BRS STRATEGY REPORT

March 2023

BARTLEET Strength of a Century | RELIGARE Values that bind

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Content

MACRO ECONOMY

BARTLEET Strength of a Century RELIGARE Values that bind

KEY ECONOMIC INDICATORS

	2019	2020	2021	2022E	2023E
OUTPUT					
GDP at nominal price (LKR Bn)	15,911.0	15,840.2	17,685.9	22,981.7	24,885.9
GDP at nominal price(USD Bn)	86.8	83.7	87.1	61.8	67.0
GDP at constant price (LKR Bn)	13,206.3	12,747.7	13,171.8	12,016.6	11,777.9
GDP at constant price (USD Bn)	72.0	67.4	64.9	32.3	31.7
REAL OUTPUT (percentage change)					
GDP growth rate	-0.2%	-3.5%	3.3%	-8.8%	-2.0%
Agriculture	0.5%	-1.4%	2.5%	-9.2%	3.5%
Industry	-4.1%	-5.3%	5.6%	-16.6%	-11.4%
Service	2.9%	-1.9%	3.3%	-2.0%	0.6%
EXTERNAL TRADE					
Exports (USD Bn)	11.9	10.0	12.5	13.1	13.7
Imports (USD Bn)	19.9	16.1	20.6	18.3	18.8
Balance of Trade (USD Bn)	-8.0	-6.0	-8.1	-5.2	-5.1
Import/ Export ratio	0.6	0.6	0.6	0.7	0.7
Trade Balance as a percentage of GDP	-9.2%	-7.2%	-9.3%	-8.4%	-7.7%
OTHER FOREIGN INFLOWS					
Tourist Arrivals	1,912,900	507,311	194,495	719,978	1,211,976
Toursit Earnings (USD Bn)	3.6	0.7	0.5	1.3	2.0
Workers' Remittance (USD Bn)	6.7	7.1	5.5	3.8	5.3

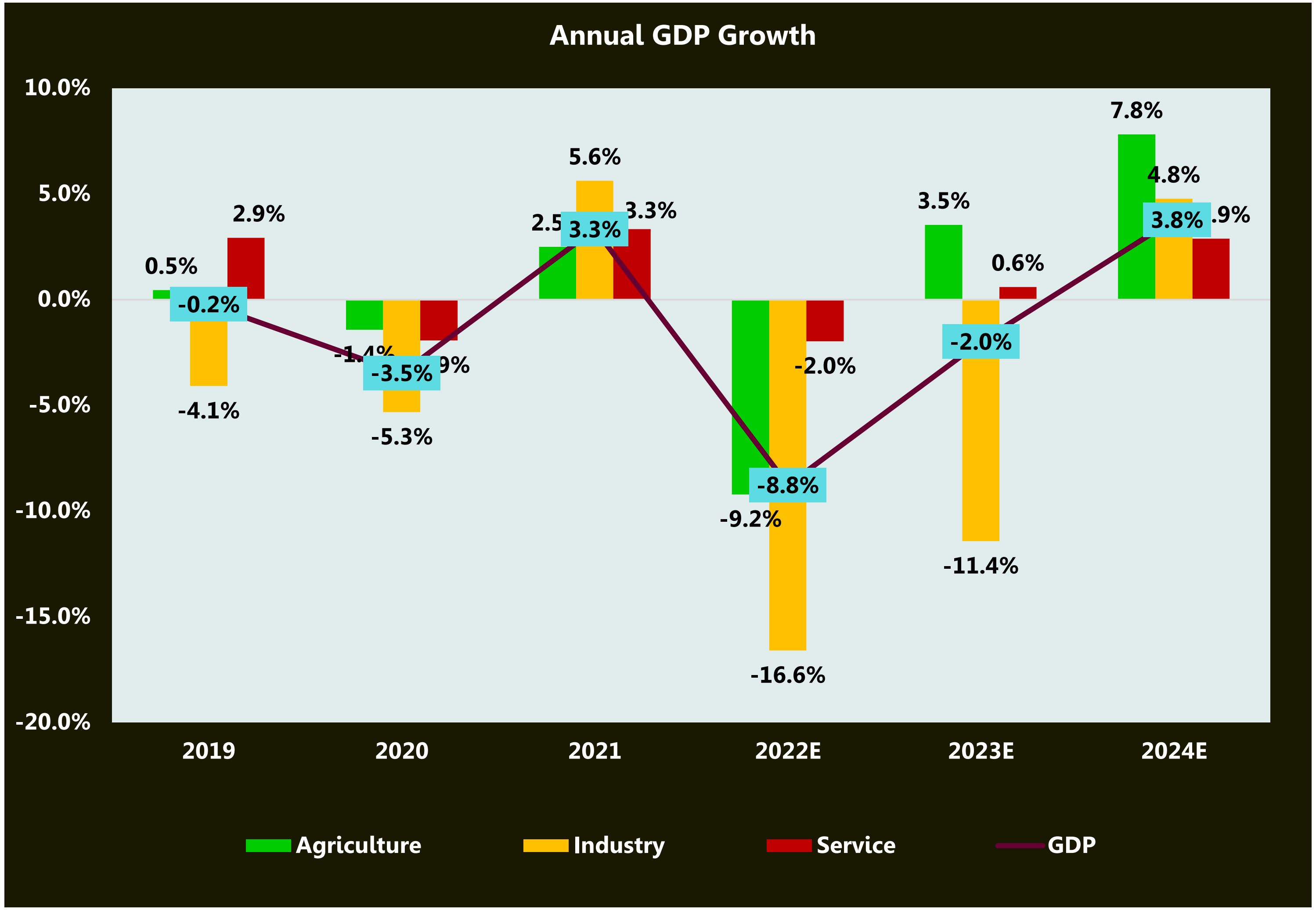
Source: Central Bank of Sri Lanka & BRS Equity Research

KEY ECONOMIC INDICATORS

	2019	2020	2021	2022E	2023E
GOVERNMENT FINANCE					
Total Revenue and Grants (LKR Bn)	1,898.8	1,373.3	1,463.8	1,960.9	2,255.0
Total Revenue (LKR Bn)	1,890.9	1,368.0	1,457.1	1,951.1	2,243.8
Tax Revenue (LKR Bn)	1,734.9	1,216.5	1,298.0	1,752.3	2,015.2
Non Tax Revenue (LKR Bn)	156.0	151.4	159.1	198.8	228.6
Expenditure and Net Lending (LKR Bn)	3,337.9	3,041.0	3,521.7	4,247.8	4,561.4
Recurrent (LKR Bn)	2,424.6	2,548.4	2,747.5	3,853.4	4,127.2
Capital and Net Lending (LKR Bn)	385.4	483.5	438.8	394.9	434.4
Current Account Balance (LKR Bn)	(533.7)	(1,180.4)	(1,290.4)	(1,902.2)	(1,883.4)
Primary Balance (LKR Bn)	(537.7)	(687.4)	(1,009.5)	(1,112.8)	(1,073.4)
Overall Fiscal Balance (LKR Bn)	(1,439.1)	(1,667.7)	(2,057.9)	(2,286.9)	(2,306.3)
As a percentage of GDP					
Current Account Balance	-3.4%	-7.9%	-7.7%	-8.3%	-7.6%
Primary Balance	-3.4%	-4.6%	-6.0%	-4.8%	-4.3%
Overall Fiscal Balance	-9.0%	-11.1%	-12.2%	-10.0%	-9.3%
PRICES (percentage change)					
Colombo Consumer Price Index (2021 = 100) YoY (end of period)					13.2%

Source: Central Bank of Sri Lanka & BRS Equity Research

Production to see a gradual improvement; albeit a challenging task

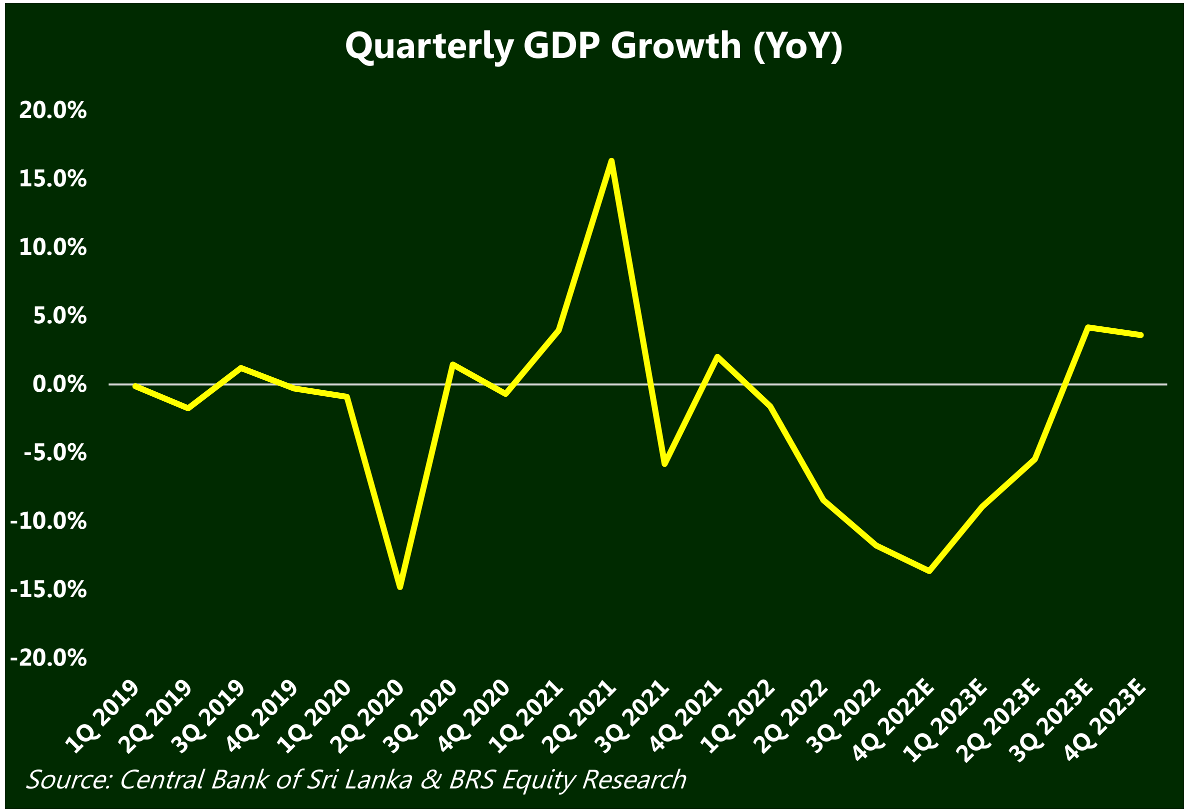


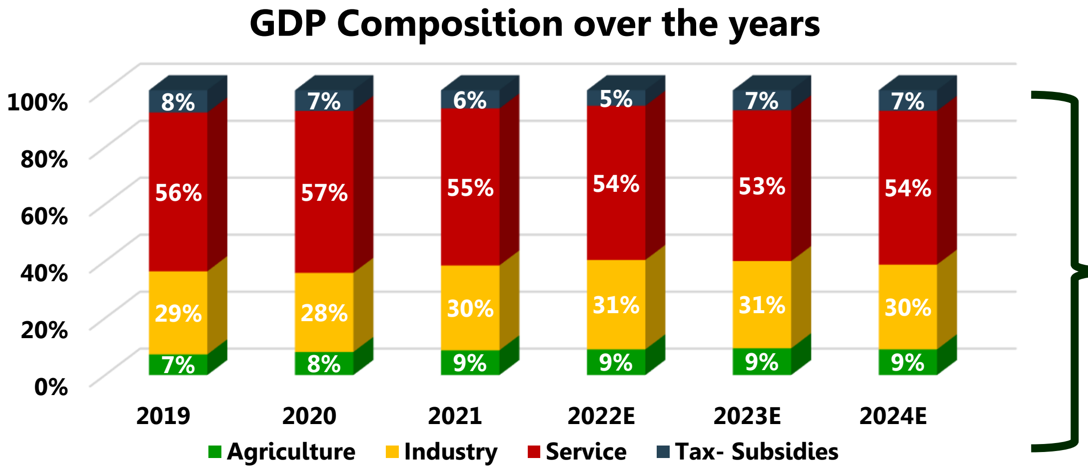
Source: Central Bank of Sri Lanka & BRS Equity Research

Due to the ongoing economic crisis, we forecast Sri Lanka's economy to contract by 8.8% in 2022E and 2.0% in 2023E. The twin deficit crunch (fiscal deficit and current account deficit) and steep depreciation of LKR triggered tightened fiscal and monetary policies, which invariably curtailed the economic activity across many sectors. Despite foreign inflows gradually increasing, we believe restoring global confidence and opening external funding channels will be critical for economic growth in an import dependent nation, such as ours. Domestic production is still lagging (production at full capacity) due to reliance on imported raw materials. Therefore, we believe, IMF intervention in Sri Lanka's economy plays a significant role in boosting investor confidence

Is the worst over?

The Central Bank and government took unpopular monetary and fiscal tightening measures since mid 2022, to control inflation, exchange rates, and the fiscal deficit. Although, the above policy decisions have yielded positive results, domestic producers have suffered the consequences due to high interest rates, tax reforms, electricity hikes, and continued import restrictions. We believe, the lag effects of the above measures will persist during 1H2023E adding further pressure on economic activity. However, given the improvements in the external sector and the expected IMF bailout, we anticipate the CBSL to gradually ease policy measures during 2H2023E to aid economic activity.



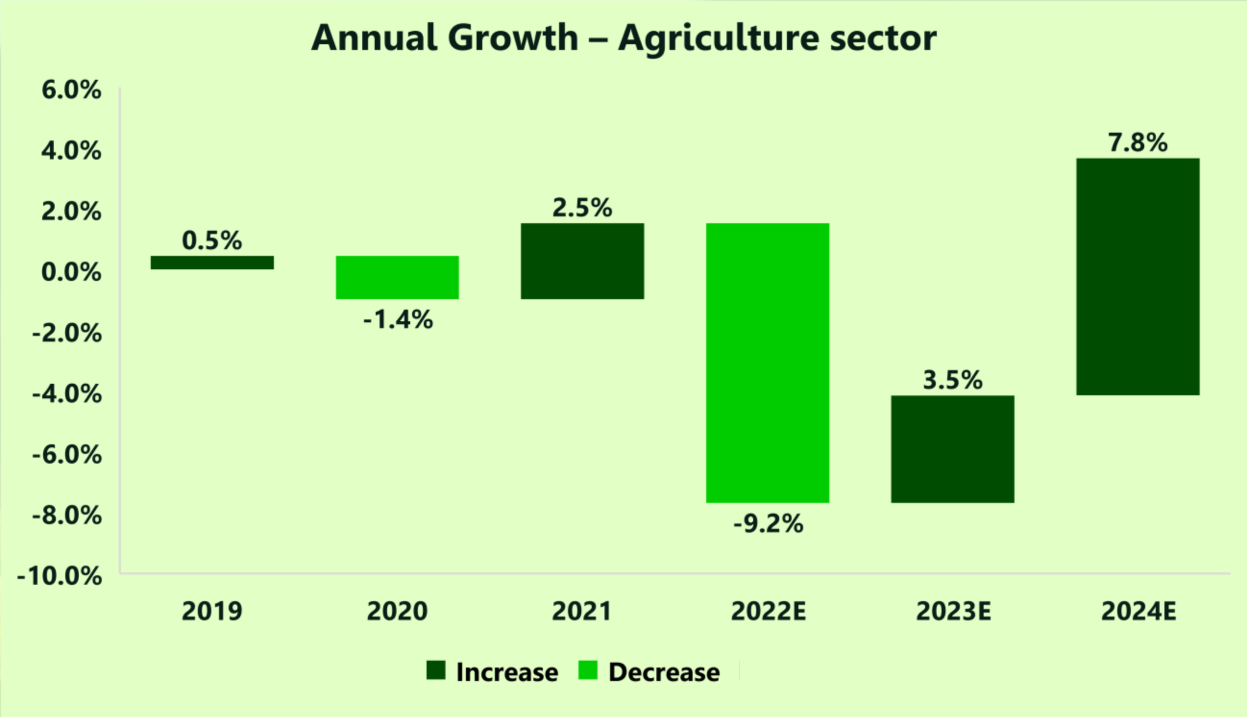


Taking into account the expected increase in producer price index, we forecast the growth of nominal GDP, based on the above we have arrived at the composition of GDP for 2023E and 2024E.

