CAL | RESEARCH

READY. SET. BUY.

EQUITY STRATEGY 2H2023

Analyst : Dilushka de Mel
Email : dilushkad@cal.lk

3rd July 2023

SUMMARY

CATALYSTS

CAL anticipates the ASPI to reach 11,500 to 12,500 levels by end-2023E. Key catalysts include:

- **DDO risk passed:** Clarity provided on the DDO, following a prolonged period of uncertainty over Sri Lanka's debt restructure
- **Lower interest rates:** Interest rates expected to decline below 12% as inflation reaches single digit levels in 2H2023E creating space for further policy rate cuts
- **Market re-rating warranted:** Market trades at a steep discount on both an inflation-adjusted basis and on a PER basis
- **Foreign push:** Increase in foreign participation with debt metrics improving and impending conclusion of debt restructure
- **Post-crisis economic revival:** Economic vital signs have recovered above expectations, promoting consumer and business confidence and a gradual uptick in credit which will drive positive GDP from 3Q2023E onward
- **Upturn in corporate earnings:** Reduced burden from finance costs supports bottom-line expansion while gradual recovery of volumes would drive top line growth.

INVESMENT THEMES

Our investment themes for the next 12 months focus on companies that will benefit from:

1) **Recovery in economic activity**
2) **Declining interest rates and**
3) **Counters that have been negatively impacted by overweighting of risk factors in the past year**

1

THE CATALYSTS

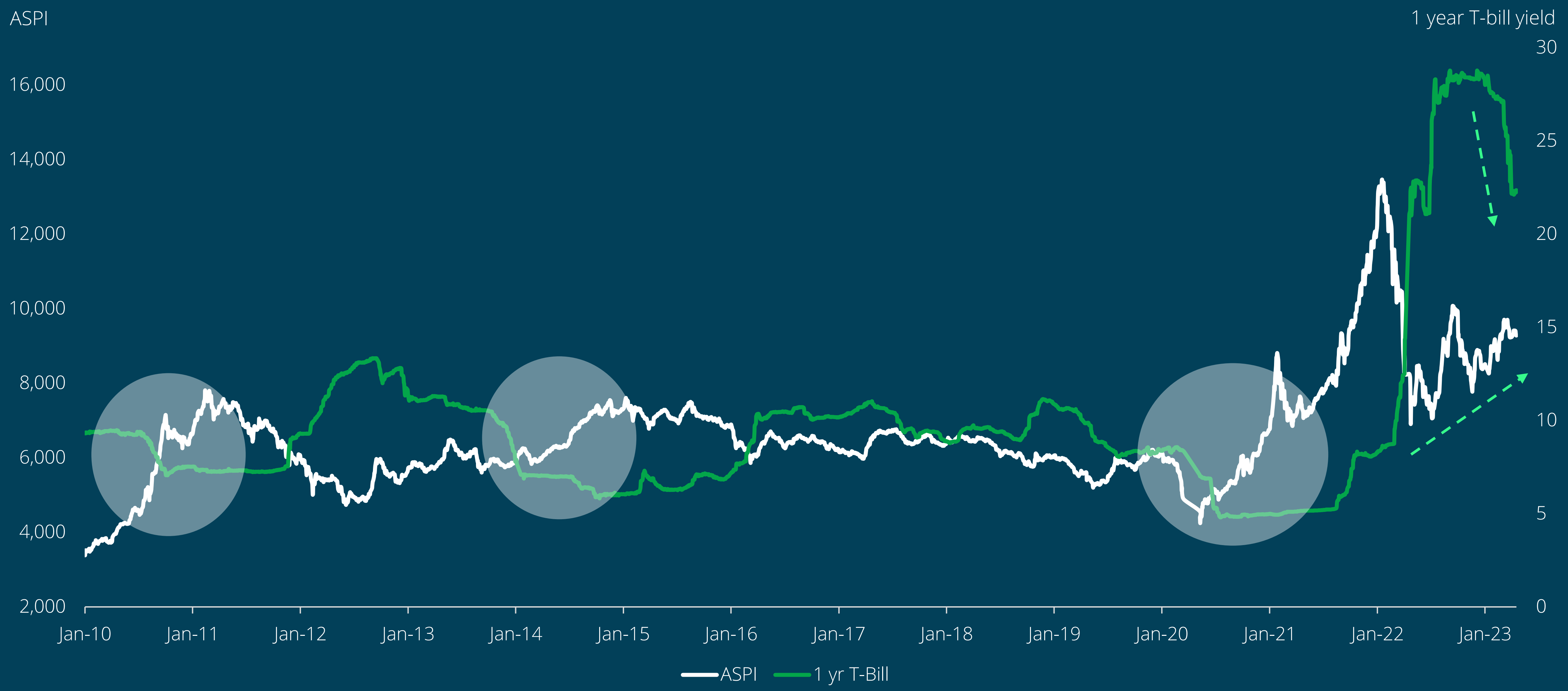
Clarity on the Domestic Debt Optimization (DDO) and lower interest rates to propel the equity market in 2H2023E

Onset of strong positive catalysts to usher in a strong revival in equities with **ASPI expected to reach between 11,500 to 12,500 by end-2023E**

We believe that the market has bottomed out following a prolonged period of uncertainty over Sri Lanka's debt restructure. With clarity being provided on the DDO and interest rates expected to reduce, we believe this would drive the overall market growth with the ASPI expected to reach 11,500 to 12,500 levels by end-2023E.

Market shift : Equity market poised for a surge as interest rates decline

Equity markets can expect upward momentum with the anticipated decline in interest rates, causing a shift in liquidity from fixed income to equity markets as seen in previous cycles of declining interest rates.



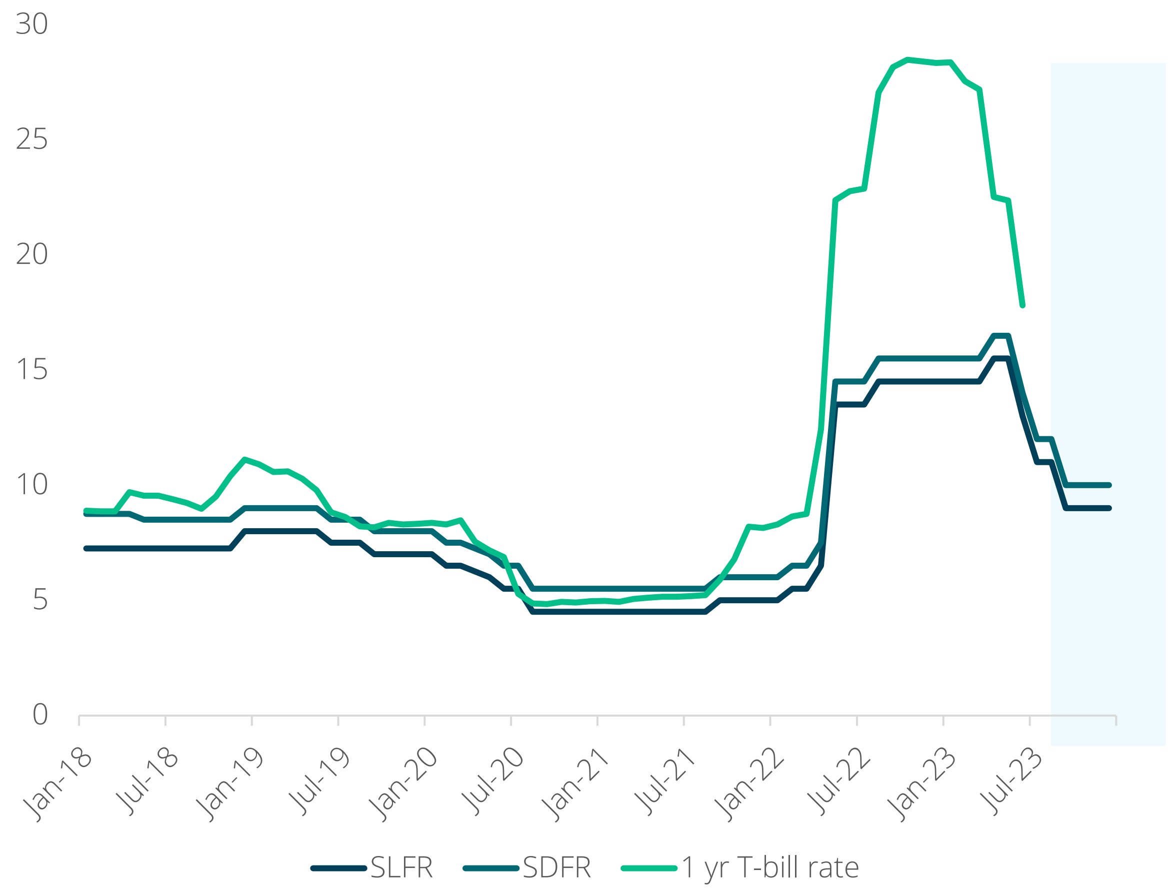
CAL | RESEARCH

Source: CSE, CBSL, CAL Research Estimates

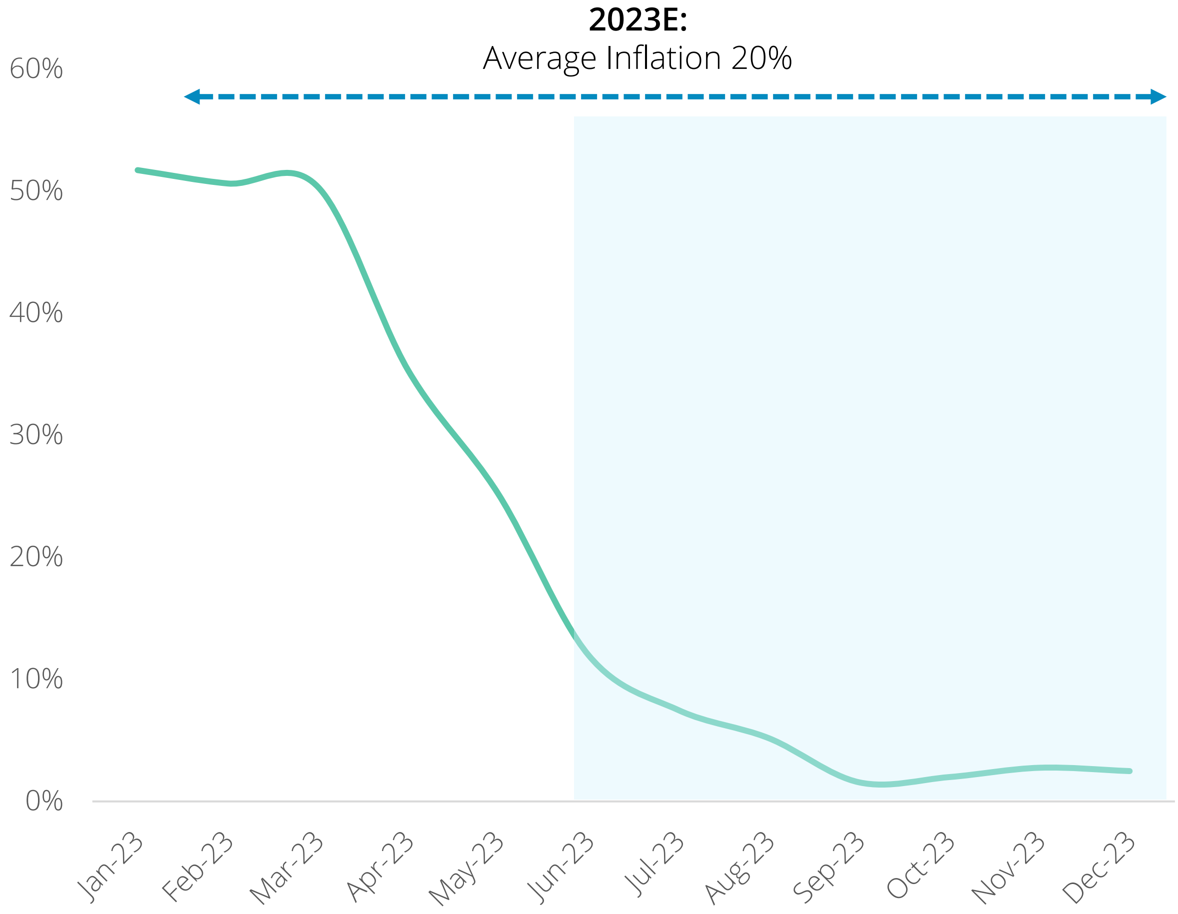
Interest rates expected to decline below 12% supported by 1) a faster than expected reduction in inflation…

We expect inflation to reach single digit levels in 3Q2023E, supported by improved supply side conditions, easing commodity prices, subdued demand and appreciation of the LKR. This would enable CBSL to continue its monetary easing cycle with further 400bps policy rate cuts expected in 2H2023E.

