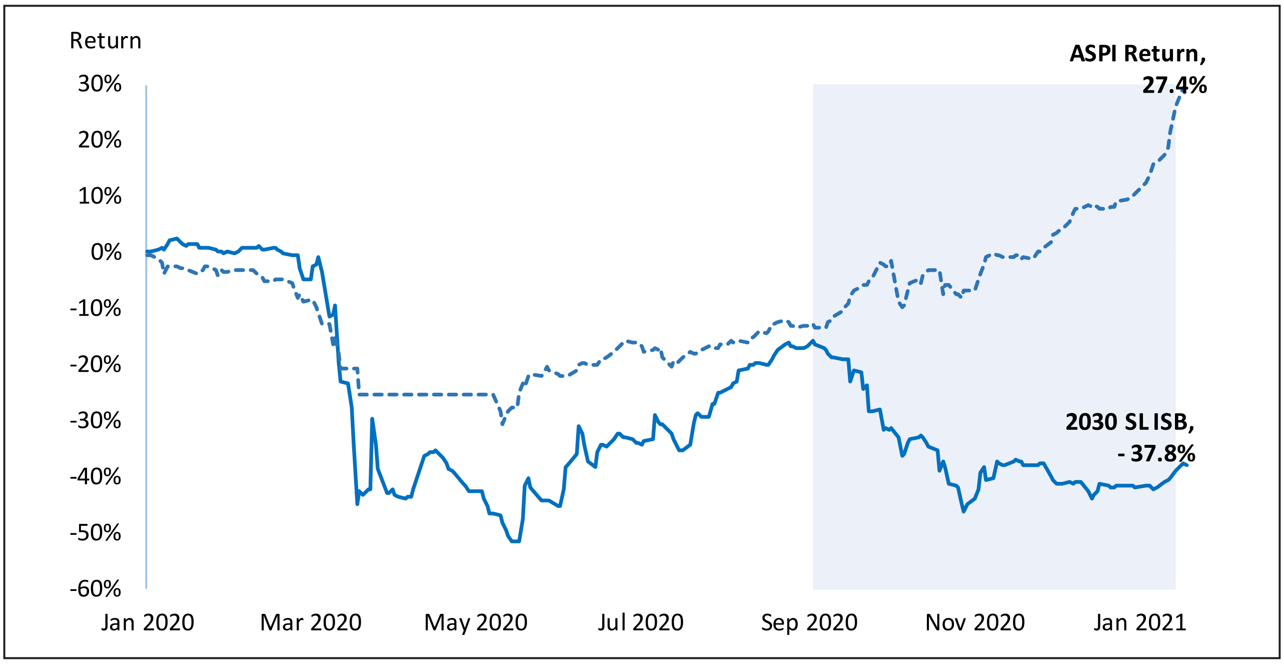
Market Index	Sri Lanka : ASPI	USA : S&P 500	India : Nifty 50	Pakistan : KSE 100	Singapore : STI	UK : FTSE 100	Malaysia : FTSE	Japan : Nikkei 225	Thailand : SET Index	MSCI Frontier Mkt.
Sri Lanka : ASPI	1	(0.405)	(0.209)	0.519	0.394	0.369	0.700	(0.183)	0.370	0.111
USA : S&P 500	(0.405)	1	0.919	(0.047)	(0.029)	(0.004)	(0.341)	0.912	(0.035)	0.649
India : Nifty 50	(0.209)	0.919	1	0.033	0.264	0.275	(0.096)	0.911	0.251	0.780
Pakistan : KSE 100	0.519	(0.047)	0.033	1	0.345	0.432	0.523	0.135	0.316	0.227
Singapore : STI	0.394	(0.029)	0.264	0.345	1	0.913	0.727	0.242	0.934	0.645
UK : FTSE 100	0.369	(0.004)	0.275	0.432	0.913	1	0.646	0.238	0.894	0.544
Malaysia : FTSE	0.700	(0.341)	(0.096)	0.523	0.727	0.646	1	(0.042)	0.755	0.308
Japan : Nikkei 225	(0.183)	0.912	0.911	0.135	0.242	0.238	(0.042)	1	0.226	0.783
Thailand : SET Index	0.370	(0.035)	0.251	0.316	0.934	0.894	0.755	0.226	1	0.589
MSCI Frontier Mkt.	0.111	0.649	0.780	0.227	0.645	0.544	0.308	0.783	0.589	1

1. Sri Lanka offers the highest negative correlation in Asia compared to India, United States and Japan while Malaysia is the 2nd highest in Asia compared to the same countries. It reveals that the CSE moved in the opposite direction to US, India and Japan stock markets during the past 5 years.

2. United States and India show an almost perfect correlation of 0.919. US, India and Japan will enjoy the maximum diversification and risk reduction benefits by investing in the CSE.