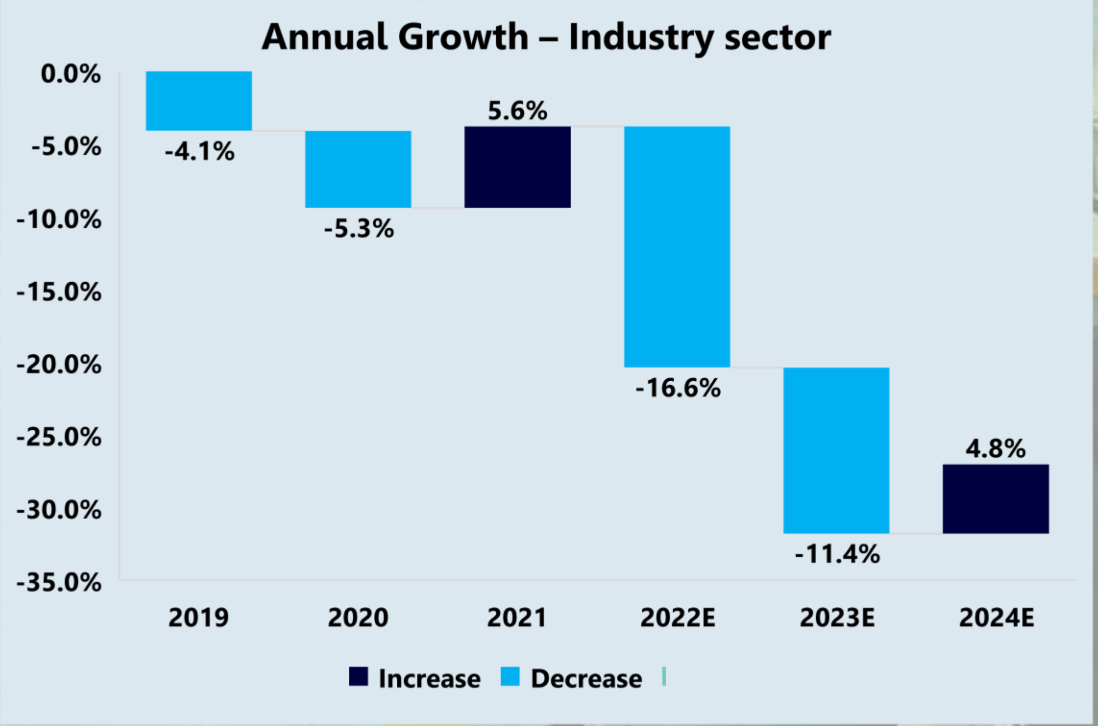
Availability of fertilizer provides relief to the agricultural sector

Bouncing back from a challenging 2022 (BRS forecast 9.2% contraction), the Agri sector is expected to yield positive results from removal of the ban on chemical fertilizer and the funding lines extended on fertilizer imports. The availability of fertilizer coupled with appreciation of LKR would encourage domestic production in the years ahead. Animal production is expected to see an initial contraction of 14.6% in 2022 due to lower consumer spending, albeit is expected to improve in line with economic developments. We anticipate the agriculture sector to turn positive in 2023E with a projected growth of 3.5%.

Source: Central Bank of Sri Lanka & BRS Equity Research



Industry recovery to stay muted



Source: Central Bank of Sri Lanka & BRS Equity Research

The industry sector has been severely impacted by recent economic conditions. The recent Manufacturing PMI depicts a continuous slowdown in manufacturing activities, particularly in the food and beverage and textiles and clothing sectors, which collectively contribute to ~14% in the industry sector (2022E). We expect the challenging conditions to continue due to material supply shortages, high electricity tariffs, transportation costs, and material prices. Demand for apparel manufacturing, is expected to be hampered by the global economic downturn. The material and labor shortages coupled with high interest rates has impacted the construction sector, However, we anticipate steady economic recovery to be linked to construction activity in 2024E.

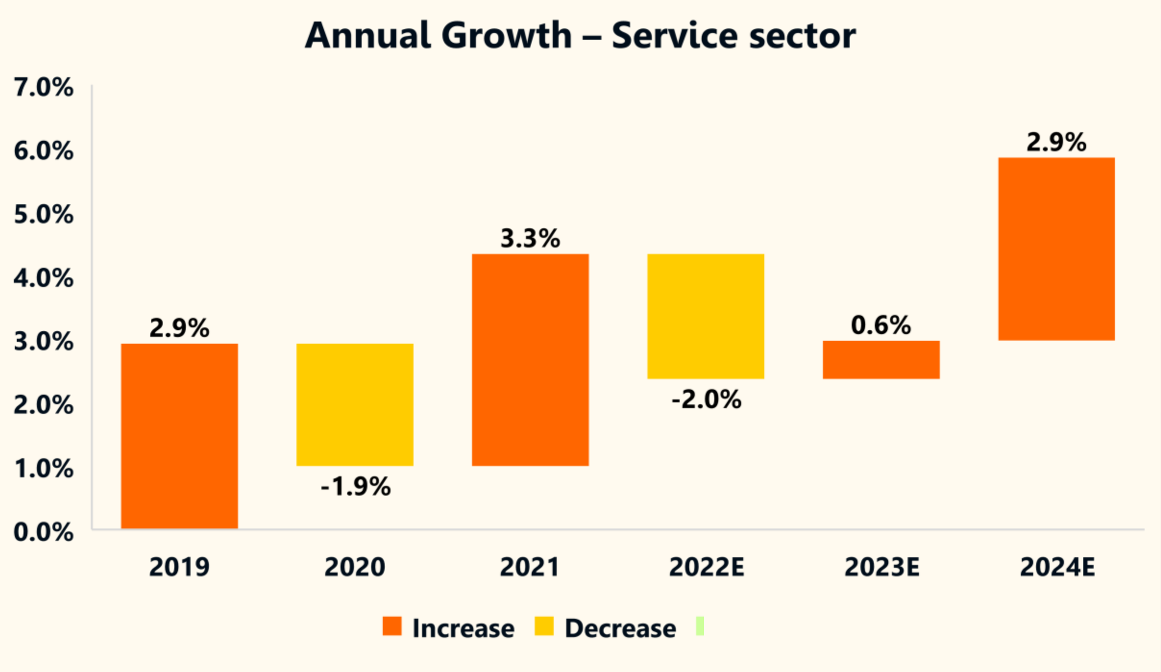
Considering the -15.5% (2022E) decline of the top three contributors (construction, Manufacture of food, beverages & Tobacco products and Manufacture of textiles, wearing apparel, leather and other related products) and the strong correlation to industrial activities, we project a further contraction of 11.4% in 2023E due to above reasons whilst expecting a growth of 4.8% in 2024E.

Service sector to gradually resume growth

The service sector is expected to grow by 0.6% in 2023E due to the lower base in 2022 (statistical impact). The real impact, however, is expected to be subdued due to lower aggregate demand hampered by consumer purchasing power.

Top contributors such as wholesale & retail trade and transportation sector, are expected to be challenged by demand contraction, higher taxes, and fuel prices. We believe, the recent exorbitant electricity tariff hikes will have a significant impact on the service sector. The government's expenditure rationalization measures will result in a probable contraction in the public administration and defense subsectors.

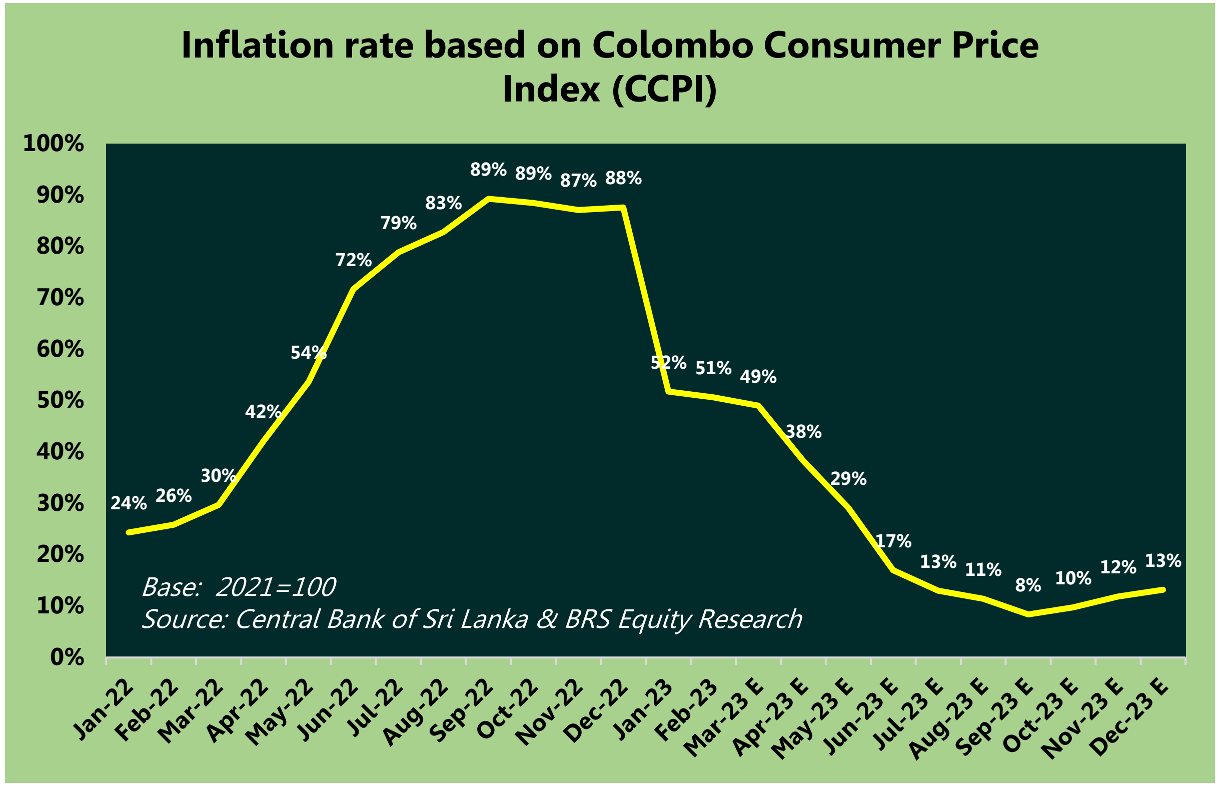
On a positive note, the increase in tourist arrivals, will aid in improvements in business activities related to other personal activities & accommodation and food and beverage sub-sectors.



Source: Central Bank of Sri Lanka & BRS Equity Research

Inflation to decelerate.....albeit remaining a challenge

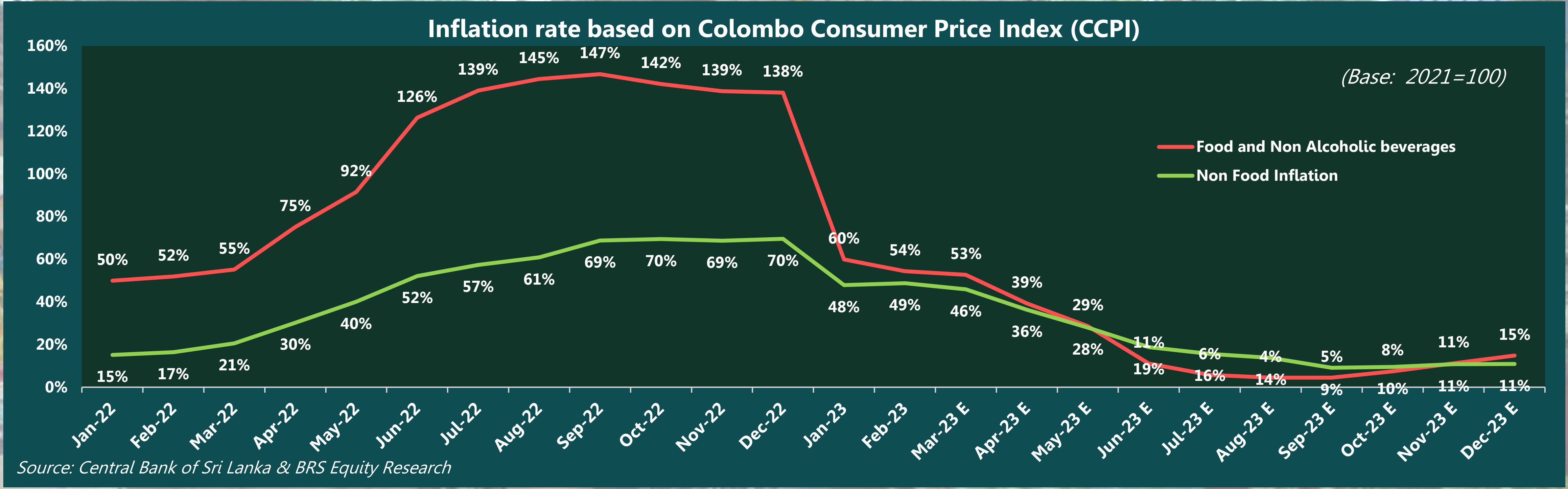
We envisage a gradual decline in inflation in 2023E, backed by contracting aggregate demand due to the lag effect of tightened monetary policy implemented in 2022 coupled with fiscal measures, significant tax hikes and effects of changing the base year to 2021. The recent upward revision of policy rates is likely to see a faster achievement of inflation targets in the coming years. With an anticipated IMF bailout to improve dollar reserves and forex liquidity, we believe that Import restrictions will gradually ease, relieving pressure on the domestic supply side. Furthermore, expected improvement in domestic production in the 2H 2023E is likely to alleviate supply shortages. An open market and the newly introduced price formulas will aid in inflation management going forward.



We believe, inflation although declining, the upward risk still remains due to global and domestic uncertainties, possible upward adjustments in energy prices and second round effects of electricity tariff hike. Political polarization would impact how closely the anticipated budget consolidation measures would stick. As a result, we have conservatively predicted inflation rates to remain in the lower double-digit band of 13% by the end of 2023E. However, given the policy changes and the positive statistical impact of rebasing, we expect a fall to mid-single digits by the end of 2024E.