CBSL Policy rates (%)



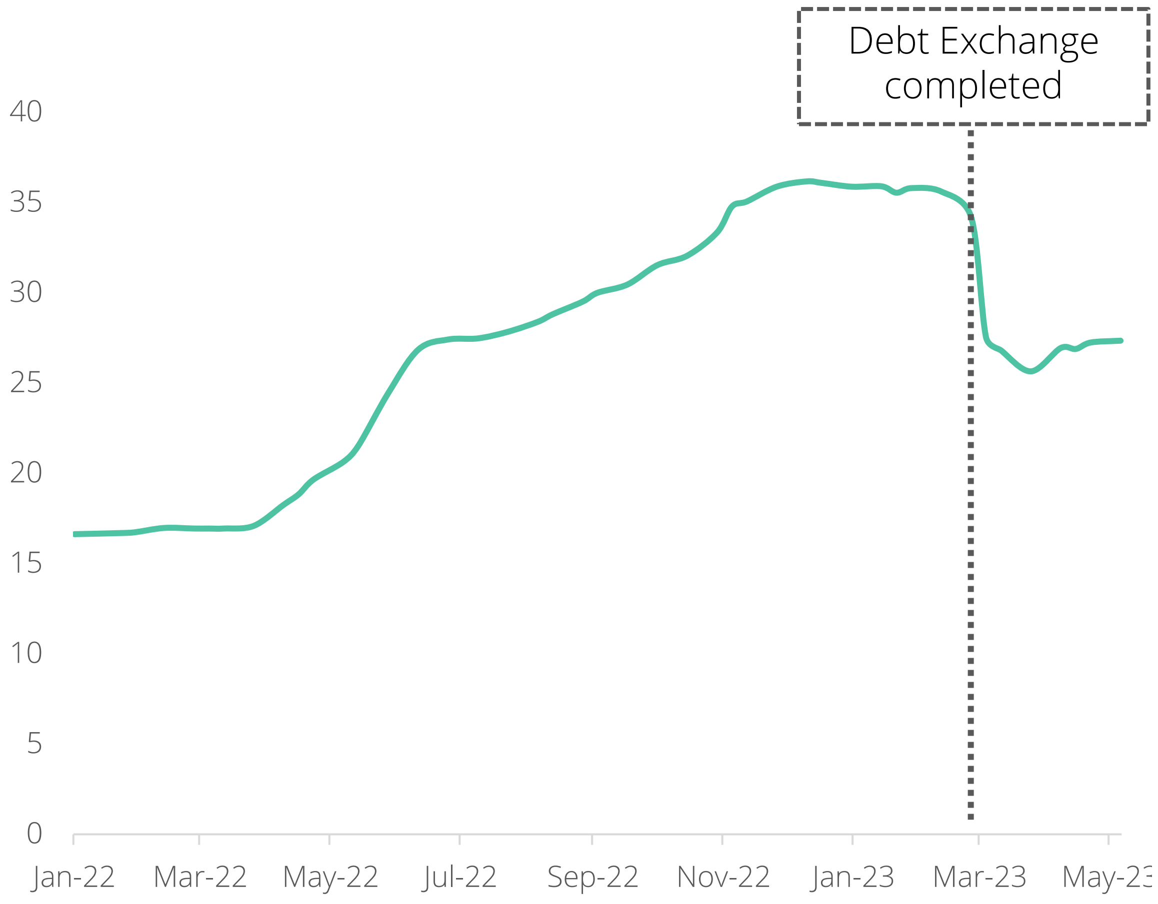
CAL Inflation Forecast



… and 2) market clarity with the **conclusion of the domestic debt restructuring**…

With the clarity being provided to the market along with the approval of the DDO proposal in the parliament, we expect interest rates to decline steeply due to the reduction in risk premia attached to the DDO. This is similar to the interest rate reactions seen in countries which have been through periods of domestic debt restructure.

Ghana T-bill rate (%) (12-month)



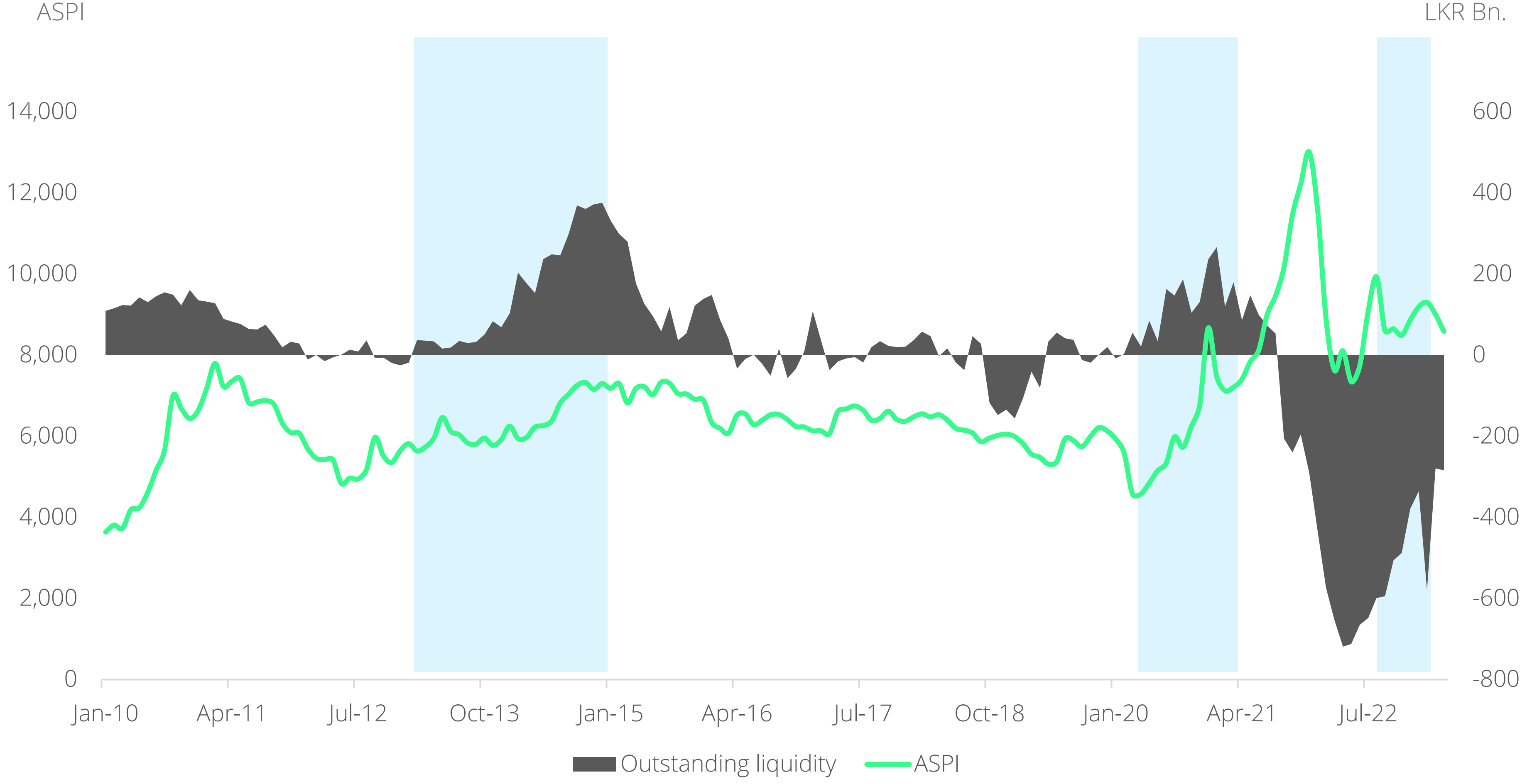
Jamaica T-bill rate

Source: Bloomberg, CAL Research Estimates

… 3) **Improving market liquidity** with increased dollar inflows bodes positively for equity markets

Improvement of dollar inflows from foreign funding sources is expected to increase market liquidity from the steep deficit in 2022. With better liquidity conditions, we believe that the interest rate environment in the economy will be seeing an easing.

Market Liquidity vs. ASPI

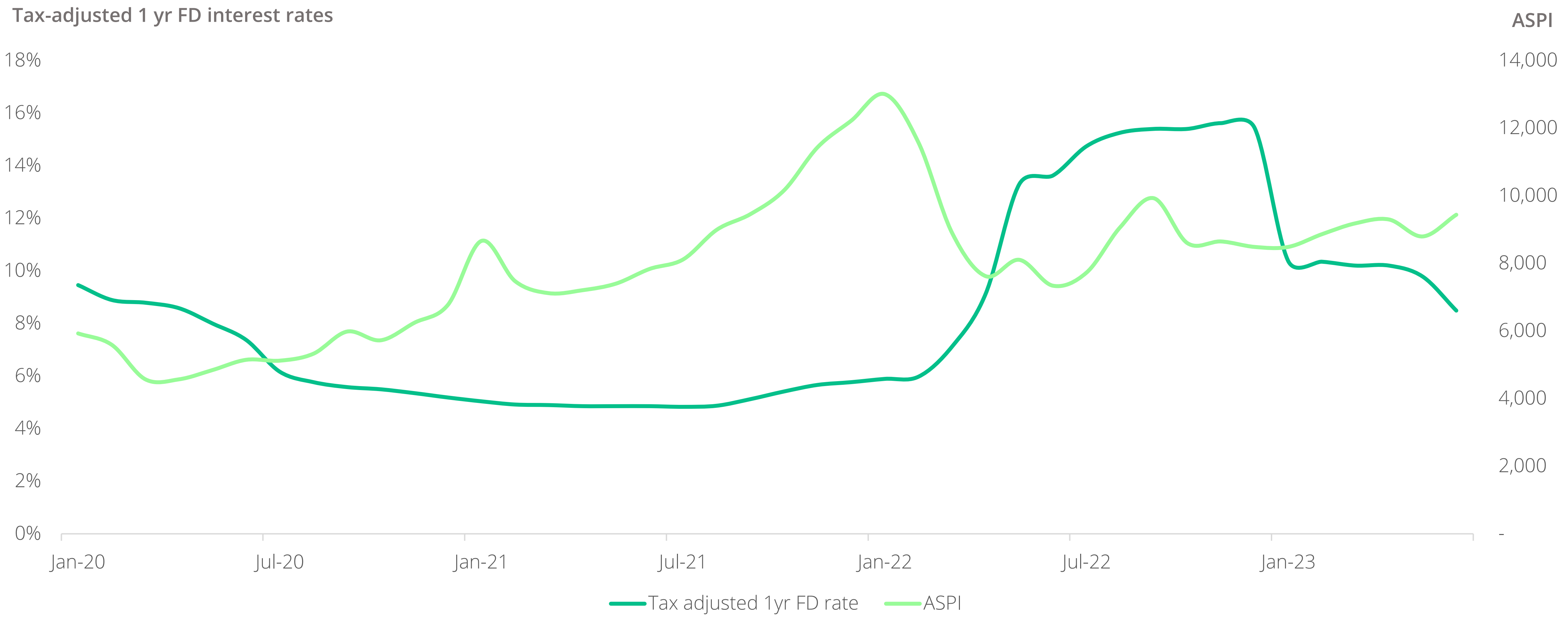


Expected USD inflows

- IMF USD 330Mn
- ADB USD 350Mn
- World bank USD 700Mn
- Portfolio Investments USD 420Mn

Equities are also positioned more attractively for investors amidst high tax rates on fixed income returns

Capital gains on equity investments continue to be tax-free, compared to high taxes imposed on interest rate income and similar alternatives, making it a more attractive asset class for investors.