Sri Lanka International Sovereign Bonds - Contrarian Opportunity

Global Negativity vs. Local Positivity



Source: www.bloomberg.com
As of 19th January 2021

Frontier economies such as Sri Lanka are experiencing credit distress which was reflected by a series of country rating downgrades by the international rating agencies. As a result, Sri Lanka International Sovereign Bond (SLISB) yields spiked to an all-time high level since the first issue during 2007. The 2030 SLISB yield of 9.1% before the pandemic (11 March) increased to 19.6% during May 2020. Currently, it has recovered marginally trading at a yield of 15.5%. The 2030 ISB price declined by -37.8% during 2020. The 2022 ISB maturities still trade at yields above 30% reflecting global investor concerns over the Sri Lanka's ability to repay maturities next year.

Global bearishness Towards Sri Lanka - Foreign investors have abandoned Sri Lanka securities perceived as "high risk" following the country rating downgrade by International Rating Agencies to "CCC" alongside Iraq, Angola and Lebanon. Foreign investors, international rating agencies and global research houses are negative on SL economy due to existing external debt obligations, weak debt sustainability, insufficient foreign reserves and hesitance to engage with the International Monetary Fund. As a result, all other "CCC" rated countries trade below 10% while Sri Lanka trades at 18.5% p.a.

Sovereign Bond Yield Comparison with Countries of similar Ratings

Country	ISB Maturity	Yield	Country Ratings		
			Moody's	S&P	Fitch
Turkey	2025	4.38%	B2	BB-	B+
Gabon	2025	4.89%	Caa1	Not Rated	CCC
Sri Lanka	**2025**	**18.50%**	**Caa1**	**CCC+**	**CCC**
El Salvador	2025	8.30%	B3	B-	B-
Angola	2025	8.40%	Caa1	CCC+	CCC

Foreign Analysts concern over External Debt Payment Sustainability

The foreign analysts are negative on the external debt repayment ability of Government of Sri Lanka over the next five years due to mounting adverse economic conditions. The absence of a credible debt repayment strategy by the Government of Sri Lanka has diluted foreign investor confidence despite the statements provided on the willingness and ability to settle the upcoming debt obligations. The major concerns over Sri Lanka economy are as follows:

a. Sri Lanka Debt to GDP ratio has increased beyond the economic growth prospects, expected FDIs and equity inflows. The prevailing debt burden is high and expects to reach 102% of the GDP by end of 2020.

b. The interest burden on outstanding debt obligations is reflected in the interest expense to GDP of 6.4% for 2020. It was noted that 72% of the revenue was utilized for debt repayments during 2020.

c. The foreign reserves have declined to USD 5.5Bn in November 2020 from USD 7.5Bn in January 2020. The average annual external debt obligation is USD 4.4Bn p.a. over the next five years.

d. The 2021 budget does not sufficiently address concerns over budget deficit and revenues affected by tax concessions offered during November 2019.

Revival of the Economy and Robust Investment Pipeline

Despite the negative impact of the pandemic on Sri Lanka economy and exit of foreign investors from the CSE, analysts observe a contrarian behavior of local investors due to their confidence in the government policies, measures to reduce the trade deficit, a strengthening current account balance, arrangements of dollar SWAPs to strengthen FX reserves to overcome prevailing challenges.

Investors remain optimistic on Foreign Direct Investment (FDIs) to grow with state-of-the-art affiliated projects in the Colombo Port City and the construction of investment and export zone in Hambanthota in the near future. The Government of Sri Lanka also has several infrastructure projects lined up on highways, ports, energy etc.

Expected FDIs

The Government of Sri Lanka expects committed FDIs of USD 2.5Bn during 2021. The following is a summary of the FDIs under discussion:

a. Shandong USD 300Mn Tyre manufacturing plant in Hambanthota investment zone and USD 600Mn Tyre manufacturing plant in Matugama focusing on the export market.

b. China Harbour Engineering Company Ltd (CHEC) and Brown Investments PLC mixed development projects of USD 450Mn in Colombo Port City.

c. USD 200Mn is expected for a pharmaceutical zone.

d. The Government of China committed an investment of USD 1Bn to the Colombo Port City.

e. The Government of Sri Lanka has offered 49% of equity ownership in East Container Terminal (ECT) of the Colombo Port to an Indian conglomerate for an FDI of USD 500Mn, as opposed to a loan of USD 500Mn to complete the infrastructure development of The Port.

f. In addition to the above, the Board of Investment (BOI) has approved investment proposals for an oil refinery and petrochemical complex of US$ 24Bn under discussion and other related projects at the Hambanthota Port.