Source: Central Bank of Sri Lanka & BRS Equity Research

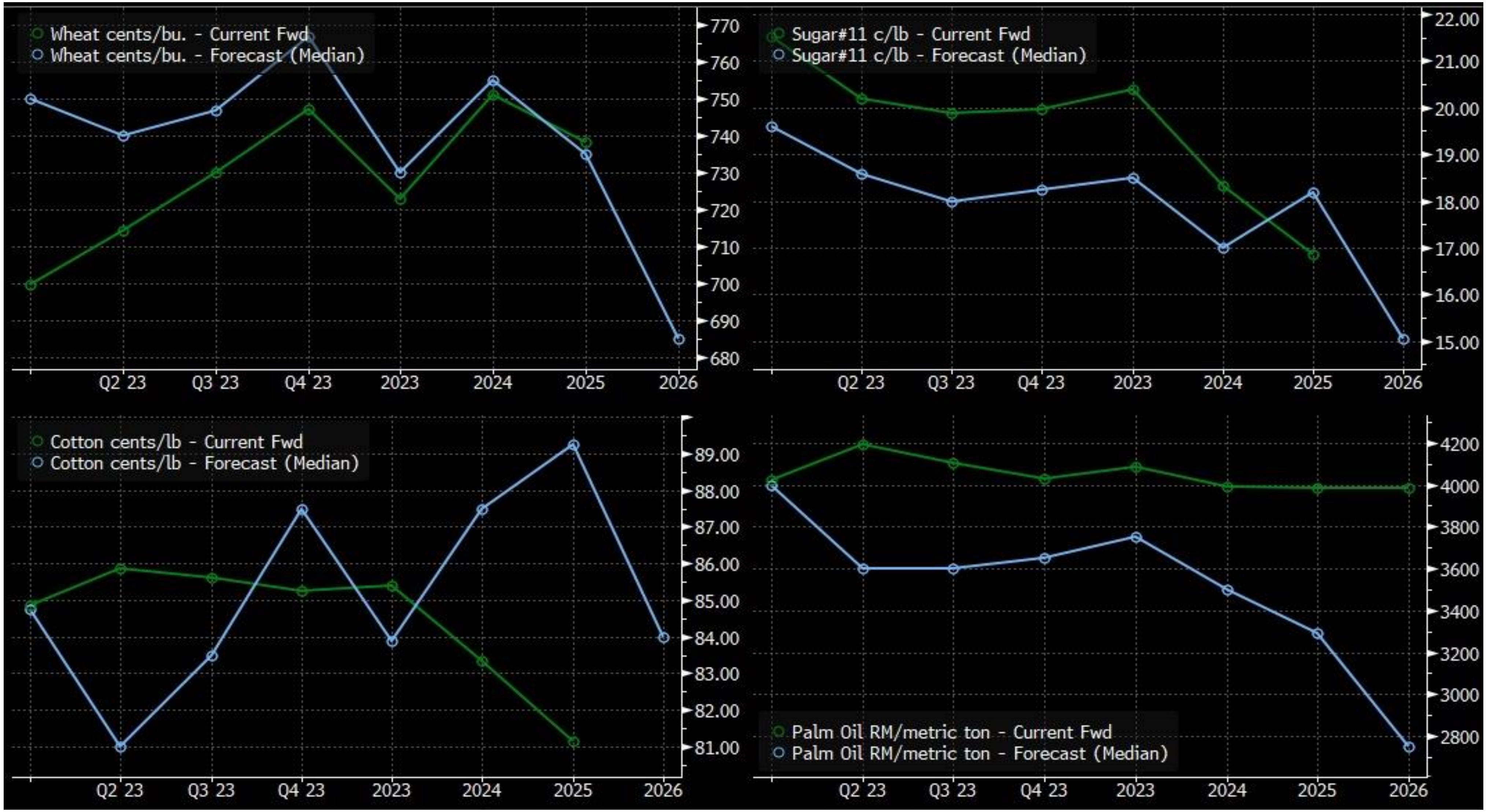
Food and Nonfood inflation



Source: Central Bank of Sri Lanka & BRS Equity Research

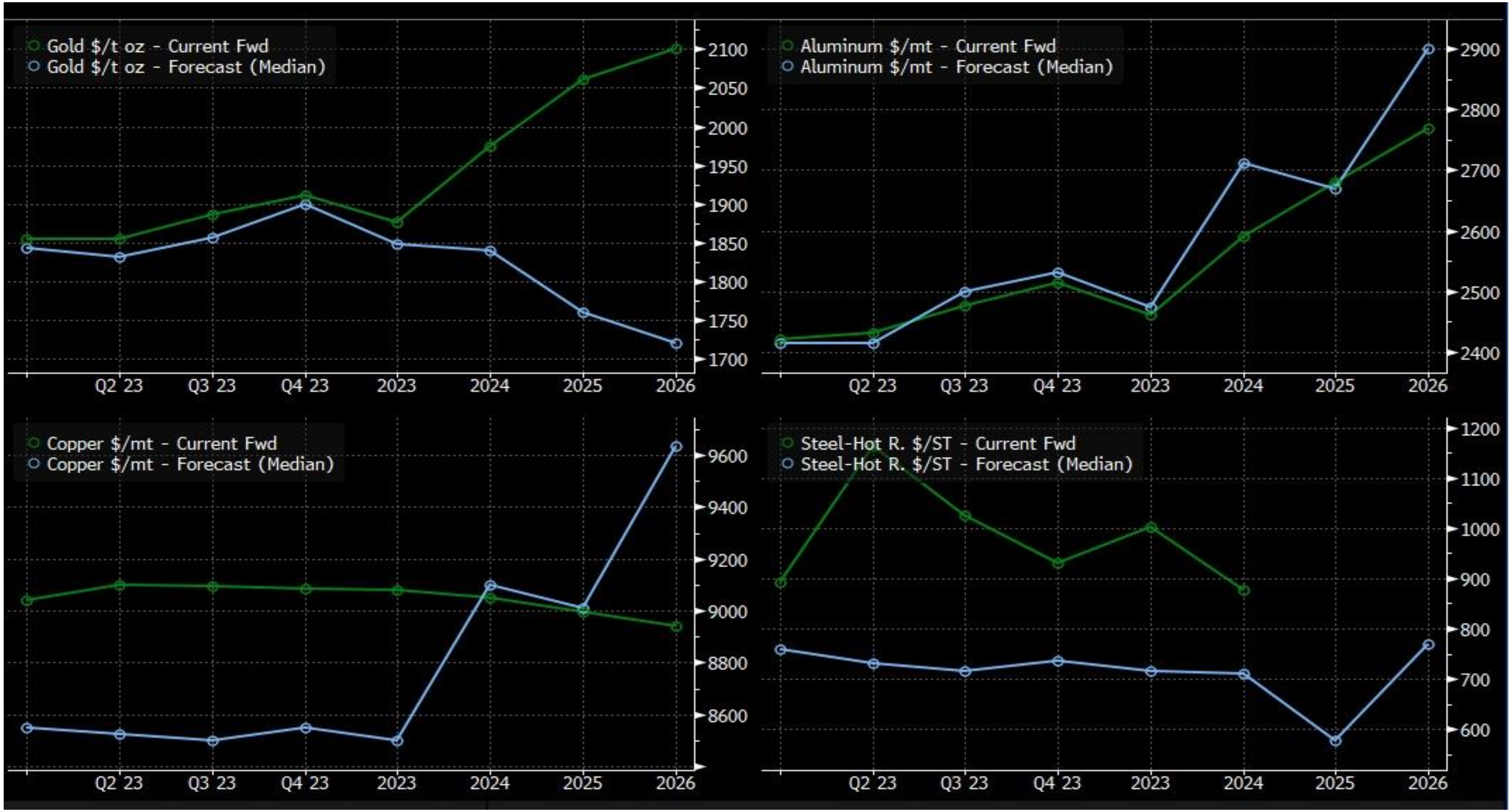
- We believe, the trending decline in global commodity futures and anticipated improvements in domestic Agri sector will ease the high food inflationary environment. Accordingly, we anticipate, food inflation to hover around 11% by the end of 2023E.
- Non-food inflation is expected to decline, owing to a high base impact. However, subsectors such as alcoholic beverages, tobacco and narcotics, housing, water, electricity, gas and other fuels, health, transportation, and communication will see price increases due to revisions in electricity and fuel prices and increase in taxes.

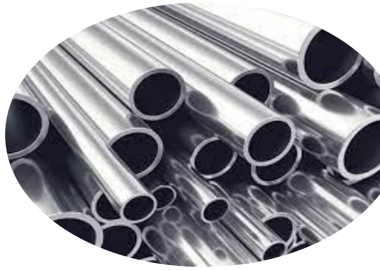
Commodity price forecast : Agriculture



Source: Bloomberg

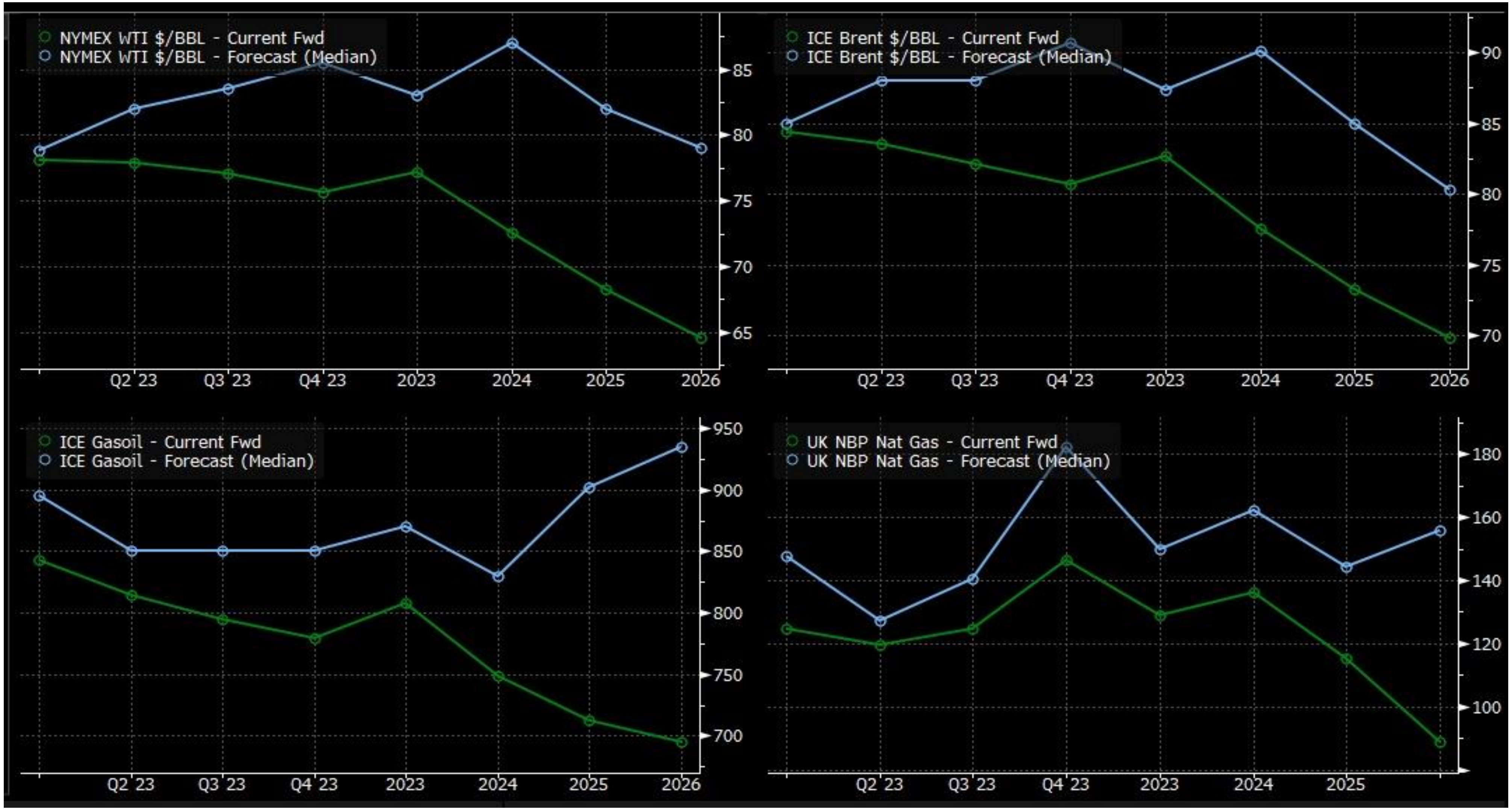
Commodity price forecast : Metal





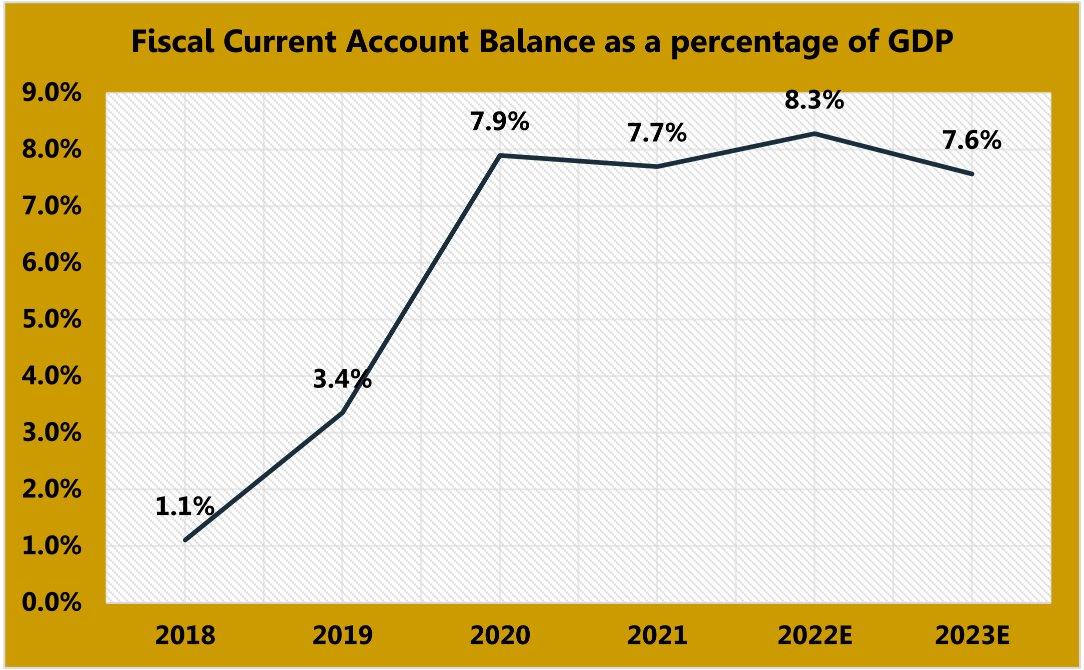
Source: Bloomberg

Commodity price forecast : Energy

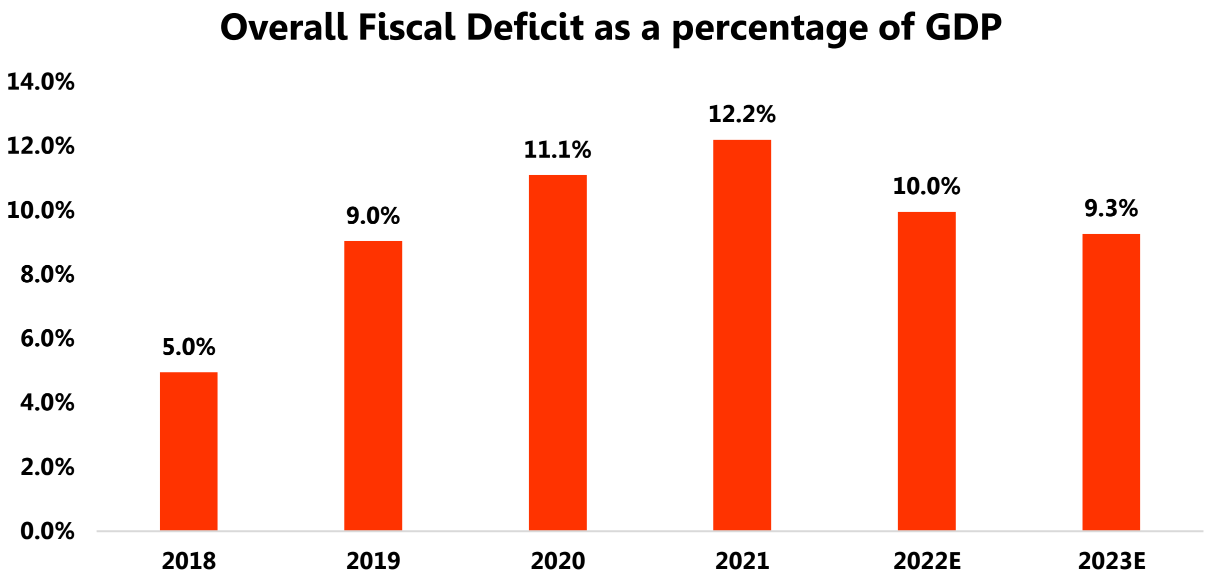


Source: Bloomberg

Fiscal strategy to manage the crisis



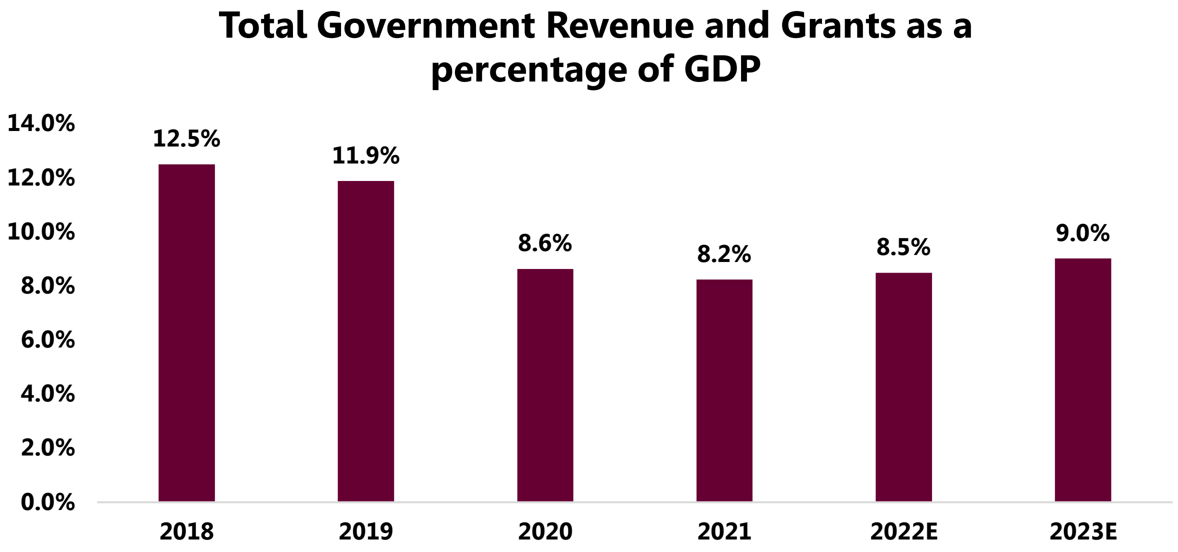
Despite tax reforms, the fiscal deficit is expected to remain at 10% of GDP in 2022, primarily owing to an increase in expenditure caused by inflation, whilst output suffered a significant decrease due to economic and social unrest. Expenditure continued to rise due to high inflation and interest rates, although, we believe, significant tax reforms implemented in 2022 will relieve fiscal deficit pressures to some extent during the latter part of the year.



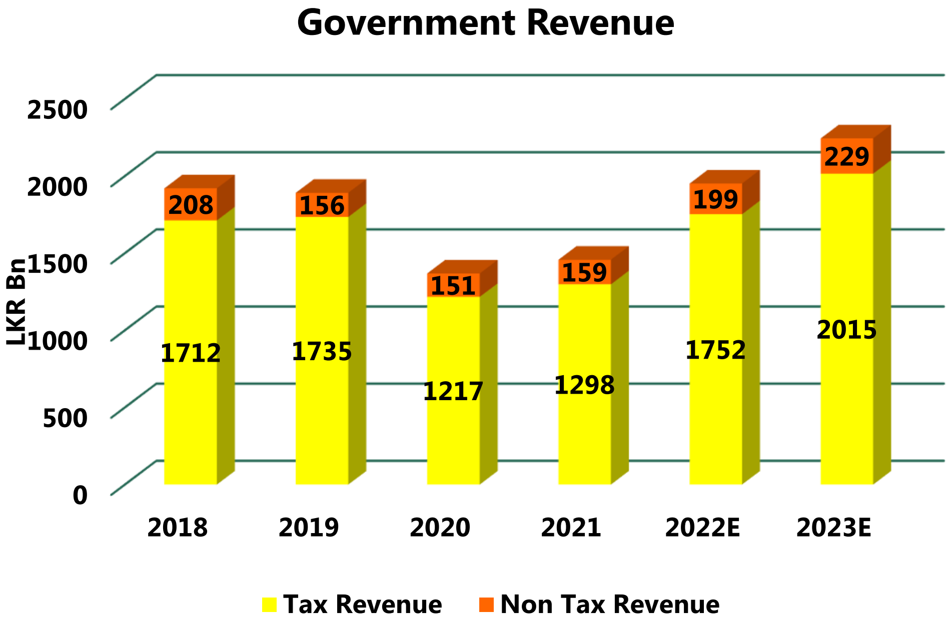
The fiscal management is expected to fall in line gradually as a result of the government's budget consolidation initiatives over the medium to long term. We forecast a fiscal deficit of 9.3% of GDP in 2023E.

Source: Central Bank of Sri Lanka & BRS Equity Research

Higher taxes to aid income shortfall



We expect Total Revenue and Grants to increase to 8.5% of GDP in 2022 from 8.3% of GDP in 2021, aided by a 34% YoY increase in tax revenue induced by new tax measures (Increases in VAT (8% to 15% within 2022), excise duties, and withholding taxes (WHT) implemented in the 2022.



The elimination of concessionary tax and increase in standard tax rate (24% to 30%), increase in personal income tax rates and reduction in income thresholds combined with other tax reforms are expected to generate 15% increase in total government revenue in 2023E. However, we believe, the slowdown in economic activity can impact tax collection for 2023E. The increase in direct and indirect taxes remain a prerequisite to obtain IMF EFF and believe the high taxes will stay in place until targets can be achieved.