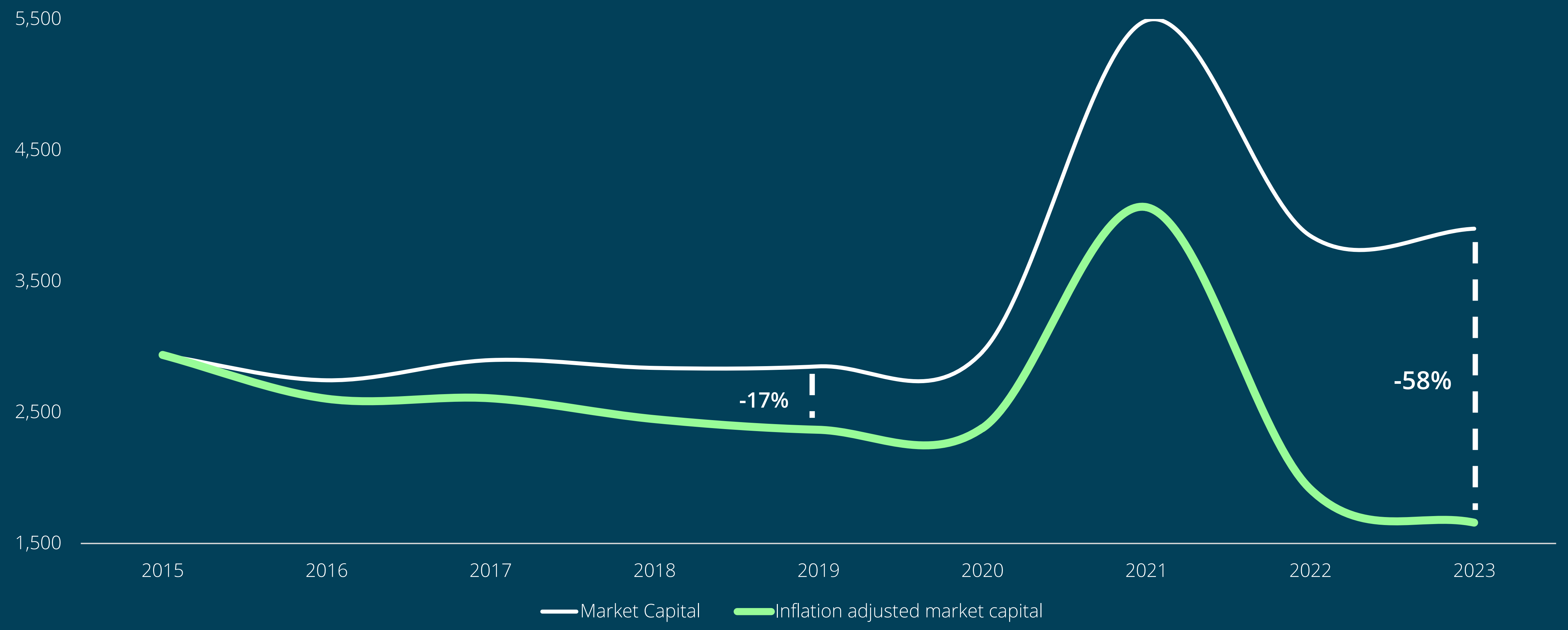


**2023 tax rate considered as 36%*

Rerating warranted: A market rerating is to be expected in order to reach market capitalization levels seen prior to the crisis on an inflation adjusted basis.

Due to the high inflation seen in 2022, in real terms market capitalization has declined to over a decade low. As a result, we believe that a rerating of the market is warranted.

CSE market capital vs. Inflation adjusted market capital (LKR Bn)

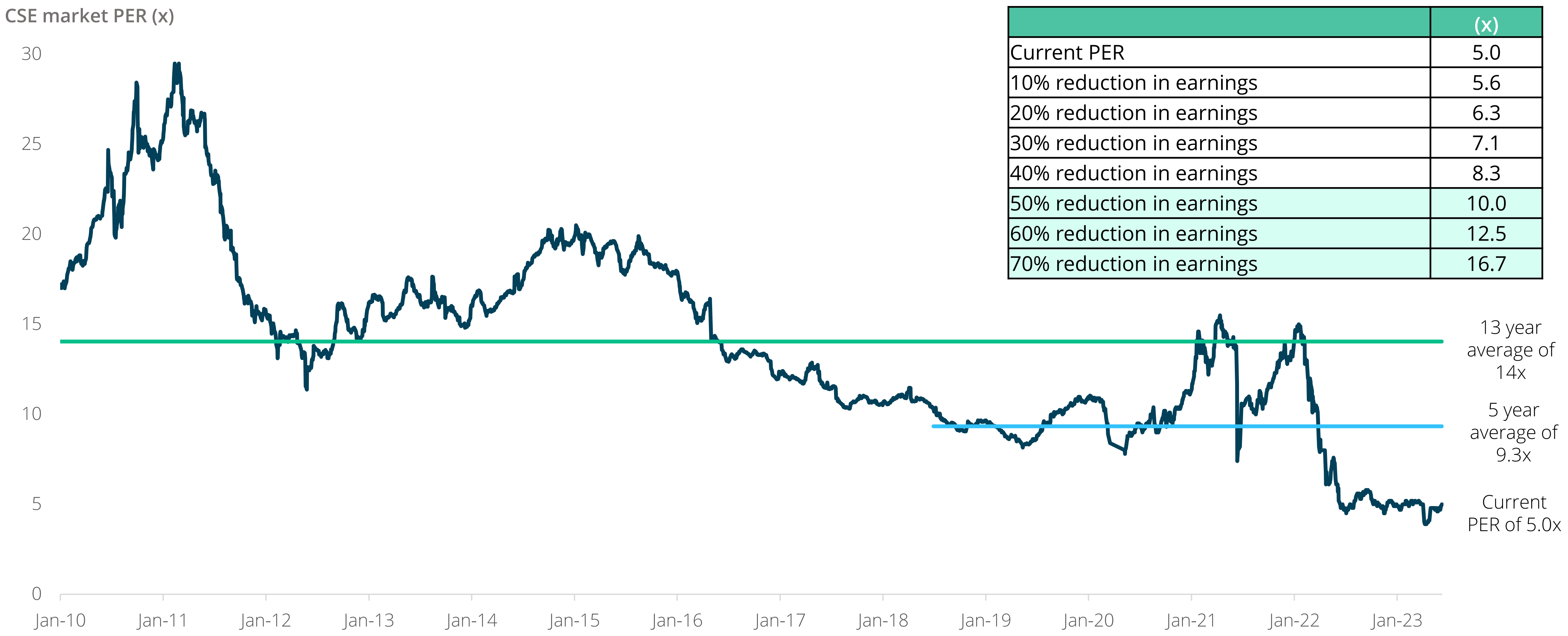


CAL | RESEARCH

Source: CSE, CBSL, CAL Research Estimates

An upward adjustment is impending given that the **market is trading at a steep discount**

The local market currently trades at a PER value of 5.0x (vs. the historic average since 2010 of 14x) and has remained undervalued over the past year, presenting a strong value proposition for investors.



	(x)
Current PER	5.0
10% reduction in earnings	5.6
20% reduction in earnings	6.3
30% reduction in earnings	7.1
40% reduction in earnings	8.3
50% reduction in earnings	10.0
60% reduction in earnings	12.5
70% reduction in earnings	16.7

Source: CSE, CAL Research Estimates

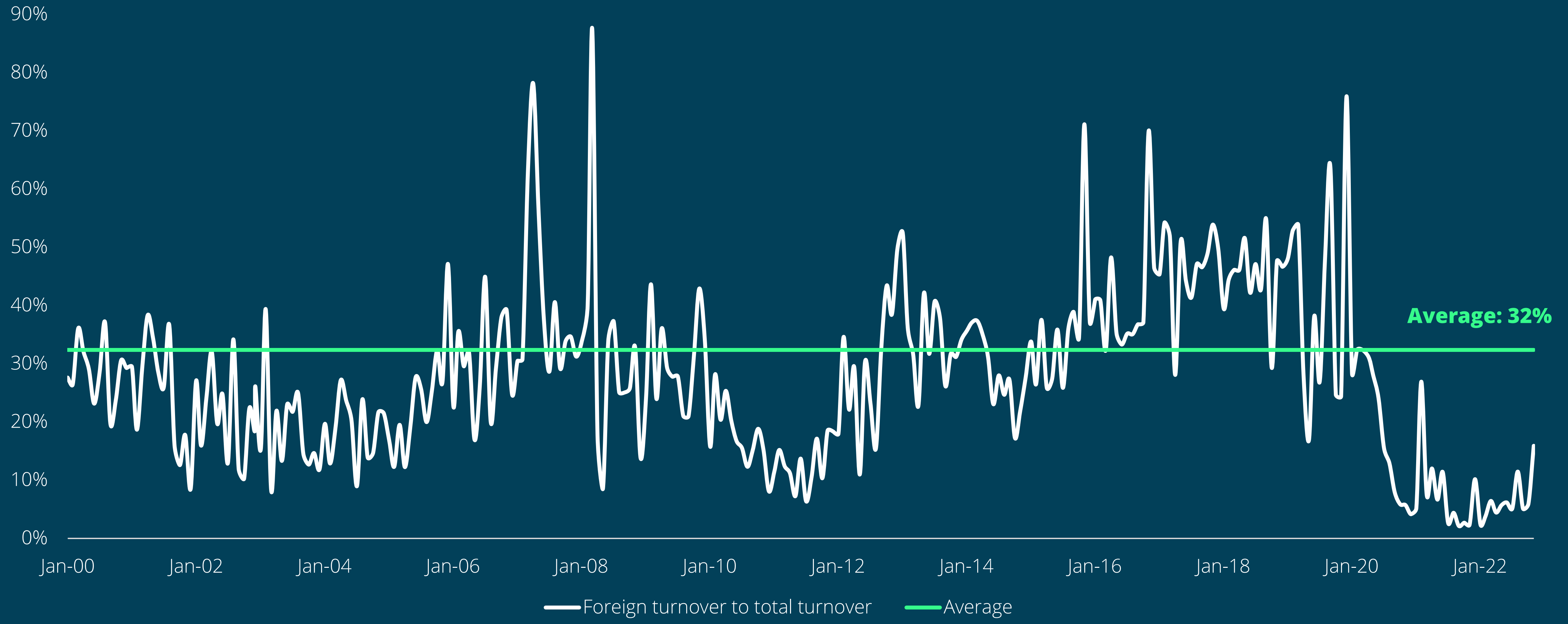
Technical indicators point towards a market poised to move upwards amidst resistance

While the positive sentiment created in the market with clarity is likely to result in the market passing the resistance of 10,131, the next major resistance for the market can be expected at 10,534 however the positive momentum could see the ASPI breaching these levels.

Foreign push: Recovery of foreign participation in the equity market following certainty over debt restructure can provide impetus to the market…

Foreign turnover currently accounts for 16% of the market turnover while this has historically stood at c.32%. With clarity on the debt restructuring and cheaper valuations making the market a lucrative investment, we believe that there will be an increased contribution from foreign participants.

Foreign turnover contribution as % of market turnover

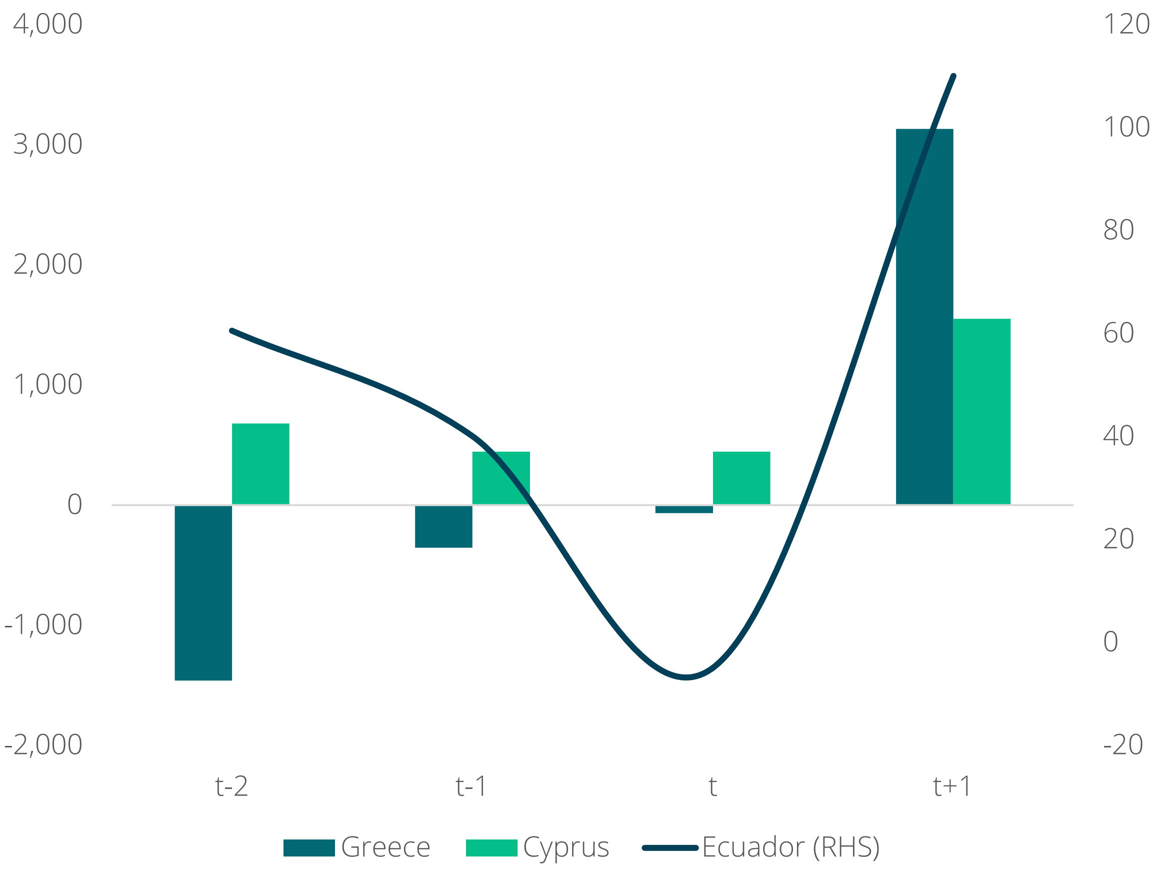


… as seen with foreign inflows into equity investments in other markets

Historically, foreign investor confidence has been renewed after a restructuring as indicated by the positive change in net equity investments the year after a debt restructuring.