Currency SWAPs of USD 2.5Bn

The government is under discussion with China and India for currency swap agreements of USD 2.5Bn to boost the foreign currency reserves and maintain sufficient foreign exchange liquidity instead of traditional means of loan financing to reduce cost of financing from external sources.

Other Positive Developments in 2021

Ceylon Asset Management Research understands the strategy and plan of the Government of Sri Lankaand Central Bank of Sri Lanka for 2021 to be as follows:

a. Sri Lanka is confident of reporting a GDP growth of 5% in 2021. The Government of Sri Lanka expects the Agricultural Sector to perform along with exports such as apparel, tea, and sea food. Export earnings have almost returned to pre-pandemic levels of USD 1Bn a month. Restrictions on imports and tax concessions on several sectors are expected to boost domestic economic growth.

b. The Central Bank of Sri Lanka expects to reach a fiscal deficit of 8.9% in 2021 along with high deficits expected from other nations around the world.

c. The following factors can be expected to improve Sri Lanka's repayment ability during 2021.

    i. Committed FDI pipeline of USD 2.5Bn including the Hambanthota port/FTZ and Port City for 2021.

    ii. Flow of increasing worker remittances.

    iii. Sri Lanka reported a reduction of 25% in the trade deficit through restricted imports.

    iv. The Government of Sri Lanka expects to reschedule debt repayments of USD 4.7Bn during 2021.

    v. The Government of Sri Lanka expects concessional loans and grants in 2021 through bilateral/multinational lending arrangements and institutions such as Asian Development Bank (ADB) the World Bank and the Asian Infrastructure Investment Bank (AIIB) for various state projects.

    vi. The Government has finalized a concessional loan of USD 700Mn with China to be received during the Q1 2021 in order to strengthen the foreign reserves.

    vii. Cancellation of Colombo Light Rail Transit (LRT) project may reduce pressure on Debt/GDP.

d. The following decisions were made to reduce the debt burden of the country.

    i. Converting the State-Owned Enterprises (SOEs) to profit-making entities, and possibly listing them, while maintaining their SOE status. This suggests that privatization, which was part of the International Monetary Fund programme, is not on the table for now.

    ii. The Government of Sri Lanka stated that they will not obtain loans for any future project and proceed as Public Private Partnership (PPP), Build-Operate-Transfer (BOT) or Build-Own-Operate-Transfer (BOOT).

e. Increasing Multilateral and Stock Market Investments

   i. One of the largest general insurance companies namely the Fairfax based in Canada is excited about Sri Lanka and its long-term prospects. Accordingly, they have been expanding their investments in the Colombo Stock Exchange to reap benefits in the near future.

   ii. The Agency of France Development (AFD) is set to expand the non-sovereign debt portfolio worth of Euro 400Mn over the next 3 years to the Public and Private sectors of Sri Lanka.

Key Risk factors for 2021

While all global economies face mounting risks and uncertainty in 2021, Sri Lanka has its share of risks and challenges to overcome. The key risks for Sri Lanka's economy are as follows:

1. If the FDIs fail to materialize, the pressure on the rupee exchange rate will invariably mount.
2. The budget deficit management is important to ward of pressure on interest rates and inflation.
3. If global pandemic risks are not overcome, tourism revenue in 2022 will fail to materialize.

Recommendations for 2021 by Ceylon Asset Management Research

1. Invest in the Colombo Stock Exchange - Investors should include equity in portfolios during 2021, before PE ratio exceed 15X.
2. Strong Buy USD Sri Lanka International Sovereign Bonds – Exploit 30%+ discount.

We are confident that the Government of Sri Lanka will finance the prevailing budget deficit. The Central Bank of Sri Lanka expects to maintain low interest rates along with other countries in order to stimulate domestic growth. As a result, we can expect a positive impact on GDP growth in 2021.

We expect the exchange rate to be volatile since the Central Bank of Sri Lanka is currently not in a position to support the LKR considering foreign exchange reserves being at a low level. However, the foreign exchange market is looking forward to dollar sale SWAPs with forward buy backs.

The Central Bank of Sri Lanka assured that they will not allow Sri Lanka's credit record to be tainted by a Sovereign default or restructure of Sri Lanka International Sovereign Bonds as stated by a few Research Agencies.

Conclusion

Colombo Stock Exchange

Local investors should exploit attractive valuations of the CSE before a Sri Lanka country rating revision and foreign investor confidence returns to the CSE.

Similarly, we recommend that long term investors such as state pension funds should enter the market at prevailing valuations before the PE ratio exceeds 15X.

SL USD Sovereign Bonds

We believe global investors should exploit this unique contrarian investment opportunity pertaining to Sri Lanka International Sovereign Bonds trading at deeply discounted prices and diversify investor risk exposure to reap benefits soon.

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