Source: Central Bank of Sri Lanka & BRS Equity Research

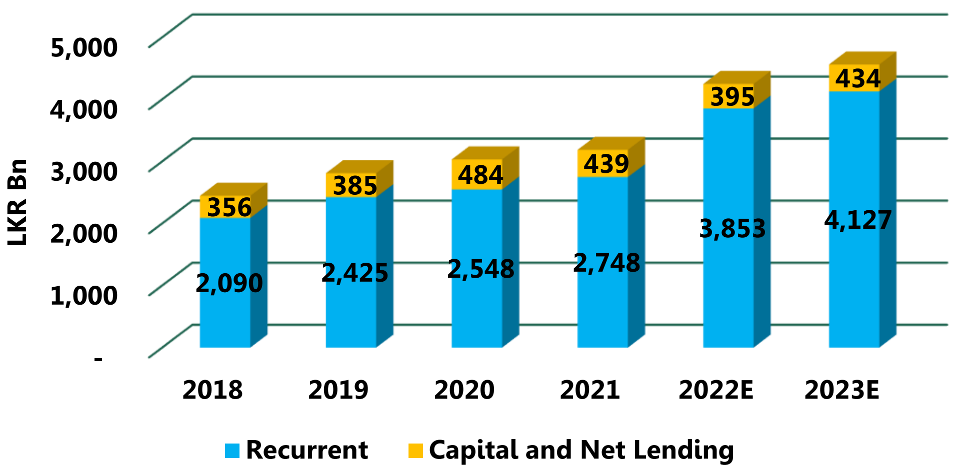
Expenditure rationalization to cope with debt burden

In 2022, government spending is expected to account for 18.5% of GDP, down from 19.9% in 2021, primarily aided by halting of many government projects. Despite government's fiscal consolidation measures, recurrent expenditure is expected to rise to 16.8% of GDP in 2022 due to expenditure related to higher interest rate and inflation, servicing of multilateral and domestic loans.

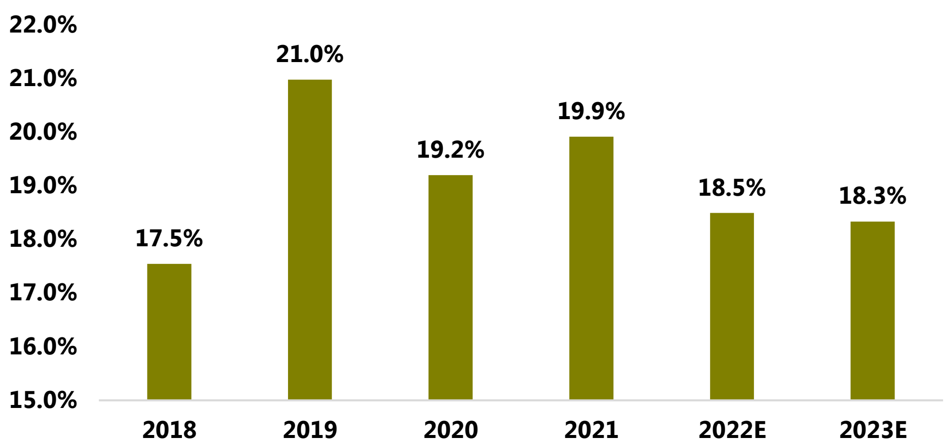
Total expenditure and net Lending are expected to rise by 21% YoY, owing to a significant increase in recurrent expenses. We anticipate recurring spending will rise further in the near term due to higher inflation and interest rate hikes. We do not foresee any significant pay rises or new recruitments in the public sector in 2023E, owing to the growing fiscal imbalance. As a result, we expect total expenditure to hover around 18.3% of GDP in 2023E.

Despite most capital expenditures are currently on hold due to fiscal constraints, we anticipate the government to increase the pace of development activities in the medium to long term.

Total Government Expenditure



Total Expenditure and Net Lending as a percentage of GDP

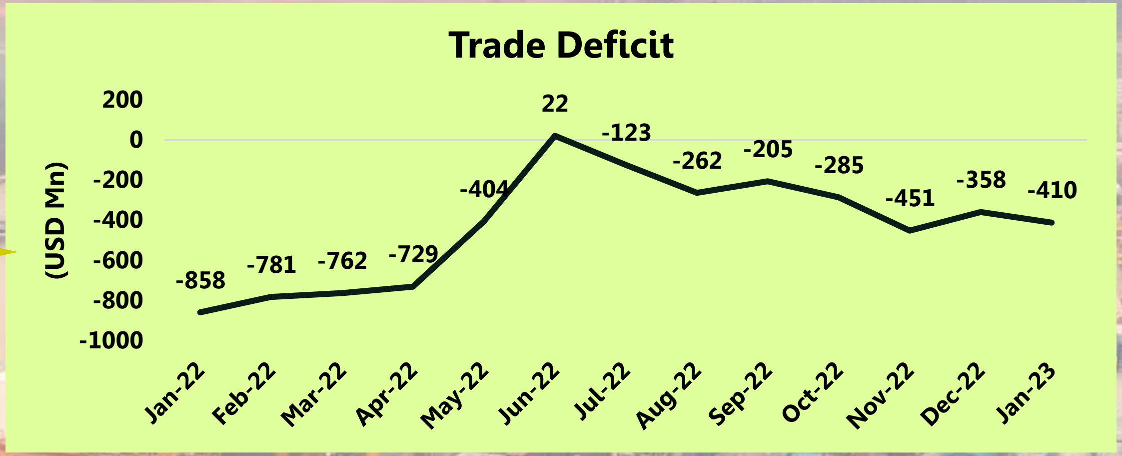


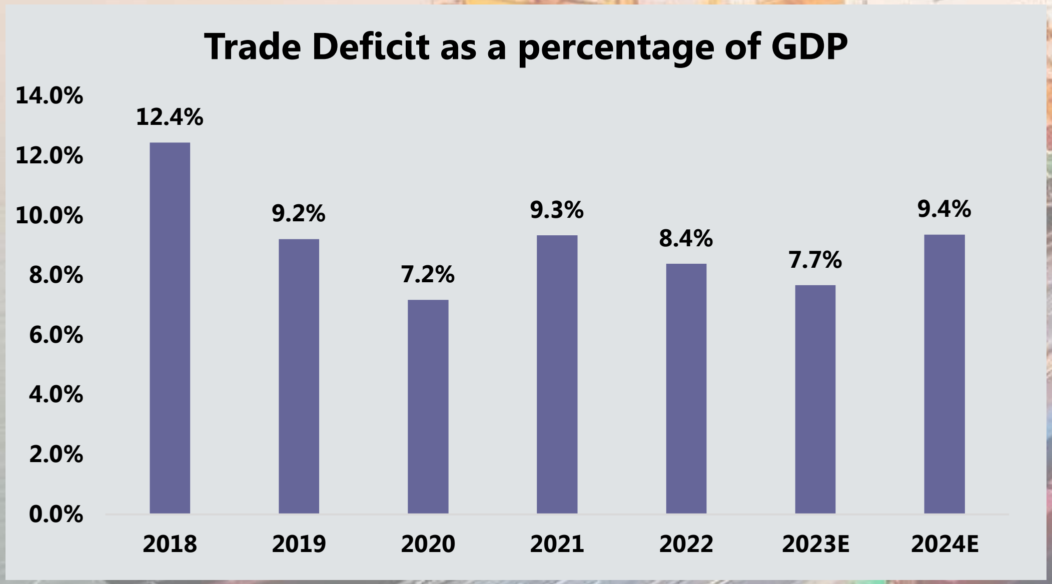
Source: Central Bank of Sri Lanka & BRS Equity Research

Trade deficit to widen

What happened in 2022?

The country's trade deficit shrank continuously in 2022, recording a surplus in trade balance (June 2022) for the first time in double decades. This was mainly supported by the policy induced moderation of imports, along with notable growth in exports during first nine months of 2022. However, export earnings declined in 4Q 2022, impacted by contraction in global demand.





Amidst the notable increase in export earnings and continued import restrictions, the country's trade balance is expected to remain at -8.4% of GDP at the end of 2022. In 2023E, we expect exports to grow by 4.9% YoY, despite global challenges, whilst import restrictions will gradually ease owing to anticipated policy measures, which could result in a trade deficit of USD 5.1bn in 2023E. We expect a further decline in trade balance to GDP to be around -7.7% in 2023E. However, with imports expected to increase gradually trade deficit to GDP is expected to rise to 9.4% by 2024E. We believe, the import export ratio will rise to 0.7x (previously 0.6x), with import restrictions expected to gradually ease within the next two years.

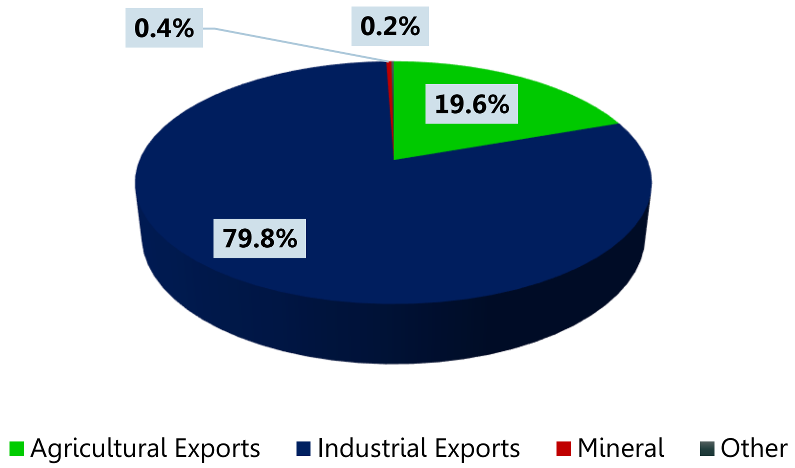
Source: Central Bank of Sri Lanka & BRS Equity Research

Major exports to decline in the immediate term

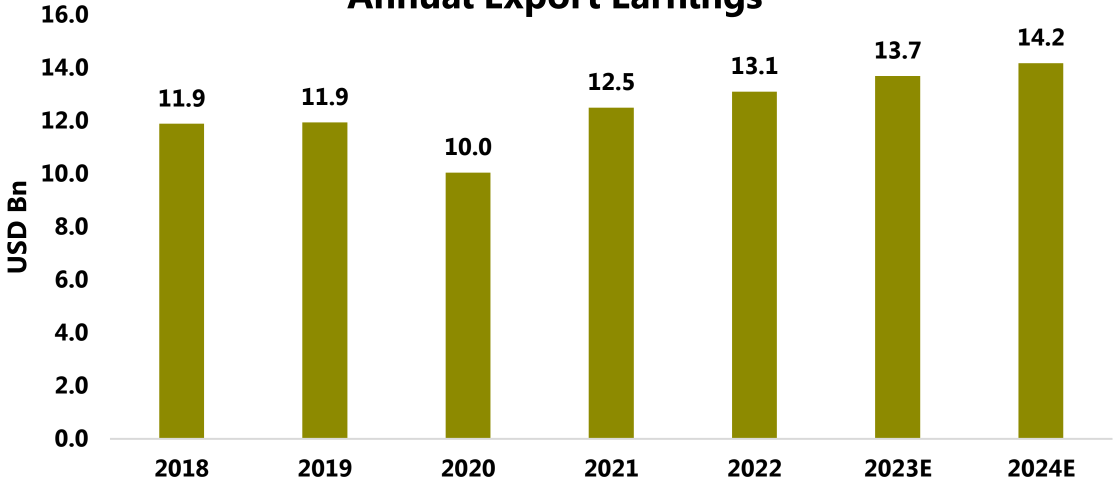
We anticipate, demand for major exports to decline in the periods ahead due to global recessionary conditions. We conservatively forecast exports to increase by 4.9% YoY to USD 13.7bn in 2023E, led by agricultural exports (15.1% YoY), which include traditional exports such as tea, rubber, and spices. Despite higher tea prices, a lag effect is expected from the plantations sector due to the unavailability of fertilizer during most part of last year. Seafood exports are expected to remain resilient in the period ahead.

Despite the robust performance in 2022, industrial exports are expected to grow at a moderate 2.1% YoY due to lower earnings from subsectors such as textiles and garments, as well as reduced spending capacity associated with high inflation and recessionary concerns in most major markets (the USA, the EU and the UK). Furthermore, exporters face the risk of losing competitiveness due to higher interest rate, energy tariff, and tax increases.

Export Composition - 2022

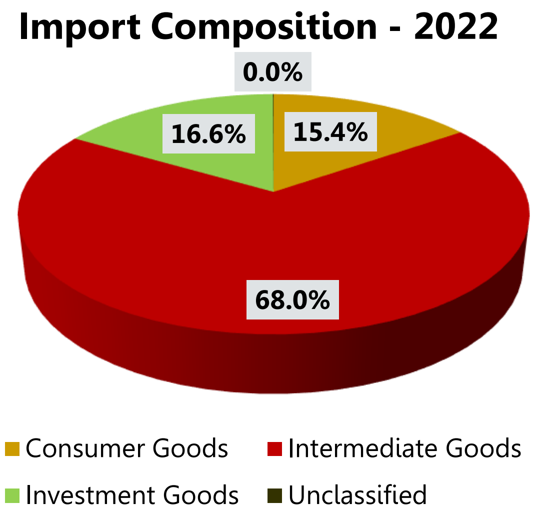


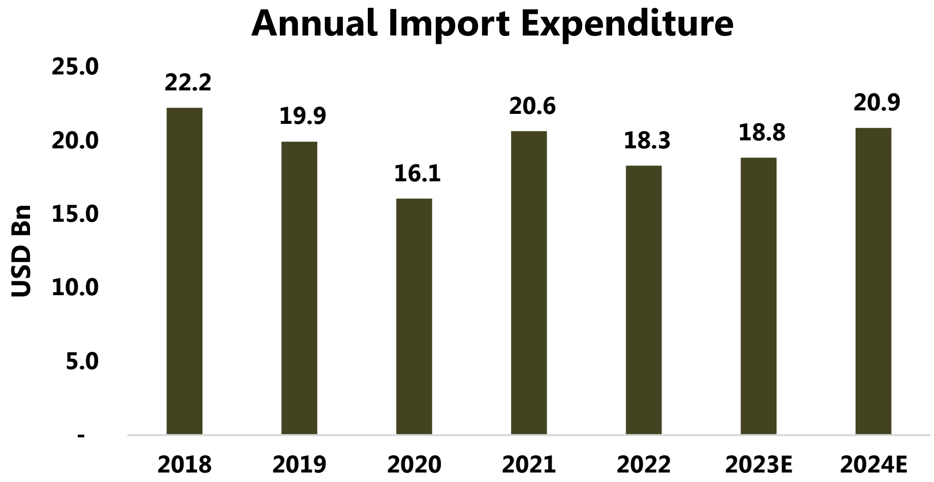
Annual Export Earnings



Source: Central Bank of Sri Lanka & BRS Equity Research

Import restrictions are likely to be lifted





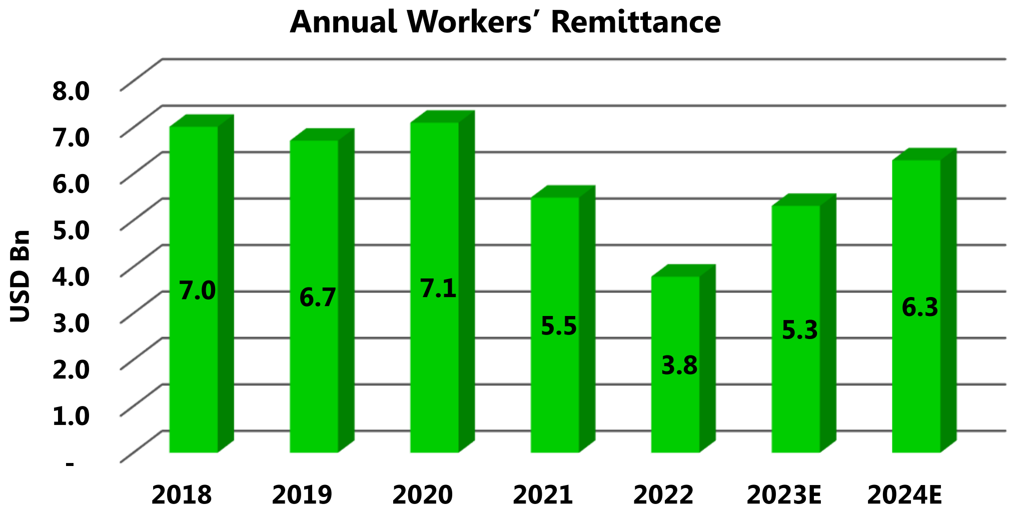
Source: Central Bank of Sri Lanka & BRS Equity Research

Forex shortages and import restrictions resulted in Import expenditure declining to USD 18.3bn in 2022. We believe, higher liquidity will ease forex pressures, strengthening the rupee further, whilst policy makers may ease import restrictions in the period ahead. The gradual turnaround in economic activity would demand higher imported material and believe this would increase import expenditure going forward.