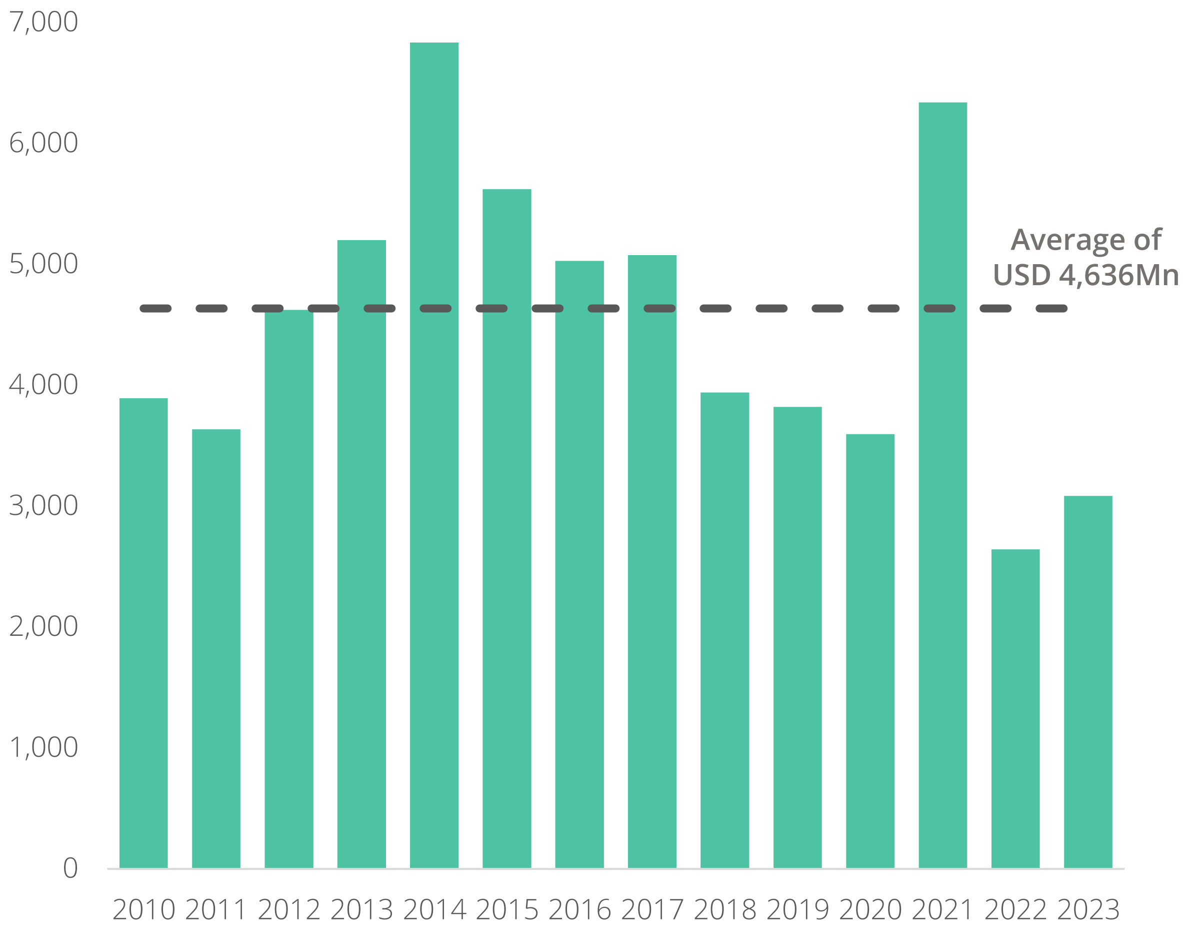
The confidence brought forth by the clarity of the domestic debt restructure would support an increase in foreign participation which stands below c. USD 1.5Bn its 13 year historic average.

Portfolio Investments – Equity (USD Mn)



**T being the year of the restructure*

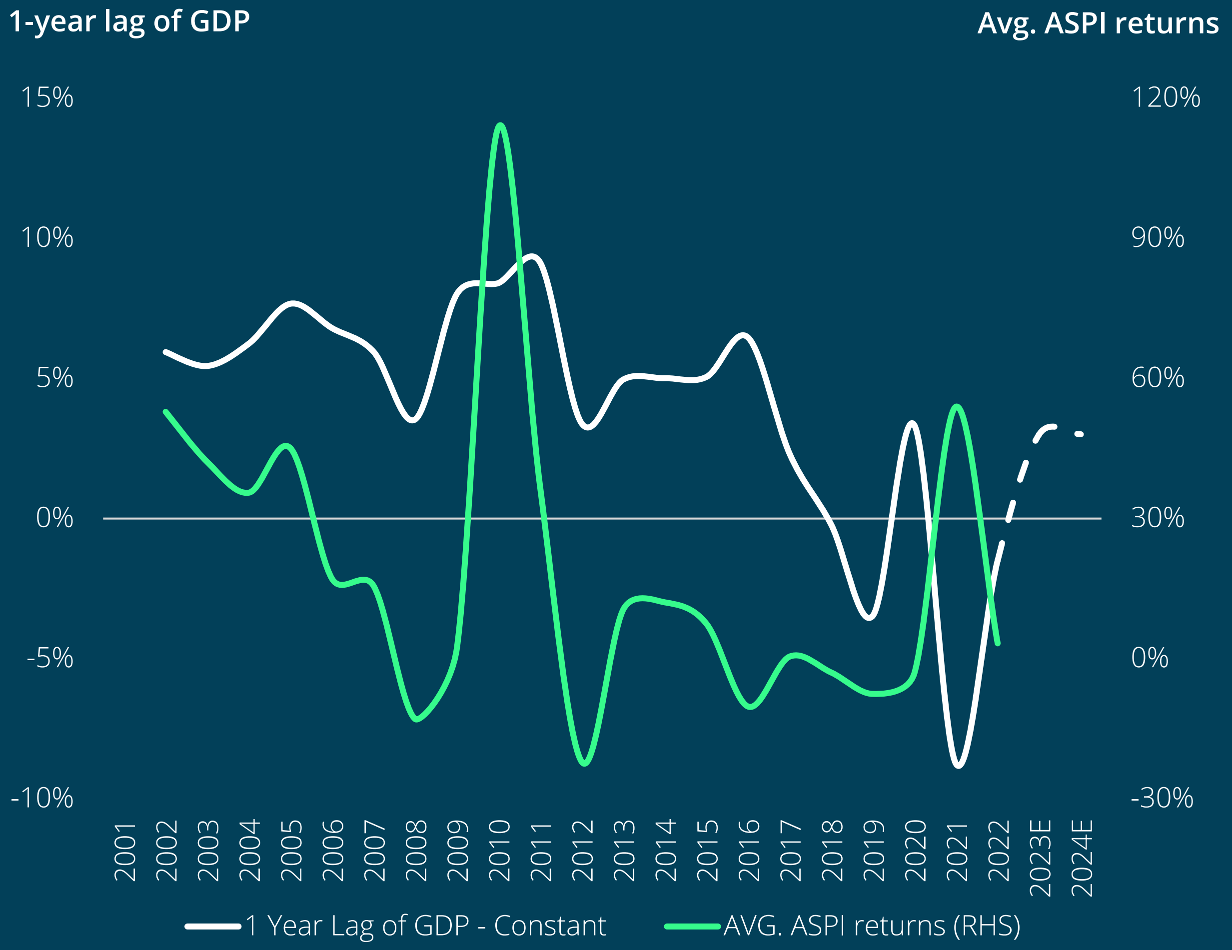
Foreign holdings in CSE (USD Mn)

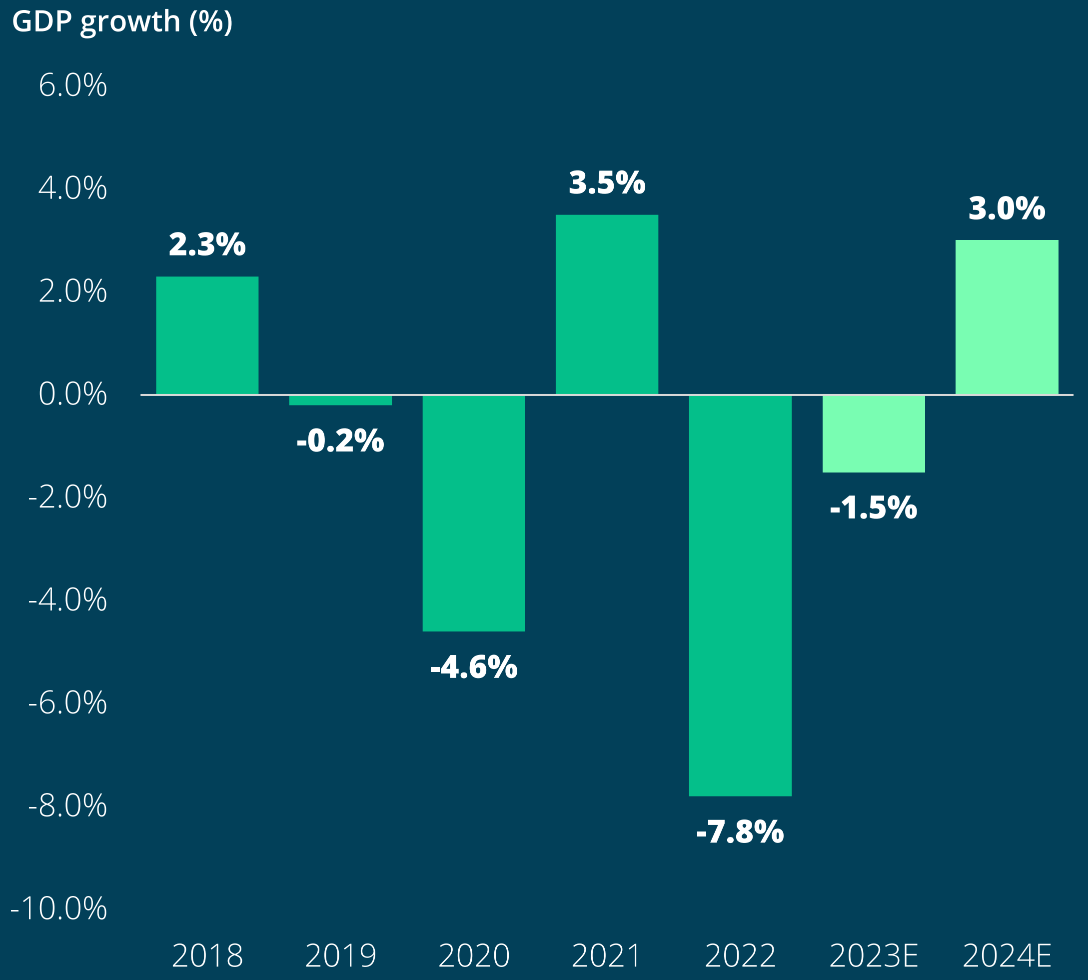


Source: CAL Research Estimates, CSE. Investing.com

Post-Crisis Economic Revival : Equity markets expected to expand in tandem with the recovery of economic activity…

The equity market has been a leading indicator of GDP growth in the past. CAL estimates GDP growth to turn positive from 3Q2023E, reaching 3% growth in 2024E supported by improved economic activity, consumption and investment. As a result, we expect market returns to reflect this recovery.