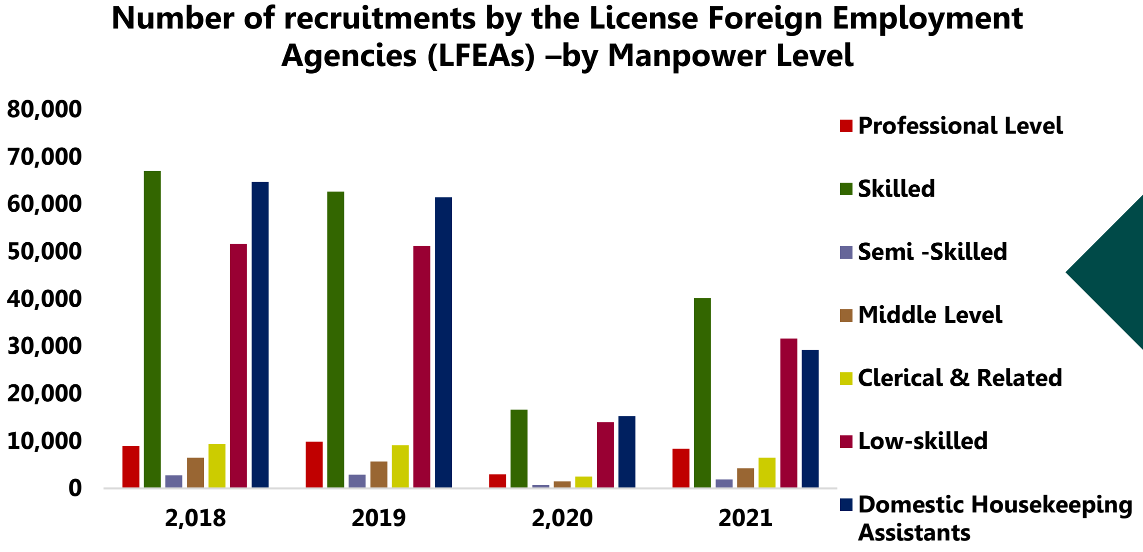
We expect imports of intermediate goods to increase by 5.6% YoY in 2023E driven by demand for fuel, textile and textile articles and fertilizers. The importation of consumer goods is also expected to increase by 13.3% YoY driven by food imports such as Sugar and Confectionery, Cereals and milling industry products and Beverages and Nonfood imports such as Medical and pharmaceuticals. The importation of investment goods may remain subdued initially, hindered by slower economic growth.

We believe, the prevailing economic condition will lure policy changes, whilst uncertainties associated with import levies will keep import expenditure at bay, leading to a forecast increment in import expenditure of 3.0% for 2023E. However, with an expected bounce back in economic activities, we believe import expenses could rise by 10.7% YoY in 2024E to pre pandemic levels.

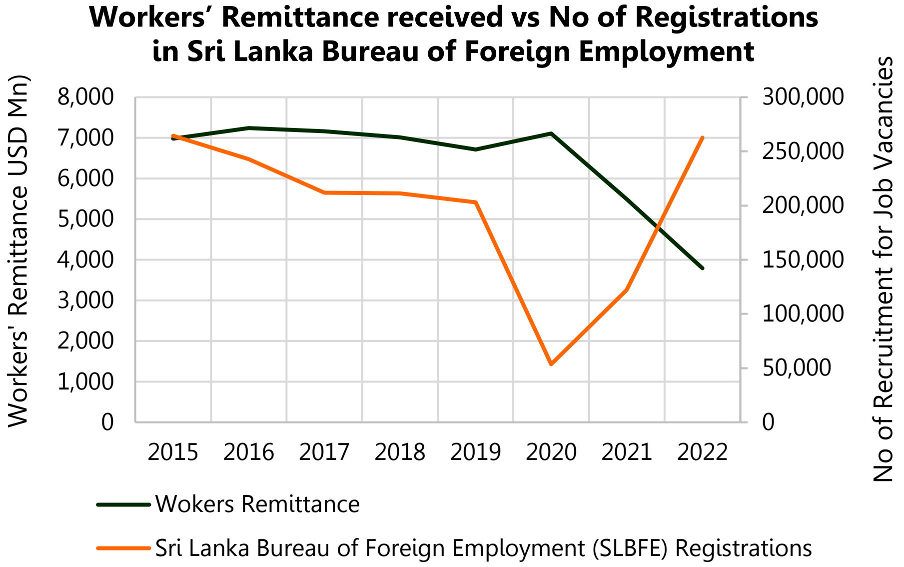
Workers' remittances bounce back….better times ahead



We expect workers' remittance to increase to USD 5.3bn in 2023E, considering the high number of migrant workers since mid-2021 to date (The registrations at Sri Lanka Bureau of Foreign Employment (SLBFE) have increased by 588% YoY in 2H 2021 whilst total registration for 2022 increased by 115% YoY). Furthermore, the re-emergence of faith in formal channels and political stability play a significant role in attracting remittance, which we believe has already reflected in the increase in remittances (Workers' remittance increased by 32% YoY during last 4 months).

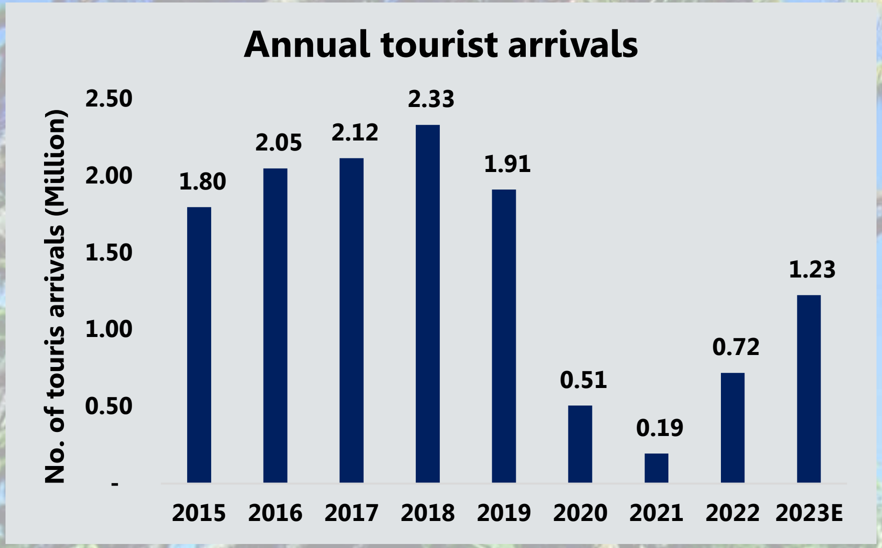


Skilled labor, Domestic housekeeping assistants and low skilled categories emerged as the to categories in recruitments.



Source: Central Bank of Sri Lanka, Sri Lanka Bureau of Foreign Employment & BRS Equity Research

Tourist arrivals returning to normalcy

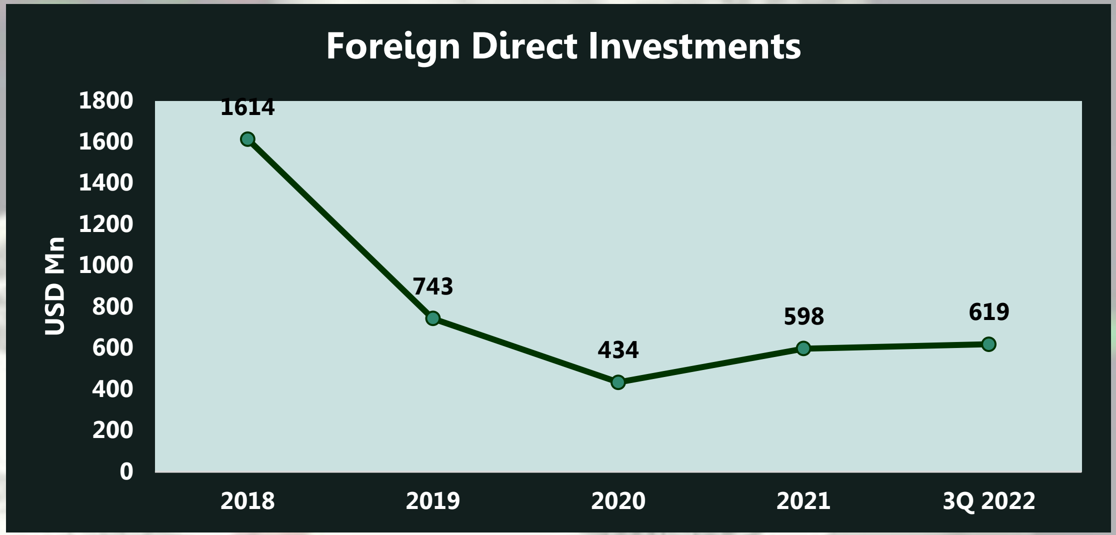


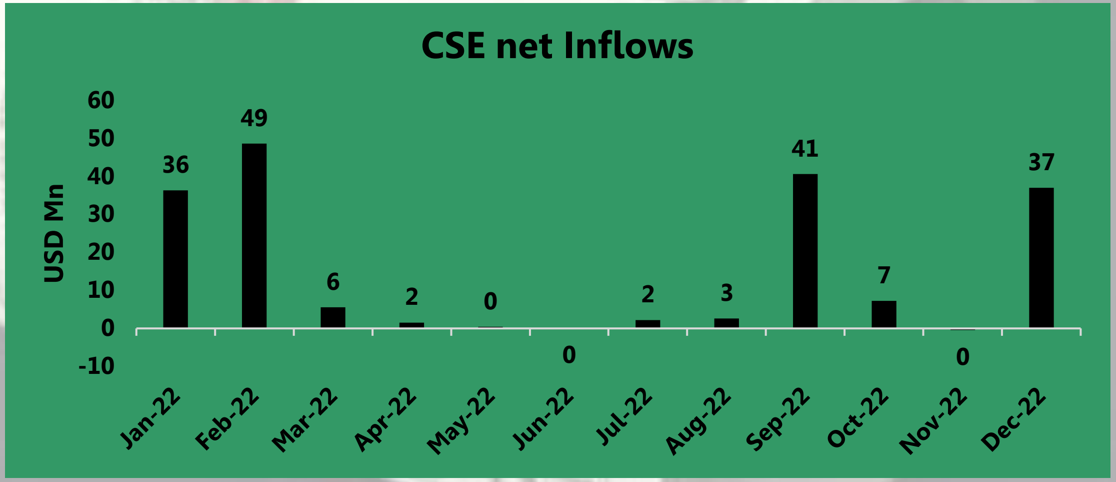
Tourism earnings increased 147% YoY to USD 718mn in 2022, making it one of the significant inflows to the external account. The total number of tourist arrivals for the year was 719,978, an increase of 278% YoY from a significantly lower base. Since 2019, the tourism industry has been plagued with continuous challenges including economic and social distress in 2022. Many international travel advisory agencies issued warnings on Sri Lanka, citing shortage of medicines, fuel, and continuous power outages. Furthermore, geopolitical tensions in Eastern Europe also impacted major source markets such as Russia and Ukraine during the previous year. Although regarded as an affordable tourist destination, the industry failed to reach pre-pandemic tourist arrivals even by the end of 2022.

On a conservative basis, we expect tourist arrivals to exceed 1.2mn in 2023E whilst earnings to reach USD 2bn (arrivals for the first 3 months reached ~332.6 thousand accounting for USD 514.1mn). We believe that arrivals will gradually normalize, with fuel and medicine shortages easing after the IMF deal is secured. Nonetheless, uncertainties remain due to weak global spending exacerbated by recessionary conditions, as well as slow progress in domestic developments. Average spending per tourist arrival is likely to remain lower, as hotels will initially use attractive dollar pricing to gain traction.

Source: Central Bank of Sri Lanka, Sri Lanka Tourism Development Authority & BRS Equity Research

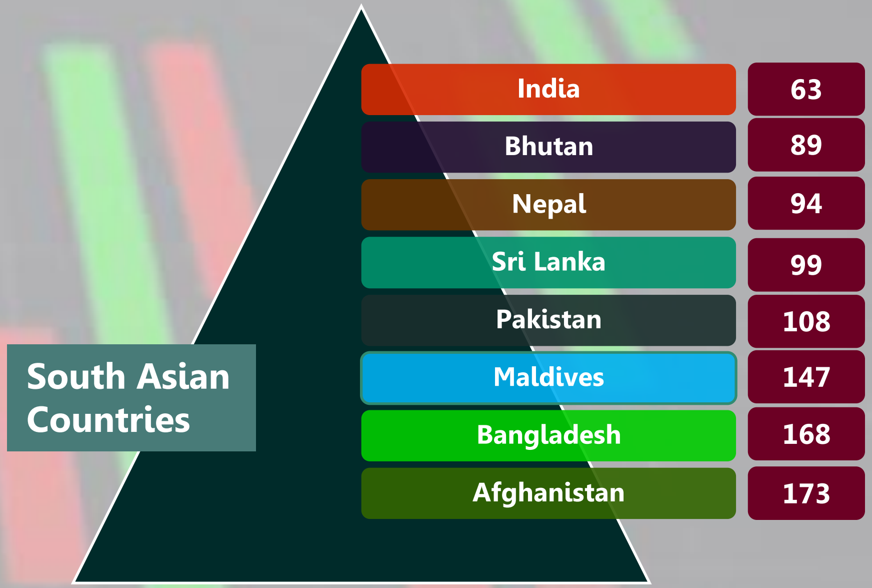
Foreign investment still lagging





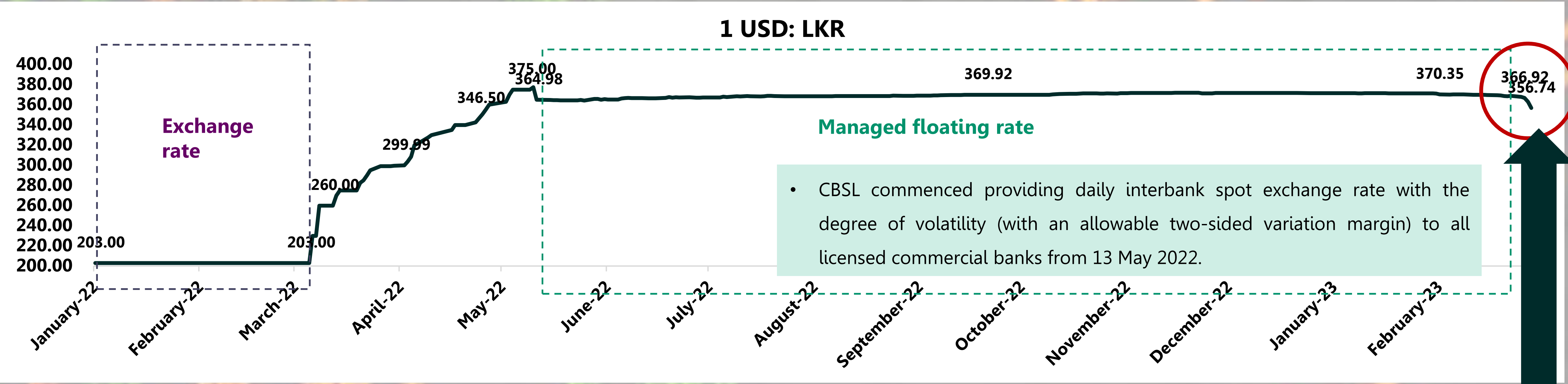
The foreign investments in the form of foreign direct investment (FDI) remained subdued, while investments in the stock exchange recorded moderate growth during 2022.

Who is more appealing in the region?
Ease of Doing Business Index



Source: Central Bank of Sri Lanka, World Bank & BRS Equity Research

LKR appreciates against USD

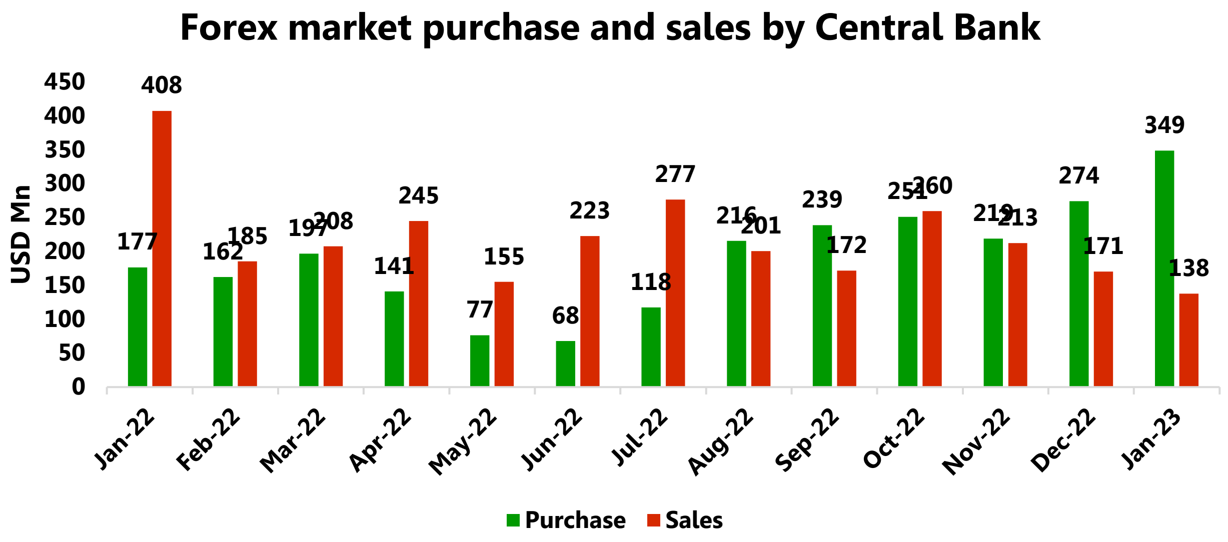


Exchange rate appreciate against USD in since 27th February 2023

Comparison with regional peers

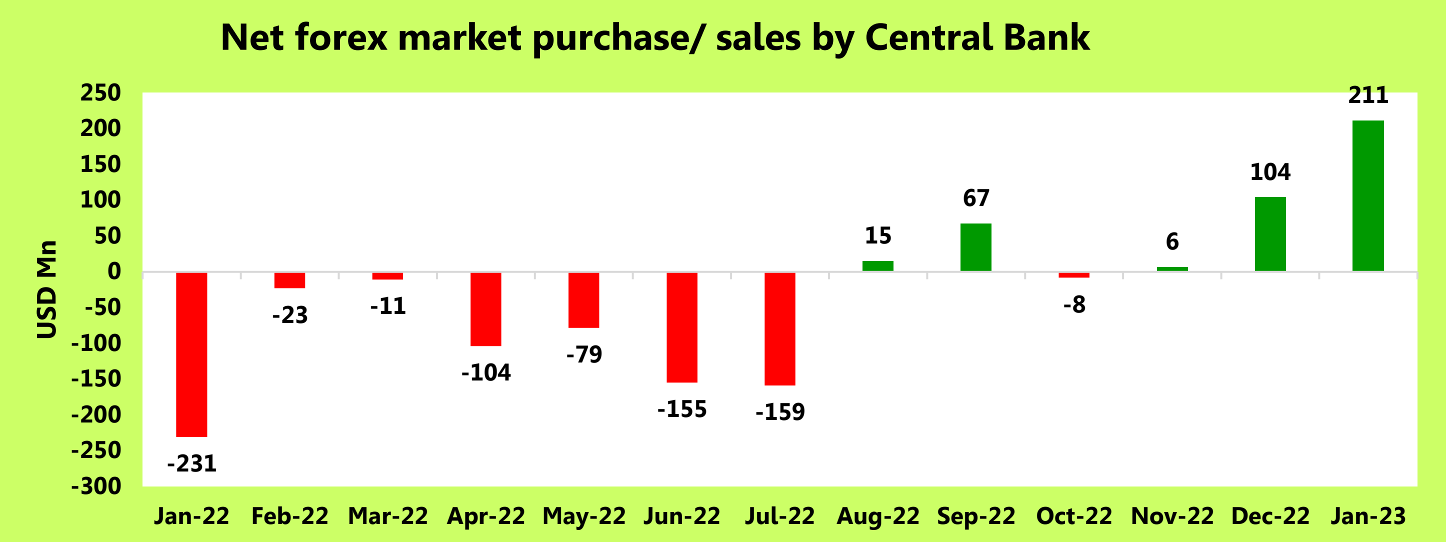
Source: Central Bank of Sri Lanka, Bloomberg & BRS Equity Research

The Central Bank a net buyer in the foreign market



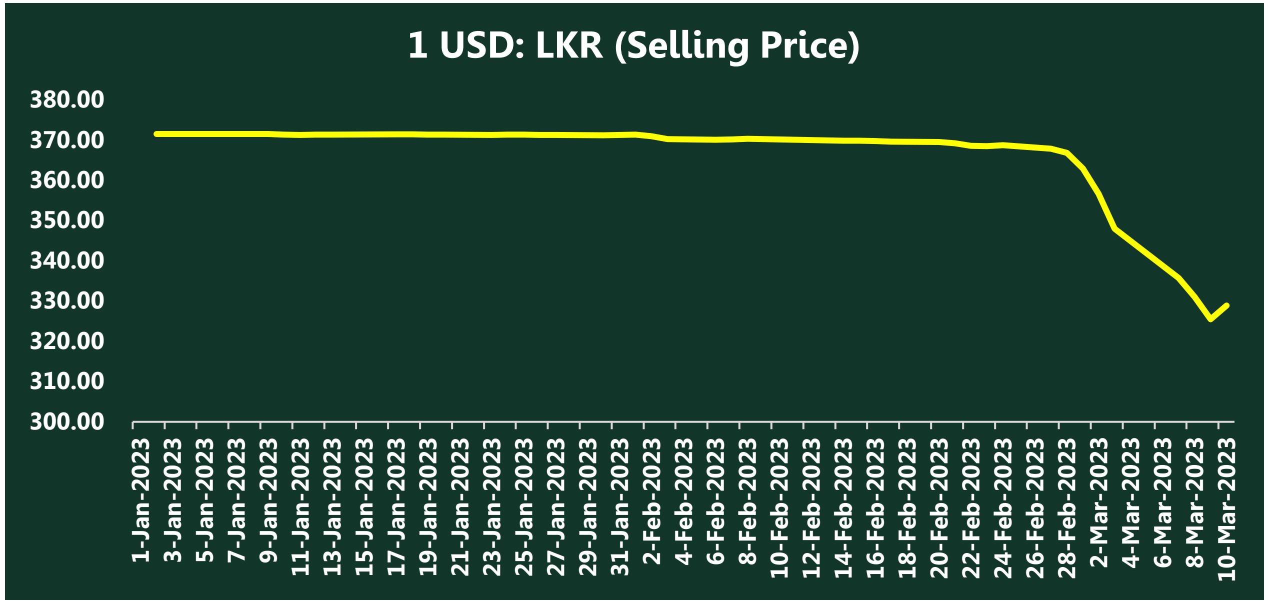
- Improvements in worker remittances and tourism earnings boosted the market's monthly forex inflows, while ongoing import restrictions continued to curtail outflows.
- Net foreign inflows into the equity market further aided exchange rate performance. (net inflow of USD 182mn in 2022 against net outflow of USD 238mn in 2021)

Since November 2022, Central Bank has been a net forex buyer For the third consecutive month.



Source: Central Bank of Sri Lanka, BRS Equity Research

YTD Exchange Rate Movement



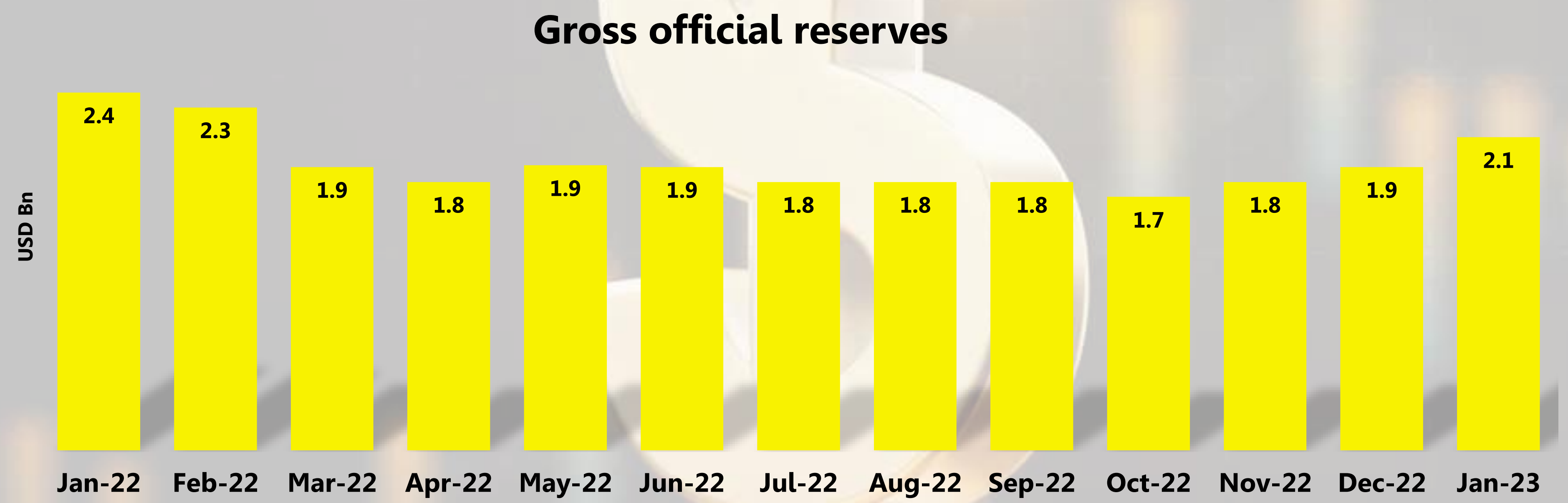
- The exchange rate appreciated by ~11% YTD owing to liquidity improvements in interbank forex market.
- Considering the enhanced FX inflows, the Central Bank removed the surrender requirement for export proceeds from 7th March 2023.
- In addition, the central bank removed the daily trading band with middle spot exchange rate effective from 7th March 2023.

The LKR has recently appreciated against the USD as a result of increased liquidity in Sri Lanka's forex market. In order to prevent a steep fall, the Central Bank purchased USD 308Mn within a week from 27th February to 3rd March.

We anticipate a further appreciation temporarily on the back of securing an IMF bailout opening new opportunities for the dollar. We expect new developments to improve migrant workers' confidence in using official methods to transfer money, whilst encouraging tourist arrivals will further strengthen the rupee. Securing the IMF package will also open opportunities for obtaining bilateral and multilateral funds towards Sri Lanka, which may strengthen the rupee in the near term. However, we expect the appreciation to normalize gradually in the medium term.

Source: Central Bank of Sri Lanka, BRS Equity Research

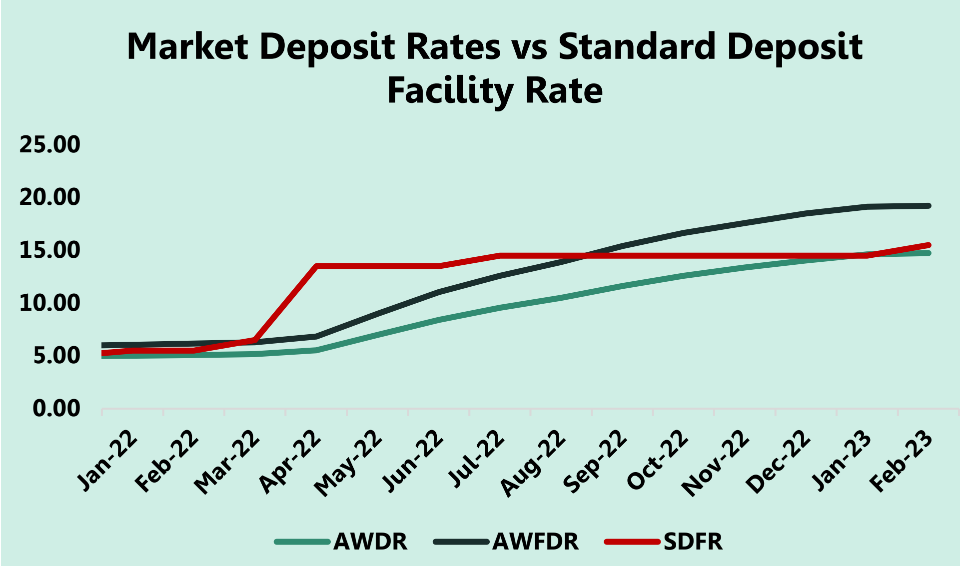
Foreign reserves are expected to improve amidst IMF bailout

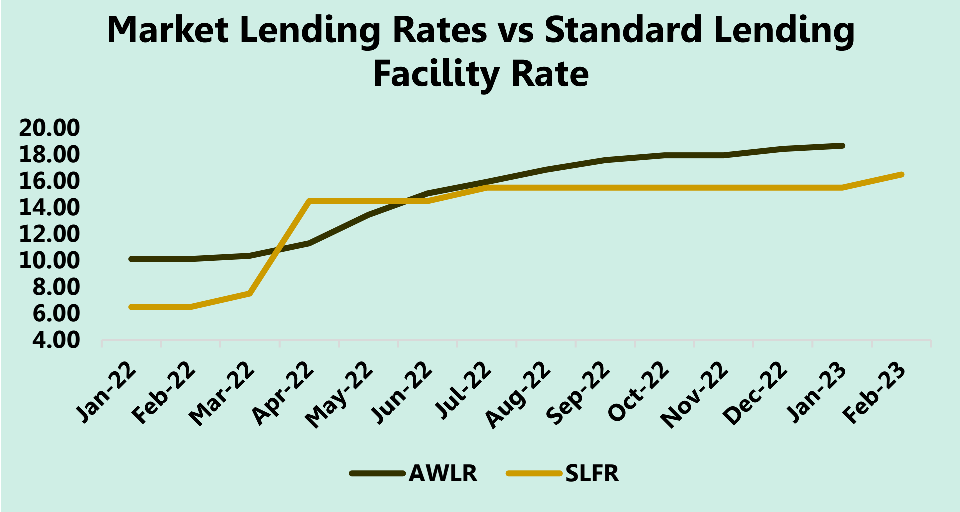


- Following the IMF bailout, gross official reserves are expected to gradually increase. Sri Lanka will be in better position to access new bilateral and multilateral fund facilities, while also opening opportunities for commercial borrowings.
- Furthermore, a gradual increase in inflows from tourism, worker remittances, exports, and investments (capital market and other projects) will boost foreign reserves in the years ahead.

Source: Central Bank of Sri Lanka, BRS Equity Research

Interest rates expected to fall in the periods ahead





Source: Central Bank of Sri Lanka, BRS Equity Research

With the intention of slowing the rapid increase in inflation and stabilizing economic activity, the CBSL increased interest rates by 1050 basis points from January 2022 to March 2023. A substantial increase of 700 basis points was done in April 2022 with the appointment of the current Central Bank Governor. Unexpectedly, in the most recent monetary policy review, the Monetary Board further increased policy interest rates by 100bps, to complete all "prior actions" requested by the IMF to move forward with the finalization of the Extended Fund Facility (EFF).

However, the central bank anticipates market interest rates would continue to fall after reaching a peak in the first two months of 2023, narrowing the gap between market and policy interest rates. This is primarily due to high uncertainty revolving around the EFF, which we believe will subside following IMF assistance. The one-year government bill rates peaked in September 2022 and have been gradually declining in recent months.

We believe policy interest rates will gradually reduce during the 2H 2023E, following the much-anticipated IMF bailout, nearing completion on China's assurance. Market interest rates will fall gradually as inflation slows and investor confidence rises.

A step forward to ensure central bank independence

The new Central Bank Act aims to give the bank administrative and financial autonomy while shielding its Governor and members of the Governing Board and Monetary Policy Board from outside influences.

	Monetary Law Act No. 58 of 1949	Proposed New Central Bank Act
Objectives	• Maintaining economic and price stability • Maintaining financial system stability	• The primary objective of the Central Bank shall be to achieve and maintain domestic price stability. • The other objective of the Central Bank shall be to secure the financial system stability.
Governing board	• Monetary Board of Central bank	• Governing Board of Central bank • Monetary Policy Board of Central bank
Responsibilities	• The monetary Board responsible for the implementation of monetary policy and management, operations and administration of the central bank.	• The Monetary Policy Board is in charge of monetary policy formulation and the implementation of a flexible exchange rate regime in accordance with the flexible inflation targeting framework. • The Governing Board delegated the responsibility for monitoring administration functions, managing affairs, and upholding general policy.

Source: Monetary Law Act,& BRS Equity Research

A step forward to ensure central bank independence

	Monetary Law Act No. 58 of 1949	Proposed New central Bank Act
Provisional advances to the Government.	• The Central Bank could make direct provisional advances to the government to finance authorized expenditure to be incurred out of the Consolidated Fund.	• CBSL shall not grant credits to the Government, any public authority owned by the Government, or any other public entity, either directly or indirectly.
Management of the public debt.	• As the government's agent, the Central Bank is in charge of managing the public debt.	• CBSL will no longer be in charge of public debt management.
Members of the board	<u>Monetary Board of Central bank</u> • Governor of the Central Bank (Chairperson) • Secretary to the Ministry of Finance • 3 members appointed by the President	<u>Governing Board of Central bank</u> • Governor of the Central Bank (Chairperson) • 6 members who shall have expertise in economics, banking, finance, accounting and auditing, law or risk management. <u>Monetary Policy Board of Central bank</u> • Governor of the Central Bank (Chairperson) • 2 experts in economics or finance • Deputy Governor of the Central Bank in charge of price stability • Deputy Governor of the Central Bank in charge of financial system stability.

Source: Monetary Law Act,& BRS Equity Research

EQUITY MARKET

BARTLEET Strength of a Century
RELIGARE Values that bind

Equity Strategy – 2023E

Despite extremely challenging conditions for businesses amidst forex crisis, power cuts, fuel shortages and inflation, listed corporations posted record breaking earnings of LKR 667bn (+42%) in 2022 driven by exchange gains, price revisions and resilient tactical decisions. While we saw a decline of earnings in 4Q 2022 impacted by economic contraction, significant rise in finance costs and increase in taxes, we expect earnings to gradually pick up on a quarterly basis leading up to a better performance in 2H 2023E. However**, 2023E earnings** are projected to **come down by 25% to LKR 497bn** (from a higher base in 2022). We believe majority of the sectors will be under pressure due to **weak economic conditions** and **elevated interest rates** coupled with **higher taxes**.

We believe equity will remain attractive for investors backed by improved sentiment around IMF board approval and hard reforms taken to revive the economy bridging down the gap between average historical valuations and forward multiples. Therefore, we remain **cautiously optimistic** and expect **an ASPI fair value 11,500** based on **2023E** earnings projections and **13,500** based on **2024E** earnings at a **justified PE of 10.0x.**

Source: BRS Equity Research

Equity Strategy – 2023E

We believe sectors with inelastic demand and larger scale of operations likely to remain strong backed by efficient price revisions and cost management (Energy, soft and hard liquor, cigarette, consumer foods). We expect market interest rates to gradually come down resulting in significant fair value gains for primary dealers for increased investments. However, we believe interest rates will continue to remain higher resulting in higher investment income for insurance companies. The revival of tourist arrivals will aid consumer services slowing down the bleeding albeit impacted by electricity and finance cost escalations. Under the higher interest rate environment, it is advisable to look at low geared companies with strong fundamentals.