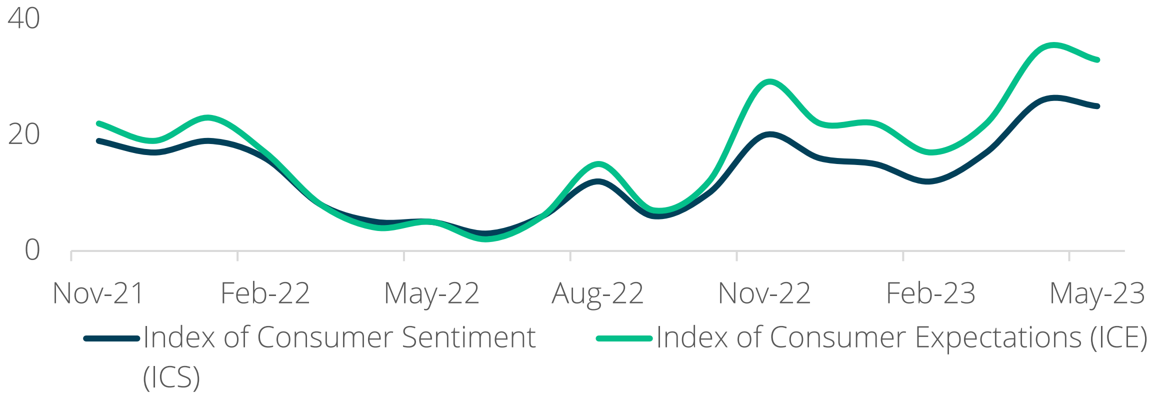
CAL | RESEARCH

Source: CSE, CAL Research Estimates

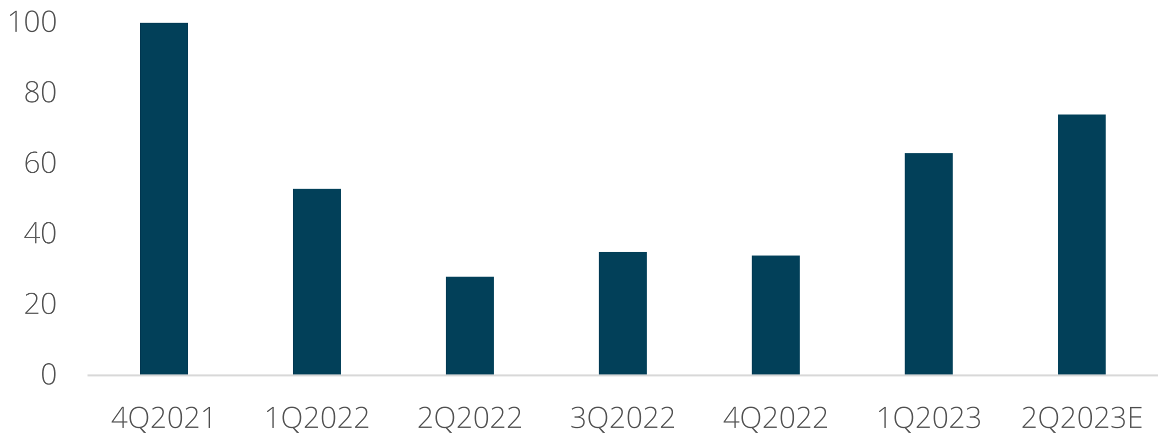
...as indicated by improved consumer and business confidence and normalizing of demand of essential goods and services

Consumer and business confidence have recovered to above pre-crisis levels providing strong forward guidance on future consumption and spending patterns.

Consumer Confidence Index

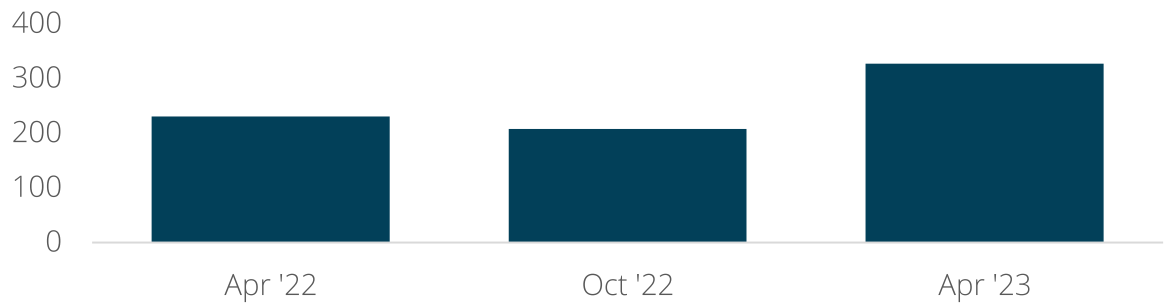


Business Sentiment Index



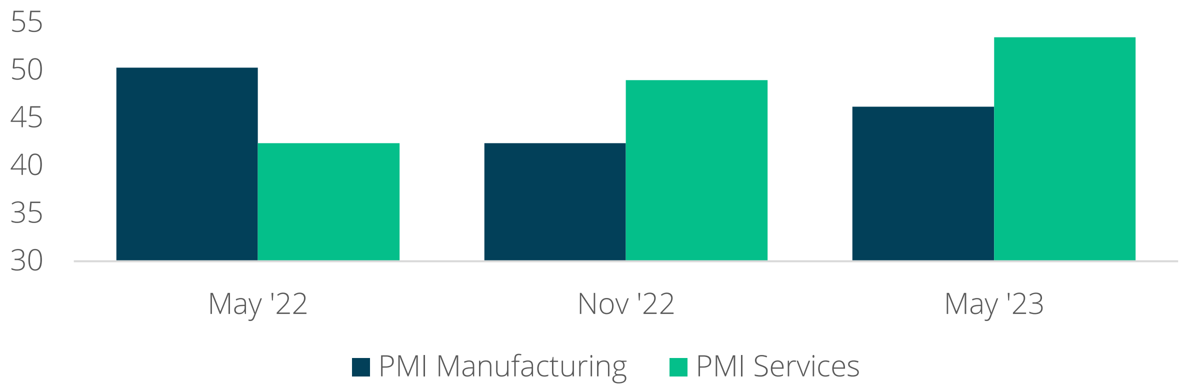
Fuel usage was constrained in 2022 due to the lack of supply, higher pricing and implementation of a stringent quota system. With supply conditions normalizing and lightening of the fuel quotas, consumption has improved, with mobility and travel returning towards normalcy.

Fuel consumption (MT '000)



As an indicator of overall economic activity the increasing PMI is an indicator of revived economic activity.

Purchasing Managers Index

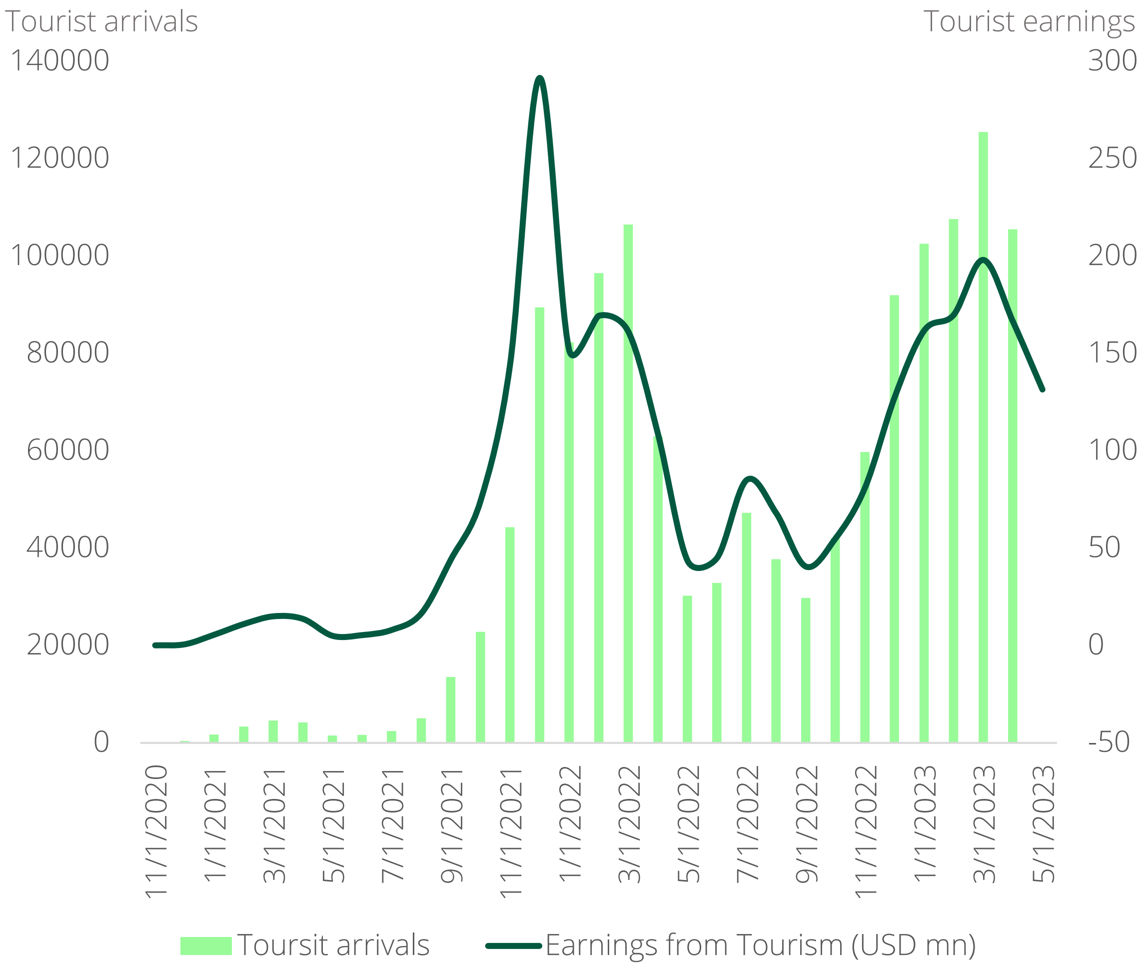


...along with the turn in changes in external sector indicators

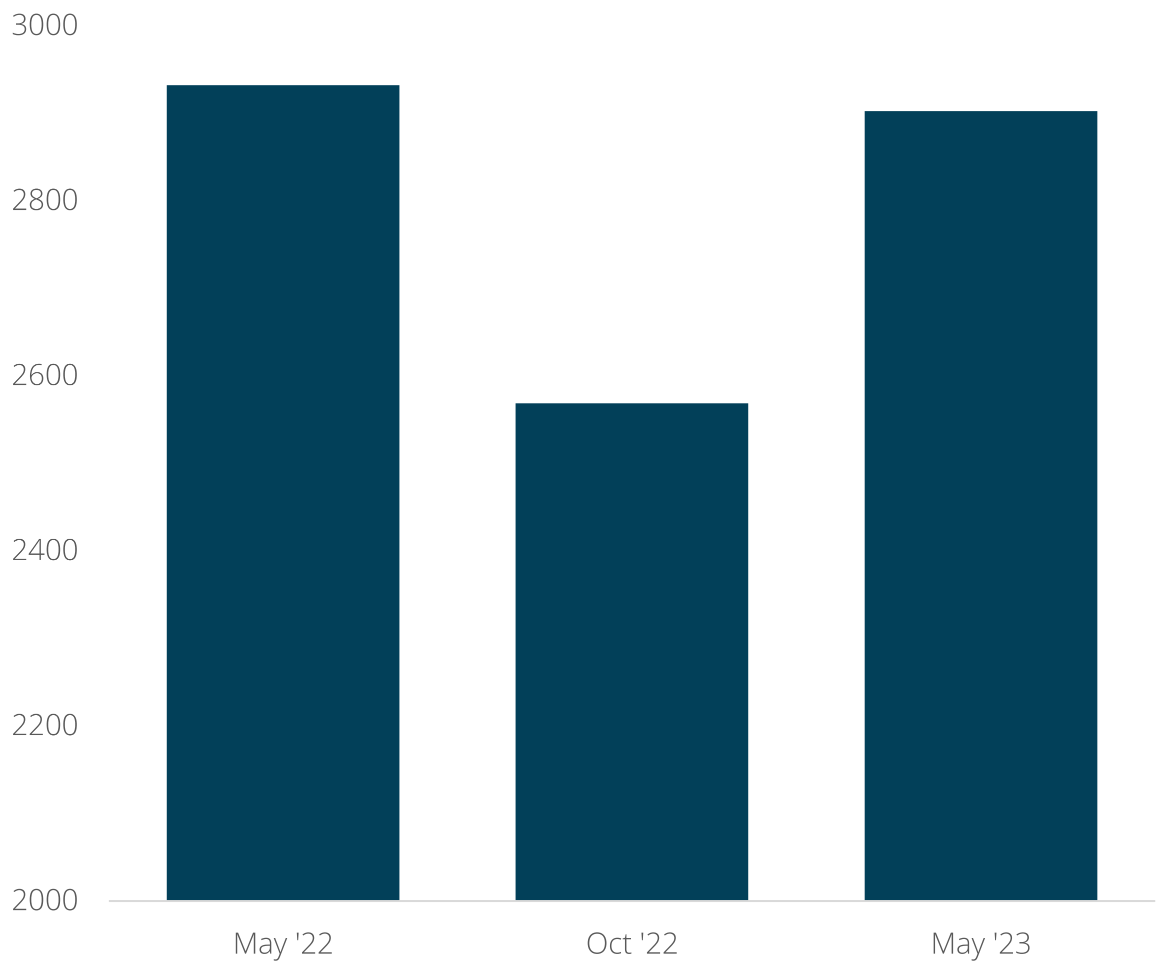
The revival of tourism after the COVID-19 pandemic has led to a resurgence in the economy's tourism sector, with an increase in spending by tourist.