Therefore, we recommend investors to be vigilant and pick up stocks with more resilient earnings at attractive entry points. While short term investors can trade on short term beneficiaries, it is advisable to formulate a portfolio consisting resilient and strong counters with medium to long term growth prospects.

-6.9% -1.5%

Source: BRS Equity Research

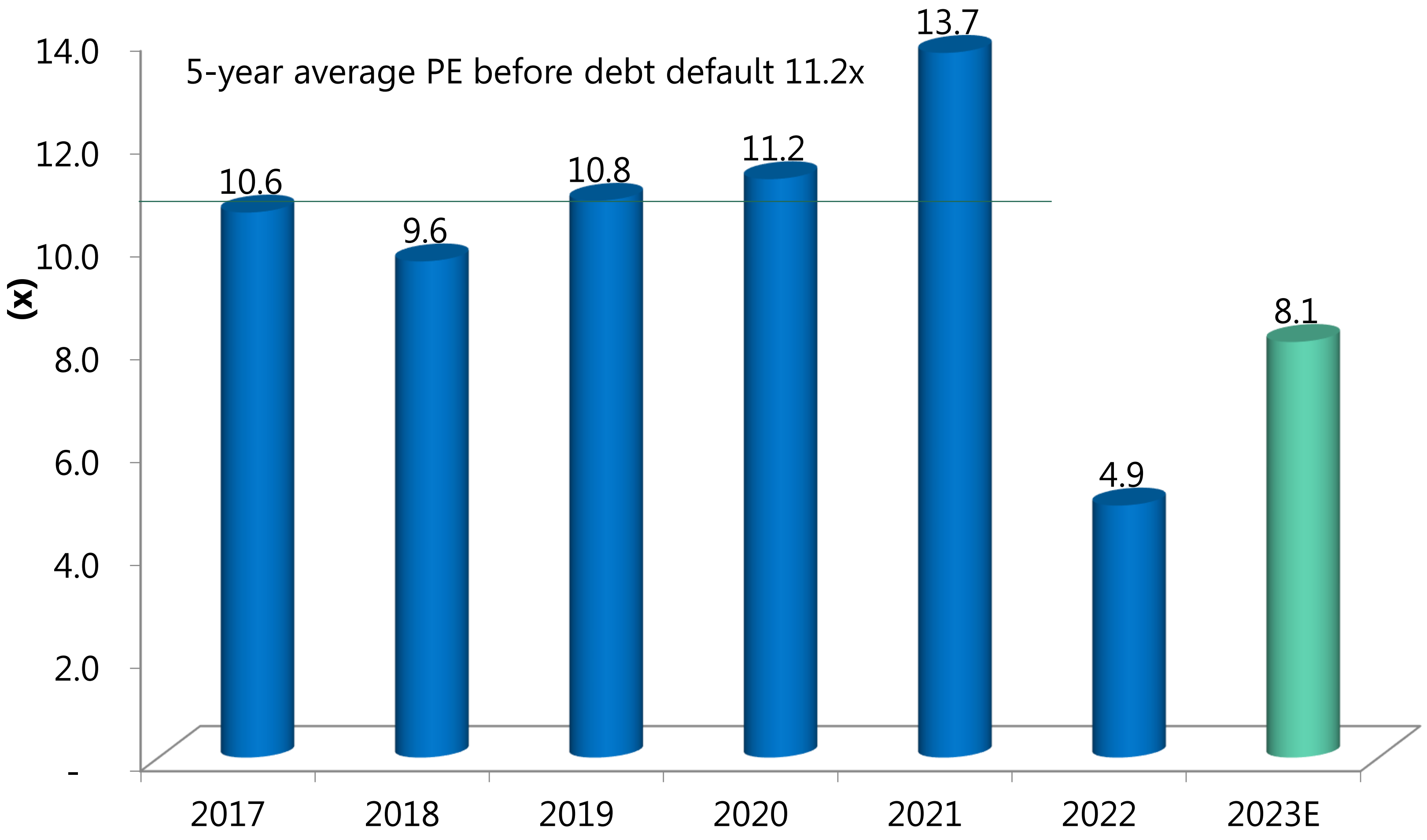
Main Catalysts for Equity Investments

Source: BRS Equity Research

Given the uncertain macro conditions we recommend investors to consider following points when making an investment decision.

- Identify counters with resilient demand and growth prospects.
- Avoid highly levered counters since interest rates are not likely to come down significantly although a gradual decline is anticipated.
- Explore high interest rate beneficiaries.
- Sectors which are expected to bounce back from poor performance in 2022 (low base effect).
- Consistent performers who withstood difficult periods for medium to long term.

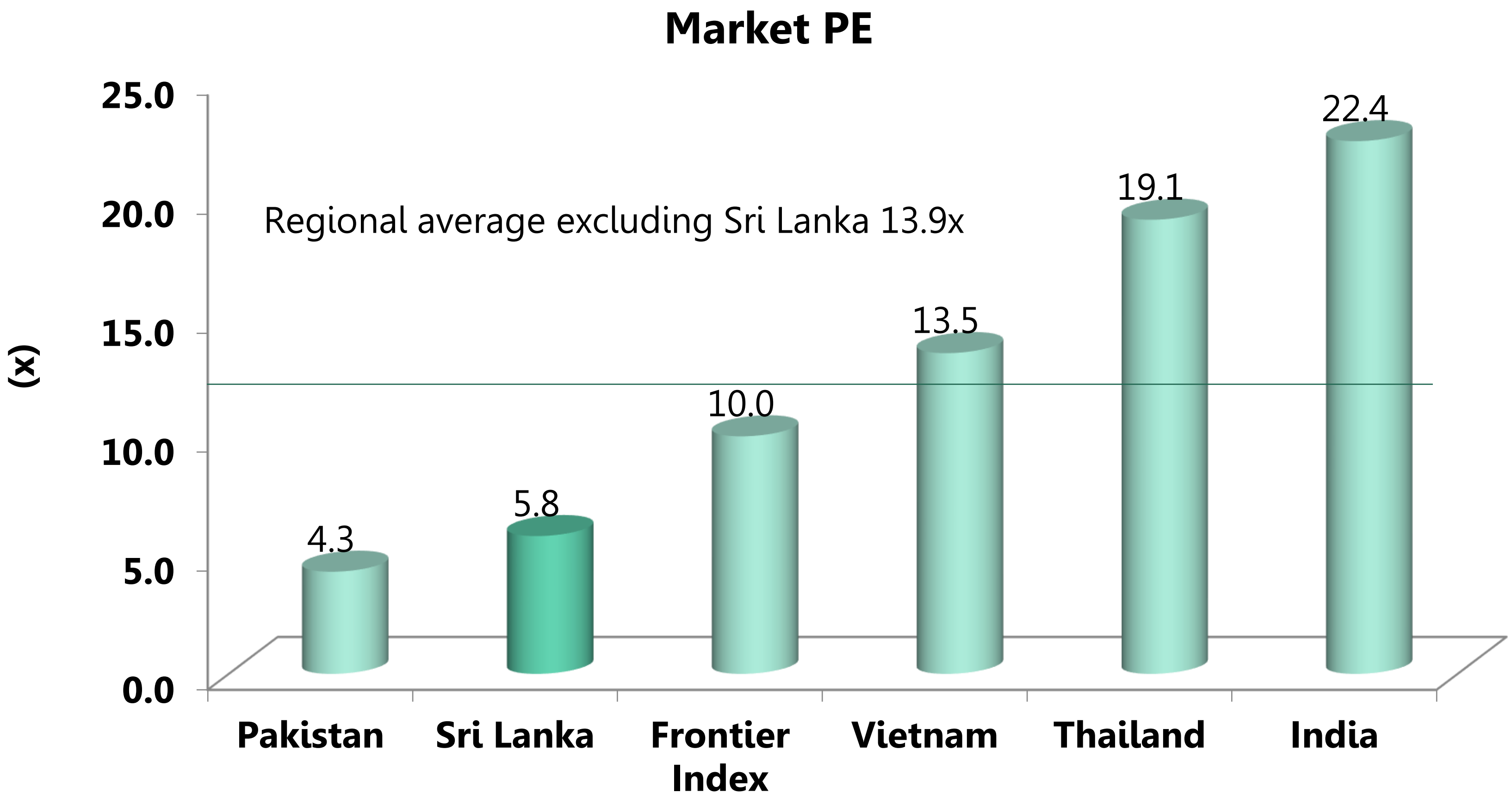
Forward PE stands at a discount to historical



The market PE stands at 8.1x on projected earnings for 2023E trading at a 28% discount 5 year average of 11.2x prior to economic crisis. This reflects the uncertainty premium attached over Sri Lanka's economic revival and debt restructuring. We believe improved sentiment post IMF board approval and eased off uncertainty towards debt restructuring along with gradual reduction of interest rates will rerate market valuations closer to past average. However, we attribute an implied PE of 10x to reflect the implications of hard reforms.

Source: CSE & BRS Equity Research

Sri Lanka Looks Relatively Cheaper compared to region



Sri Lanka is among the cheapest in terms of valuations in the region where forward PE (2023E) trades at a ~42% discount to the regional average of 13.9x. While better performing economies are naturally traded at premium multiples, we believe a justified multiple of 10x is more than fair for Sri Lanka as reflected by the frontier index which includes markets with weak macro fundamentals.

Source: Bloomberg & BRS Equity Research

ASPI Fair Value of 11,500 based on 2023E Projections

Based on a justified PE of 10x on 2023E earnings, market valuations indicate a 24% discount to fair value of overall market. Therefore, we assign an ASPI fair value of 11,500 for 2023E although decline in interest rates earlier than expected is likely to result in an upward revision for ASPI. Further, recovery of earnings in 2024E pave the path for further appreciation in market values.

	2023E	2024E
Forecasted Earnings	**LKR 497 bn**	**LKR 575 bn**
ASPI Fair Value	**11,500**	**13,500**

Source: BRS Equity Research

Positivity is Back with Bullish Sentiment

11 days EMA has taken over 22 days EMA and both 20,50 MA which indicates the bullish momentum and confirmed by other indicators of MACD, SAR and RSI (which is used as a momentum indicator). We believe positive sentiment will continue to drive the market amidst eased off uncertainty of IMF program and hard reforms.

Source: Investing.com & BRS Equity Research

Improved Sentiment to Drive ASPI to Its Projected Fair Value

Backed by relative valuation, we expect improved market activities to push the index to its fair value as discussed under equity strategy. However, volatility will continue to be theme of CSE providing trading opportunities.

Source: Investing.com & BRS Equity Research

Buy on Technical – Short Term Target 11,500 (+23%)

Based on a risk to reward ratio of 3, we recommend a long position on CSE with a fair value and trading projection of 11,500 which yields an upside of ~23% while setting a stop loss value of 8615 (stop loss ~8%). Trading discipline is key when taking short term positions.

Source: Investing.com & BRS Equity Research

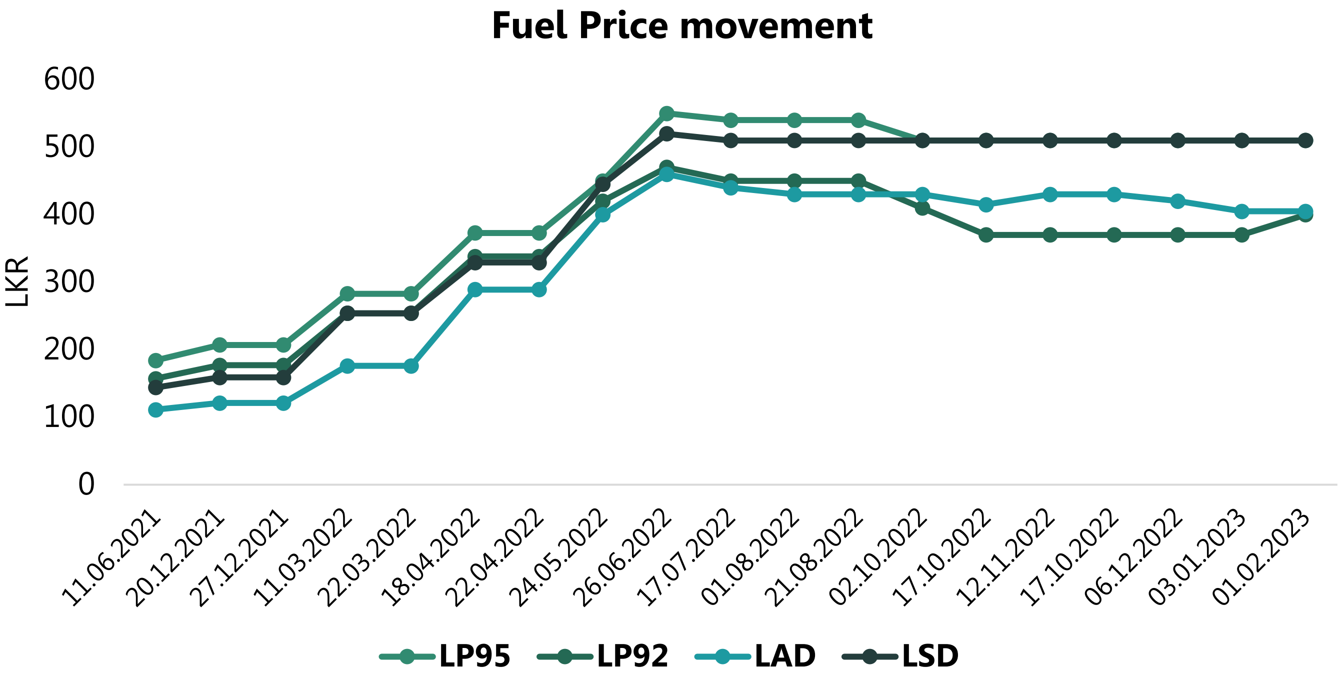
2023E Earnings to Contract by 25%

Sector	Market Capitalization (LKR Mn)	2022 Earnings (LKR Mn)	2023E Earnings (LKR Mn)	Earnings Growth (%)	TTM PER (x)	Forward PER (x)
Automobiles and Components	4,671.24	363.92	575.00	58.00	12.84	8.12
Banks	331,953.15	74,801.37	65,913.28	(11.88)	4.44	5.04
Capital Goods	625,396.98	128,884.03	51,508.36	(60.04)	4.85	12.14
Commercial and Professional Services	5,893.27	2,647.80	1,659.63	(37.32)	2.23	3.55
Consumer Durables and Apparel	75,422.13	5,720.75	11,134.35	94.63	13.18	6.77
Consumer Services	170,171.39	(11,646.84)	(7,958.90)	31.66	nm	nm
Diversified Financials	657,415.51	106,813.03	68,139.17	(36.21)	6.15	9.65
Energy	116,956.98	34,722.84	35,917.93	3.44	3.37	3.26
Food & Staples Retailing	96,335.96	11,422.57	6,306.68	(44.79)	8.43	15.28
Food, Beverage and Tobacco	841,381.80	191,903.68	137,441.53	(28.38)	4.38	6.12
Healthcare & Equipments	76,804.56	5,961.22	5,614.99	(5.81)	12.88	13.68
Household & Personal Products	8,991.07	999.23	1,260.01	26.10	9.00	7.14
Insurance	152,065.33	23,673.78	27,717.90	17.08	6.42	5.49
Materials	165,028.33	40,758.50	34,407.66	(15.58)	4.05	4.80
Real Estate	49,641.80	11,743.49	12,372.96	5.36	4.23	4.01
Retailing	51,409.00	1,224.39	4,092.92	234.28	41.99	12.56
Software & Services	4,427.13	633.72	608.61	(3.96)	6.99	7.27
Telecommunication Services	241,327.03	(28,655.70)	19,726.45	168.84	nm	12.23
Transportation	295,630.86	63,491.15	13,162.54	(79.27)	4.66	22.46
Utilities	44,950.40	1,430.95	7,501.01	424.20	31.41	5.99
Market	**4,015,873.90**	**666,893.89**	**497,102.07**	**(25.46)**	**6.02**	**8.08**

Source: CSE & BRS Equity Research

LIOC to spearhead the Energy Sector despite local macro condition

The Energy sector will continue to be a key beneficiary, despite economic headwinds, directly benefitting from the performance of LIOC. We believe the addition of 96 new sheds to be commissioned in 2023 and a possible expansion in fuel quota limit anticipated during the 2H of 2023 would add to topline, albeit operational expenses maybe on the higher end during the initial period. The blending of lubricants and greases locally will be steady contributors, which will be strongly supported by the wide distribution network.



Bunkering revenue has edged upwards in FY22 and will continue to be a key contributor, aided by Sri Lanka's strategic location. The initial commissioning of ten oil tanks in Trinco will enable LIOC (in terms of bunkering) to be in the competitive space, although benefits to accrue in the medium to long term. LIOC will benefit from higher net finance income by the reduction in short term debt by LKR 15bn to LKR 10.5bn whilst short term investments sored to LKR 21.7bn in 3Q FY23.

Source: Ceypetco, CSE & BRS Equity Research

Inelastic Demand on Sin Industries (CTC, DIST & LION)

With the tourism industry getting off to a good start in 2023 and global travel showing promise, we believe demand will see a gradual improvement making up for any loss in local consumption. The appreciation in rupee will augur well for imports of raw material in the beverage segment (ethanol). We believe, larger companies will keep cost at bay, minimizing any margin contraction. The healthy financial position of all three companies remains strong, giving higher leverage to withstand macro challenges.

The sin industry to a larger extent remains price inelastic, however, given the rapid deterioration in economic conditions, and additional taxes in terms of excise hikes, VAT and SCL, we believe consumer demand has declined, albeit trends suggest volumes normalizing after the initial drop. The decline in demand has been cushioned by steep price increases taken during 2022. Excise taxes will have to be kept at bay, with the government aware of cheaper alternatives and the illicit market growing rapidly. During an economic downturn CTC, DIST and LION remains a good dividend play.