The incremental increase in imports with the steady removal of the import ban on certain items has also shows that the Sri Lankan consumption has seen an uptick signaling much awaited economic revival.

Tourist arrivals vs. Tourist Earnings



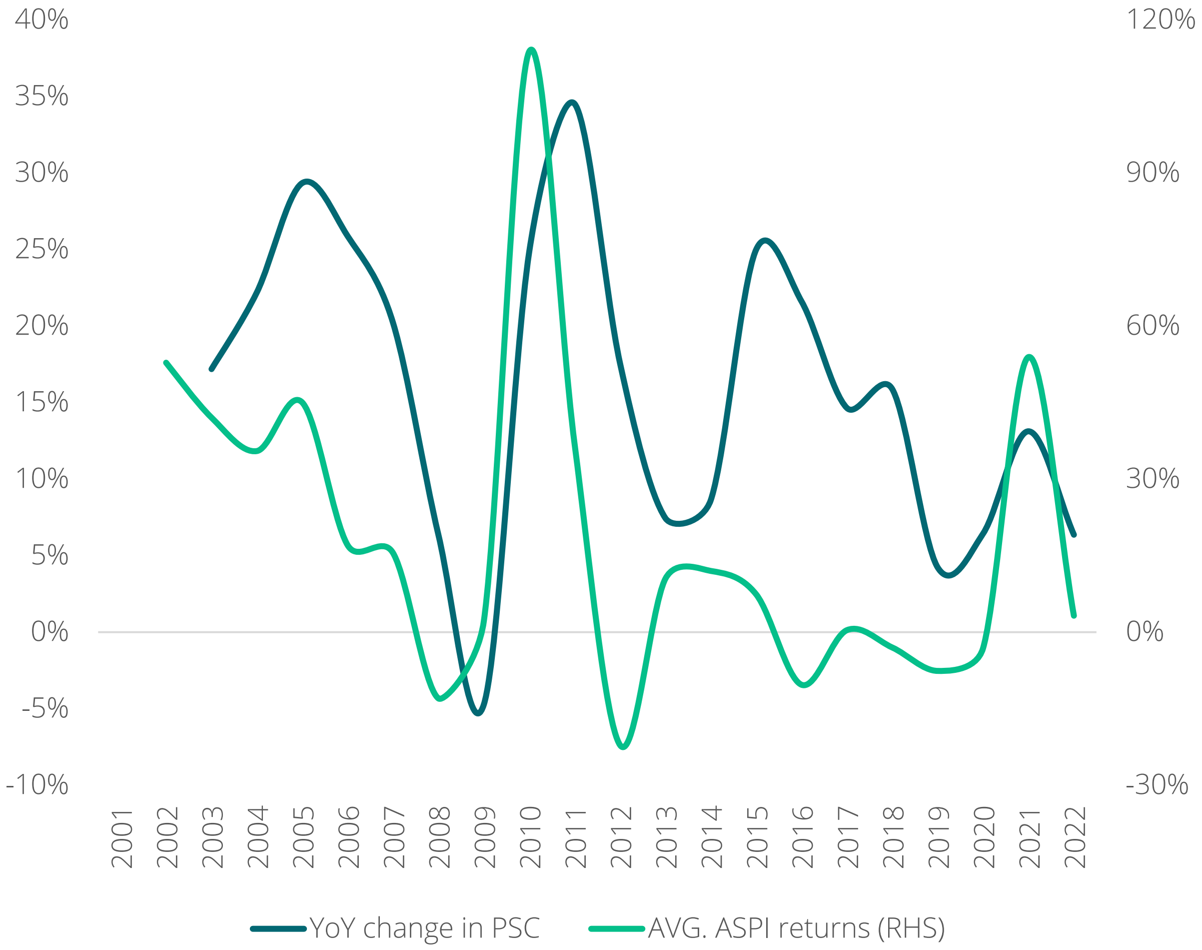
Import (USD Mn)



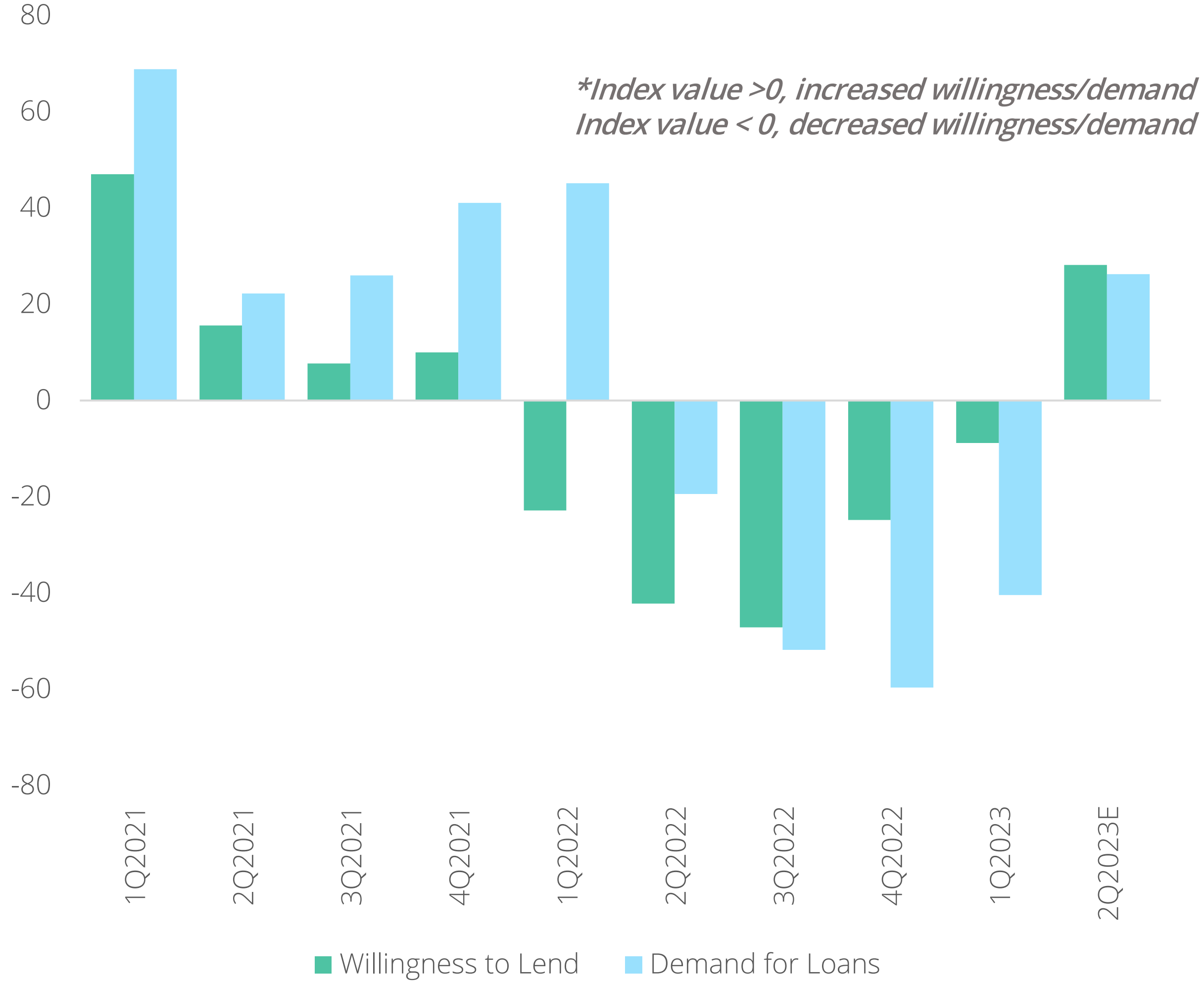
Credit pick-up: Gradual upturn in credit growth creates upside potential for ASPI returns

Historical data indicates a positive correlation between annual returns from the ASPI, private sector credit growth and GDP growth in the country. Given the increase in banks' willingness to lend and demand for loans amidst declining interest rates, improved credit growth and positive GDP growth expected from 2H2023E, CAL foresees higher returns for the ASPI.

ASPI growth vs. YoY change in PSC vs. 1 yr lag GDP



Banks' willingness to lend



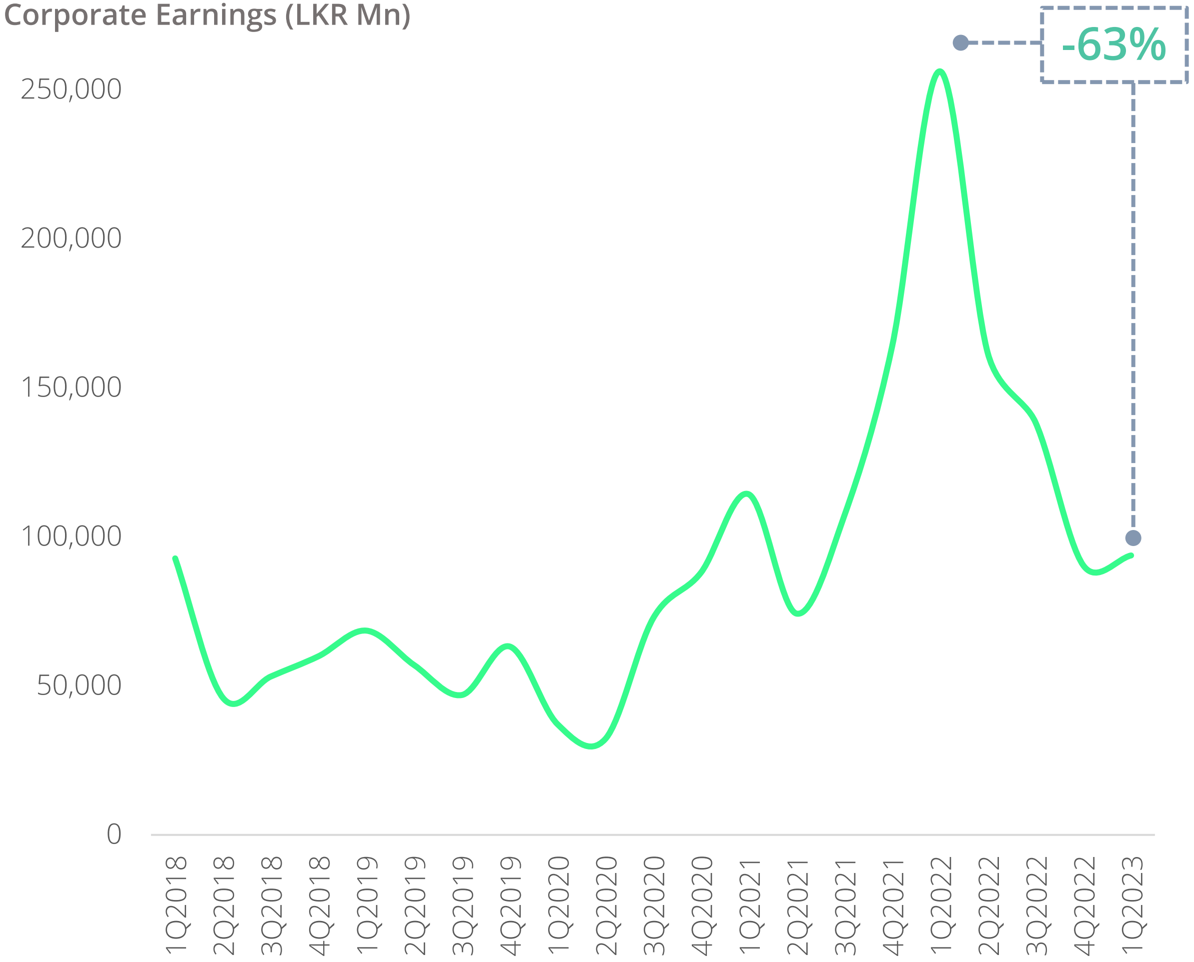
Source: CBSL, CSE, CAL Research Estimates

Anticipated rise in corporate earnings starting from 3Q2023E, amplified by the impact of the base effect and finance cost

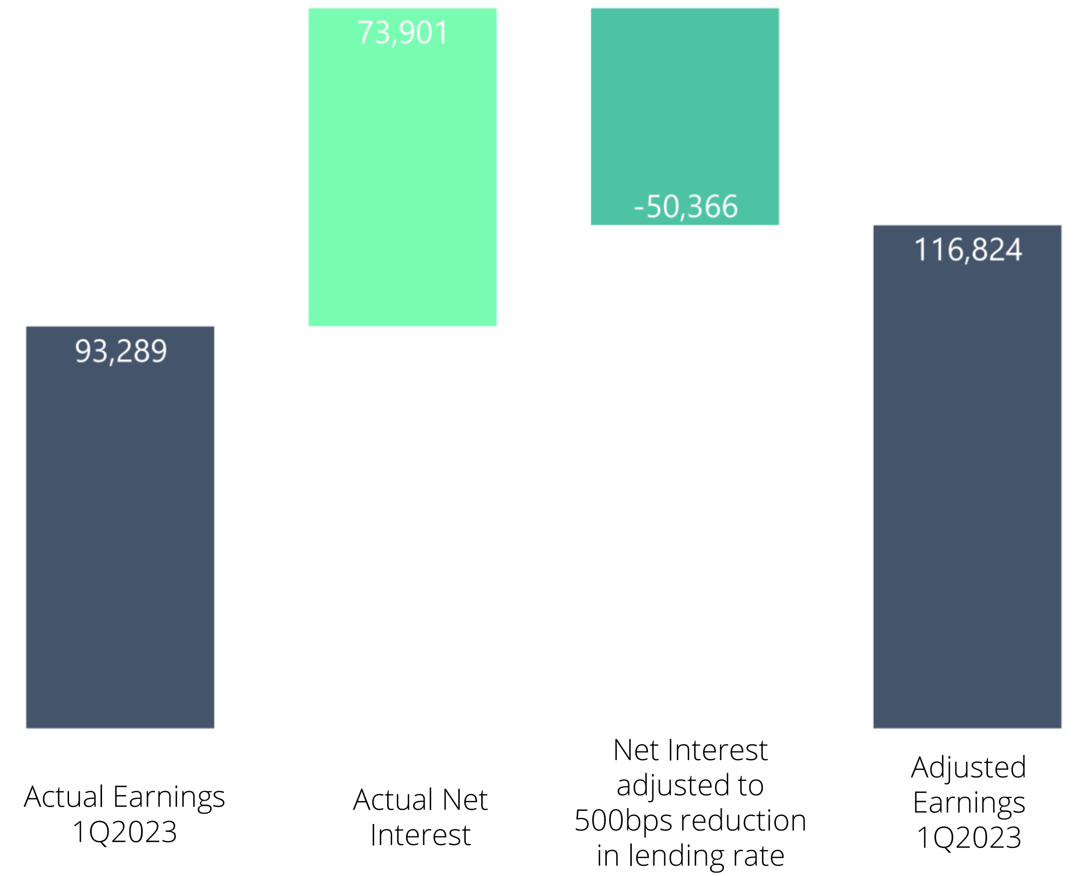
While corporate earnings have seen a 63% YoY decline in 1Q2023, we believe that this would begin to turn in 2H2023E on the back of the declining interest rates and recovery in economic activity.

Net interest accounted for 4.8% of listed company revenue in 1Q2023. Assuming interest rates decline by 200bps with all else equal, implied earnings would be c.25% above 1Q2023 levels.

Corporate Earnings (LKR Mn)



Corporate Earnings adjusted for a decline in interest rates (LKR Mn)



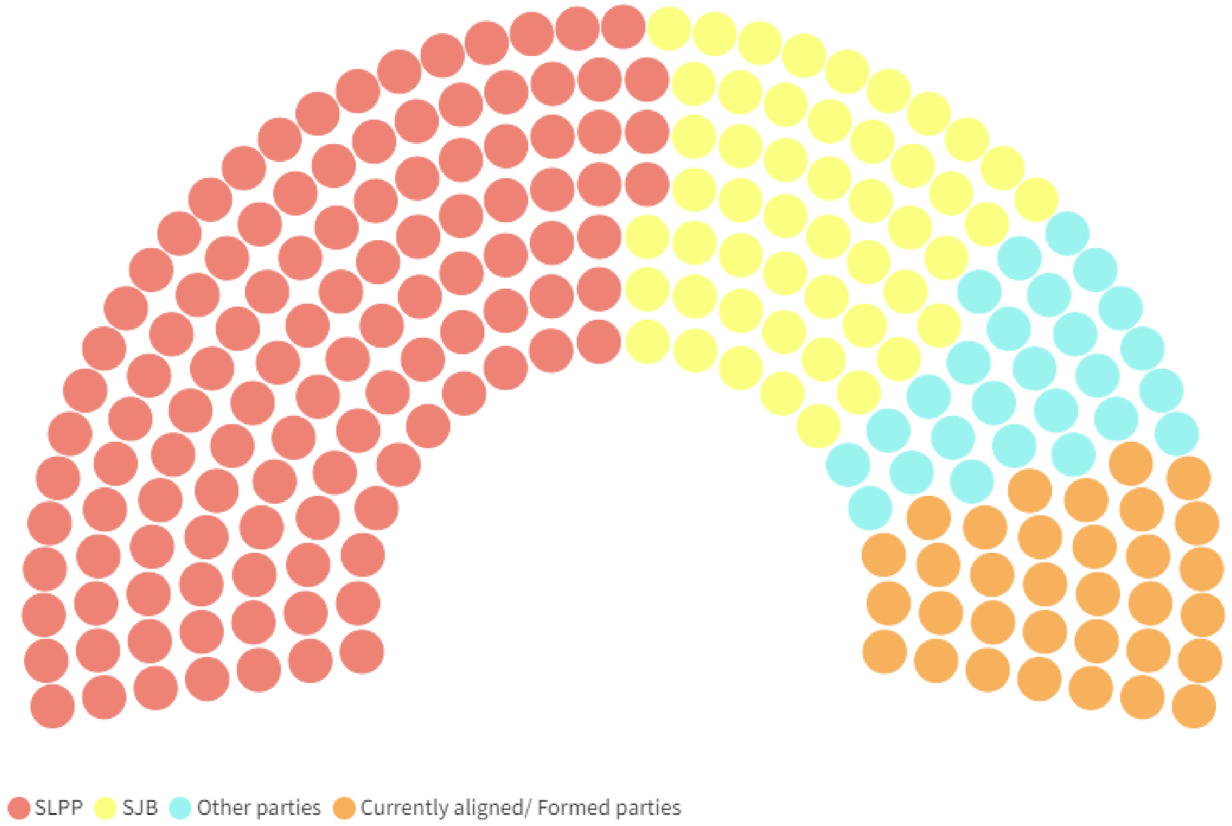
2

EBB AND FLOW

The upturn is not without its risks; as external creditor negotiations progress, tighter fiscal environment, domestic political risks and global risks may keep the upward momentum volatile.

Political risk: With elections on the cards in 2024E, political uncertainty can keep markets volatile

Current Parliament Structure



Timeline of General and Presidential Elections

Nov 2023

Nov 2024

Aug 2025

Tenure of current Presidency ends in Nov 2024, however, **Presidential election can be called after Nov 2023**

Parliamentary election to be held after Aug 2025; President can call an early election after Feb 2023

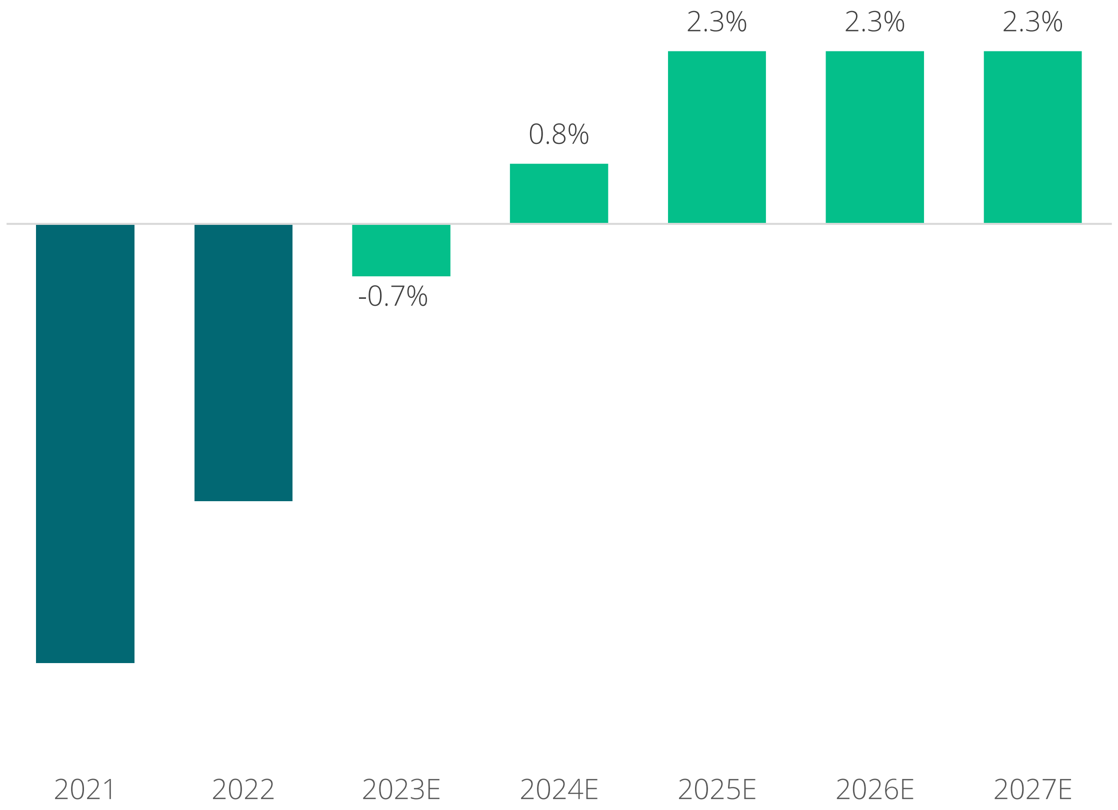
Provincial council elections are expected to be postponed, with the first major election on the cards would be the Presidential election, which can be held after Nov 2023E.

With party lines being crossed close to Parliamentary elections in the past, the probability of a majority is thin. Considering 30 elected officials from the SLFP are currently aligned with other parties/formed new parties, if this changes, SLPP majority would reduce to c.52%.

Tightening the belt: Further fiscal tightening measures are required in order to hit IMF targets

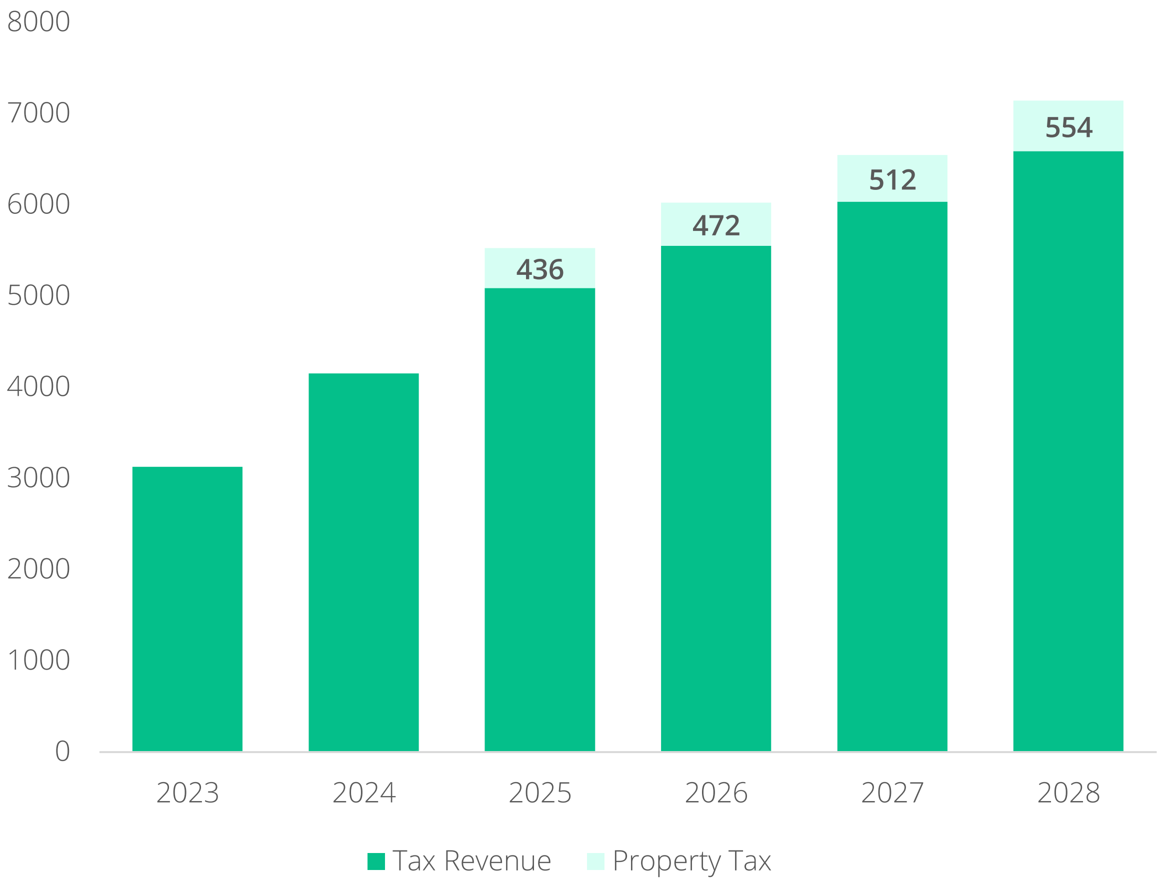
CAL believes that achieving the primary balance target of 2.3% of GDP by 2025E would be a challenge, despite the fiscal consolidation measures already undertaken. As a result, we expect further increases in taxation which may weigh on potential earnings of individuals and corporates.

Primary Balance (% of GDP)



As part of the increased taxation, the IMF has proposed the implementation of a property tax from 2025E onward.

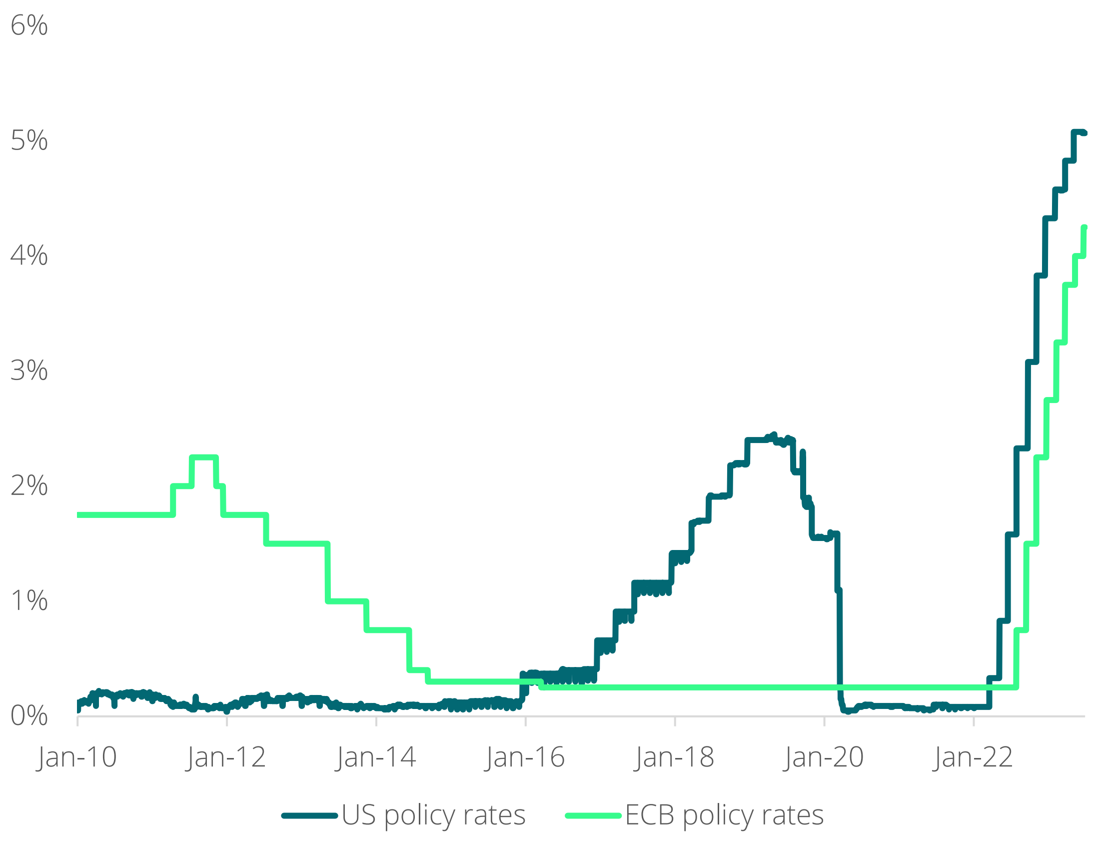
Expected tax revenue increase due to the property tax (LKR bn)



Global risks: Recessional stresses in the global front, higher interest rates and possible geo-political tensions can trickle in to domestic market sentiment

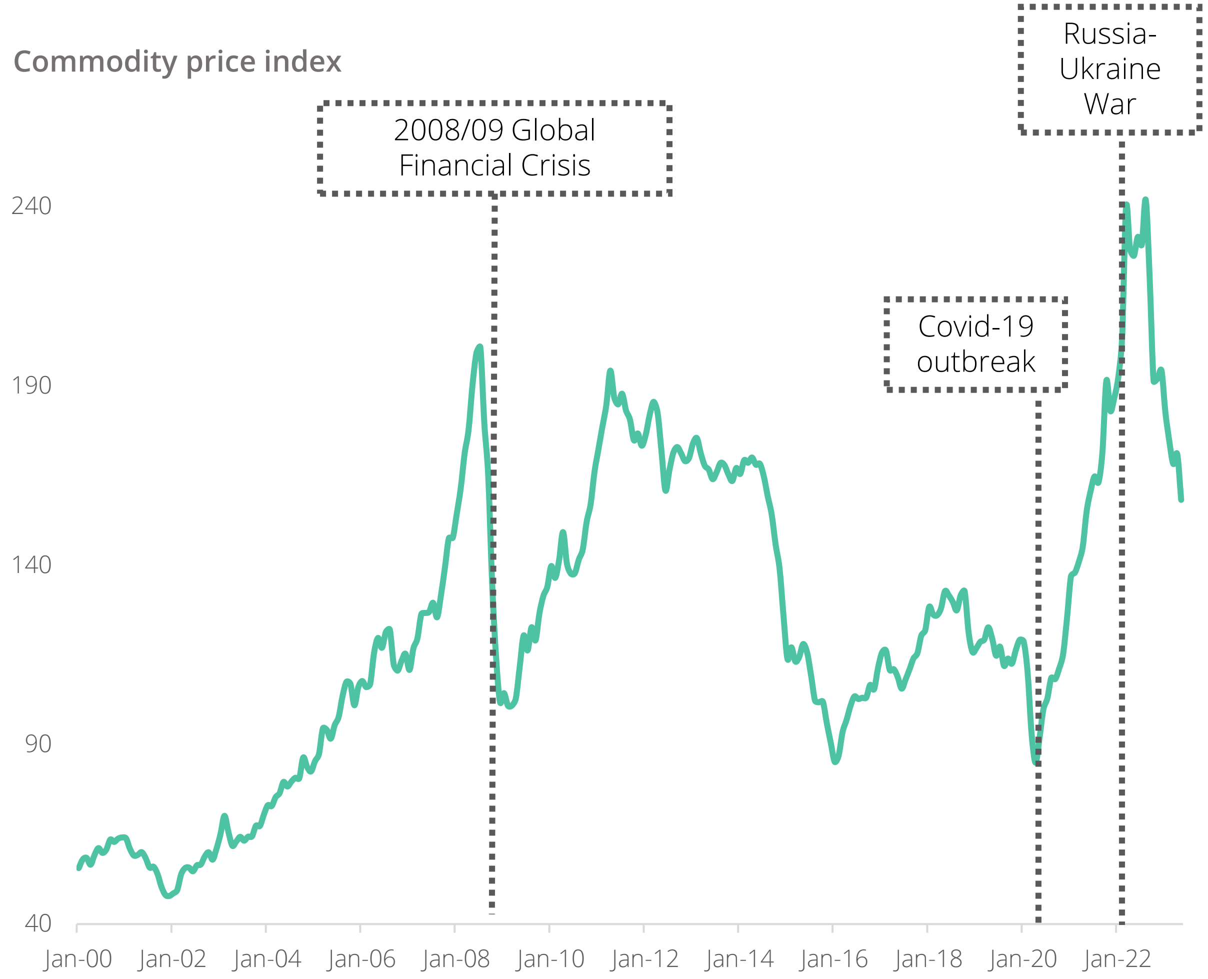
High inflation and recessionary conditions persisting globally can weigh on export company prospects. High interest rates may also dissuade investments into Emerging and Frontier markets

FED and ECB policy interest rates



Volatile commodity markets since Covid-19 have added pressures on local companies and to supply of essential goods in Sri Lanka's import basket.

Commodity price index



3

STOCK PICKS

Our investment themes for the next 12 months focus on companies that will benefit from 1) recovery in economic activity 2) declining interest rates and 3) counters that have been negatively impacted by overweighting of risk factors in the past year

Investment Themes for the next 12 months

Theme	Rationale	Category	Counters
Economic recovery	• As economic activity begins to normalize following the crisis and GDP growth expected to turn positive from 3Q2023E onwards and reach 3-4% levels in 2024E, we expect most consumer and capital good companies to be the first to see the benefit of this trend. • Meanwhile, the tourism sector is also expected to have an uptrend with the revival in tourist arrivals to the country. • Revived foreign interest in the market will enable historically foreign heavy stock to see a price uptick	**Consumer & Capital goods**	CARG, CCS, CTC, DIST, HHL, LLUB, MELS, SUN
		Tourism	AHUN, KHL
		Foreign Heavy counters	CTC, DIAL, DIST MELS, JKH, SUN
Declining interest rates	• With interest rates declining, we expect companies that have been incurring high interest cost over the past few quarters to see easing of finance cost pressure. • In addition to this, Finance companies would see widened NIMs as interest rates reduce (in line with the historic trends) and loan compositions shift, while NBFIs with strong asset-backed lending portfolios would see the largest upside. • Companies that have maintained high dividend yields are positioned more attractively as interest rates reduce.	**Finance companies**	LFIN, VFIN, CFIN
		Companies benefitting from declining interest rates	AHUN, CARG, CCS, MELS, HAYL
		High Dividend Counters	CTC, DIAL, DIST, LFIN, LLUB, MELS
Discounted counters	Over the past 3 years, the banking sector and large-cap counters with heavy foreign ownership saw steep price declines as investors overweighted on risk. With these risks now easing off, we believe these deeply discounted counters would see a correction in the coming period.	**Banking**	COMB, HNB, SAMP, NTB
		Other	DIAL, HHL, JKH, MELS

Disclaimer

Contacts

Trisha Peries
Head of Research
Tel: +94 11 231 7786
Email: trishap@cal.lk

Niroshan de Silva
Email: niroshand@cal.lk

Dilushka de Mel
Email: dilushkad@cal.lk

Pramodya Edirisinghe
Email: pramodyae@cal.lk

Sajani Dewapura
Email: sajanid@cal.lk

Amrith Fernando
Email: amrithf@cal.lk

For general queries please email teamresearch@cal.lk or contact +9411 2317777
Address: Level 5 "Millenium House", No46/58 Nawam Mawatha,Colombo 02, Sri Lanka