Recent Excise Duty Revision on Cigarette and Liquor

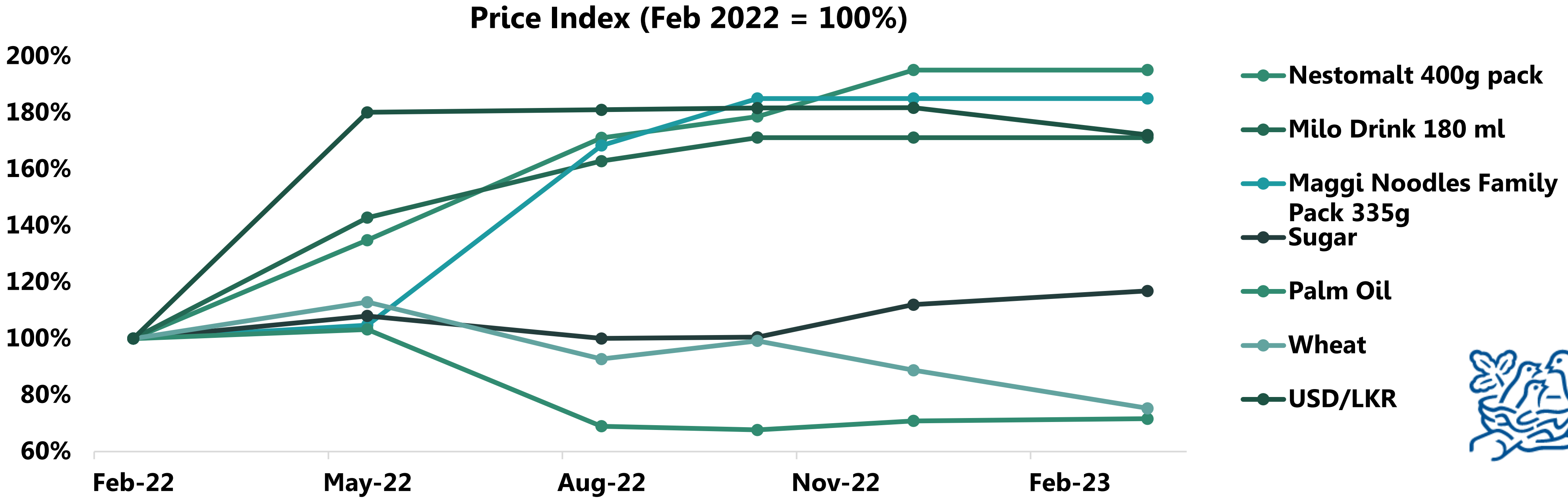
Stick Length	Current Price (LKR)	New Price (LKR)	Increase %
> 84 mm	90	105	17%
72mm - 84mm	85	100	18%
67mm - 72mm	70	80	14%
60mm - 67mm	60	70	17%
less than 60mm	15	24	60%

Type	Duty per bottle (LKR)	
	Existing	New
Special Arrack (750 ml)	1,050	1,256
Aged molasses, palm and coconut arrack	1,121	1,344
Locally brewed foreign liqour	1,309	1,576
Beer < 5% (625 ml)	103	124
Beer > 5% (625 ml)	194	233

Source: Ministry of Finance Media Release, CSE & BRS Equity Research

Consumer staples to remain defensive amidst inflationary pressures - NEST

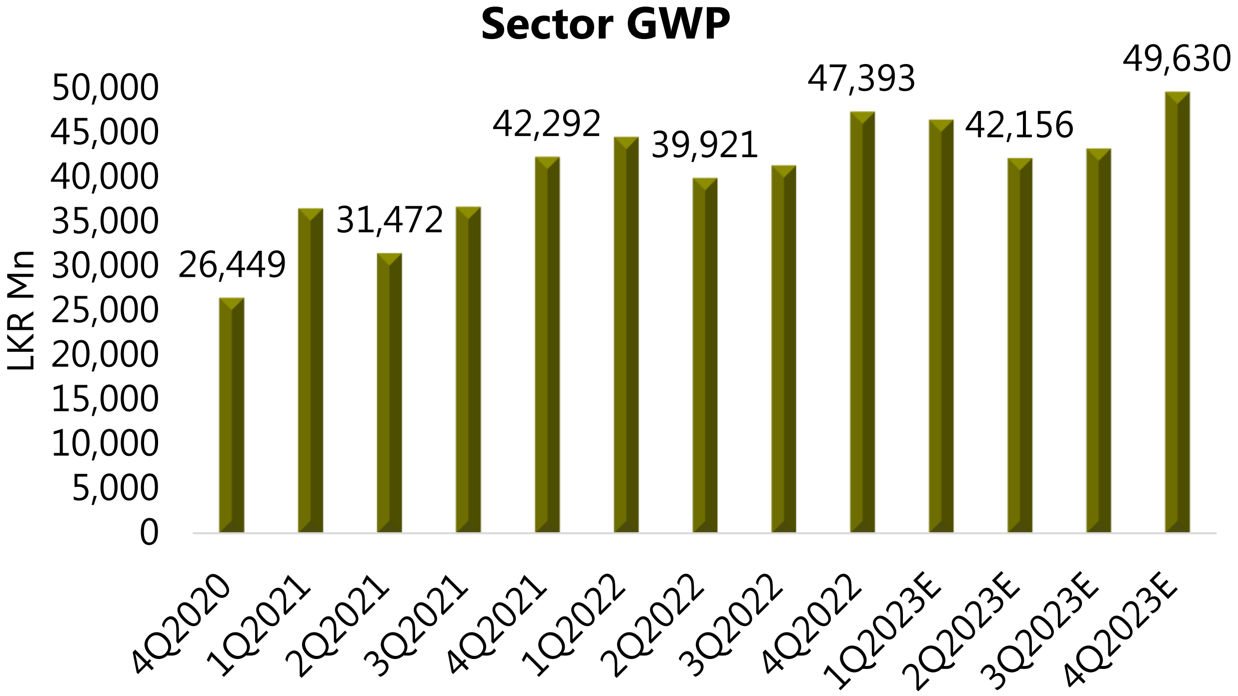
NEST posted consistent earnings amidst high food inflation that prevailed during the past year. Steady volumes were posted despite a slowdown in the 4Q 2022, amidst significant price increases being taken across their product portfolio. Lower price elasticity of their major brands catering to the household and child nutrition categories, Malt Beverages in which NEST holds market leadership gaining more traction with unavailability and higher prices of milk powder, Economies of scale and high level of general trade penetration will continue to bode well for NEST whilst also focusing on increasing their export revenue. The company margins will further benefit from easing of some key raw material prices in the global market (wheat and palm oil) and strengthening of the local currency.

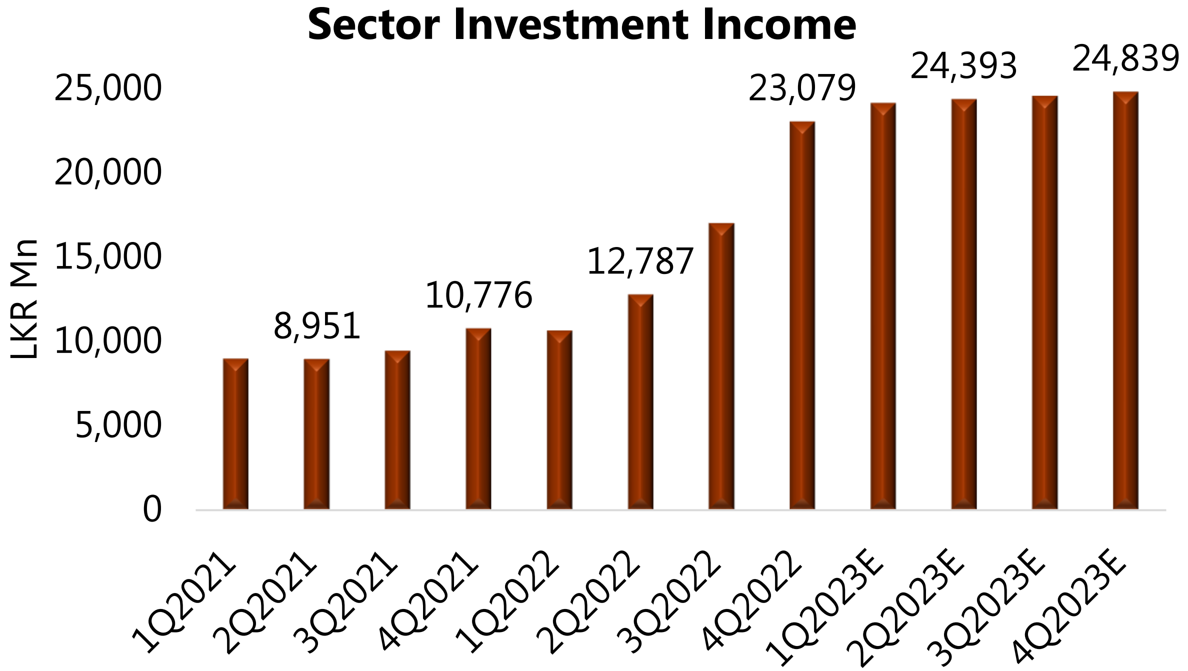


Source: BRS Equity Research, Trading Economics, Nasdaq

Insurance Sector to Benefit from Higher Interest Rates

Albeit a slowdown in consumer disposable income and vehicle import restrictions, we believe insurance sector GWP will continue to record a slight growth due to mandatory nature of vehicle insurance and increased awareness on the need for life insurance policies under uncertain and inflationary environment. The elevated interest rates will result in higher investment income cushioning the cost escalations. Further, change in insurance contract liabilities will continue to be lower at a higher discount rate as opposed to a lower rate. Therefore, we remain positive on insurance while skewing bit more towards life insurance for medium to long term.

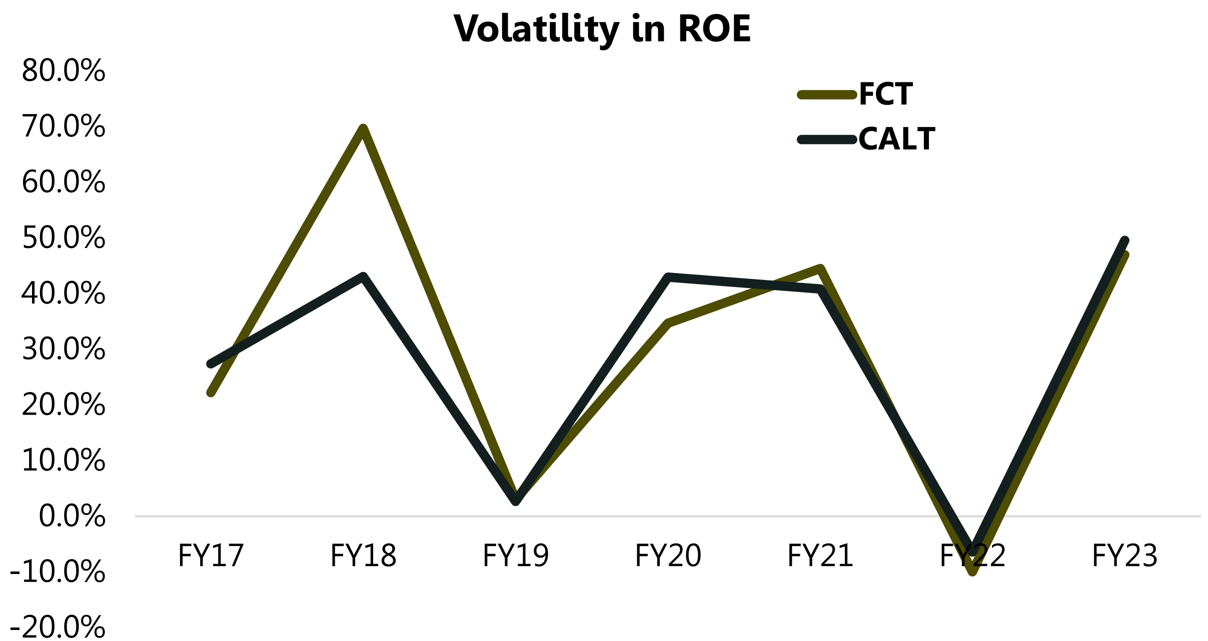




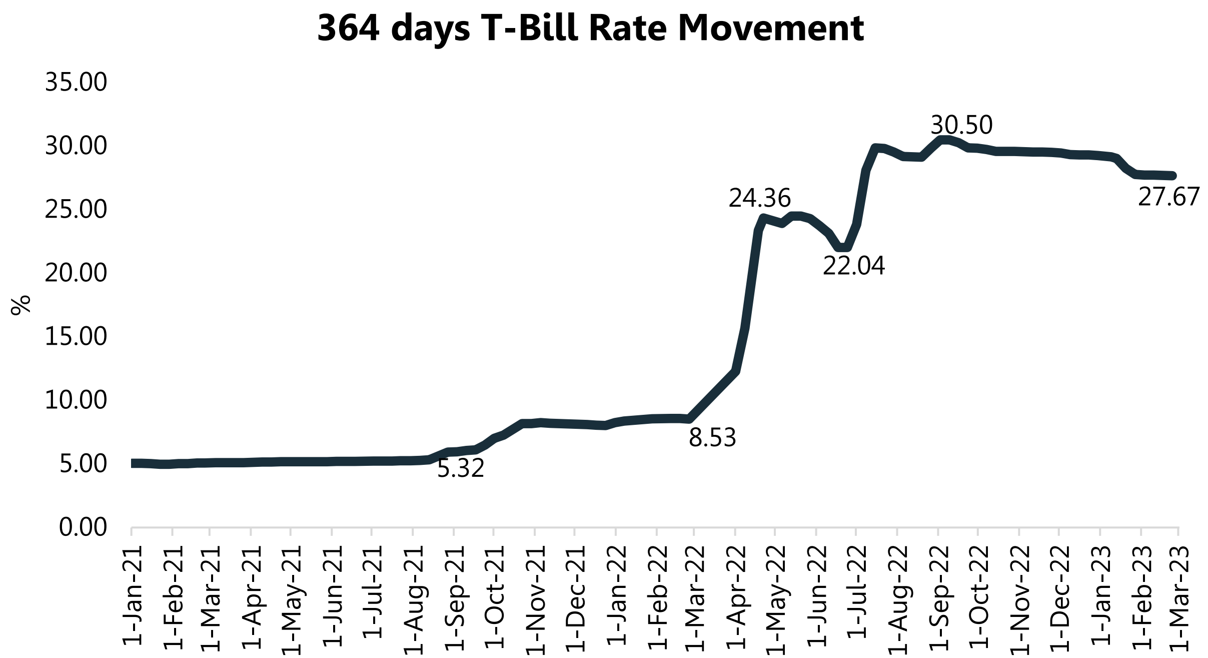
Source: CSE & BRS Equity Research

Tailor Made Environment for Primary Dealers

Rising yields of government securities gained the traction of investors expanding the balance sheet of primary dealers. Although higher interest rate environment generates higher net interest income, reduction in interest rates make significant trading and fair value gains for primary dealers. Therefore, we expect CALT, FCT, CFVF to benefit from reduction in interest rates as anticipated in 2H 2023E. However, it should be noted that earnings of primary dealers are quite volatile and depend on interest rate cycle. Therefore, may not be suited for investors who expect consistent earnings with less volatility.



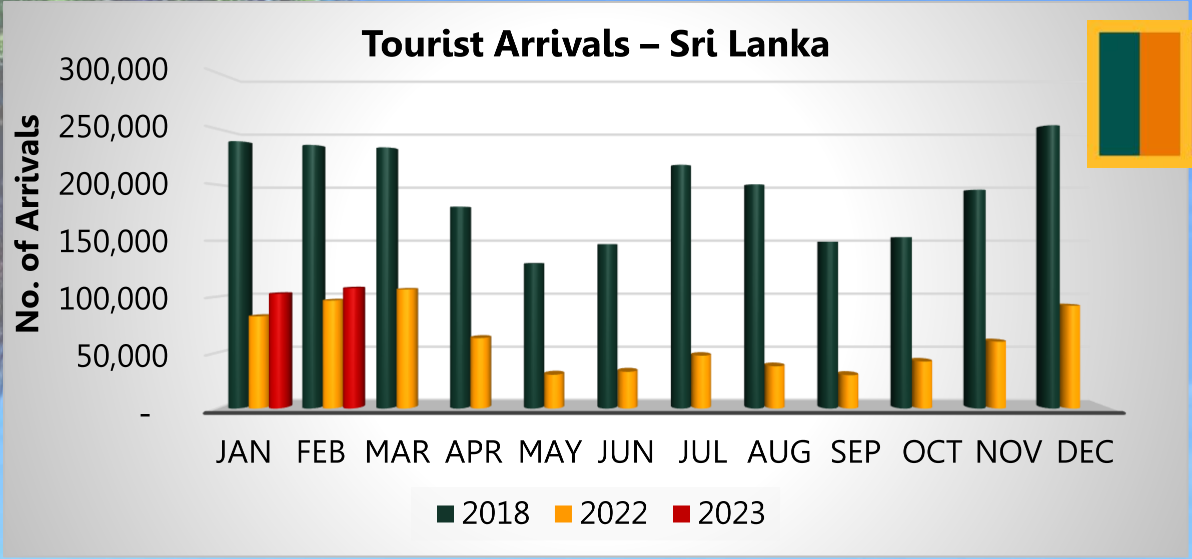
*FY23 ROE is annualized on 9M FY23 earnings

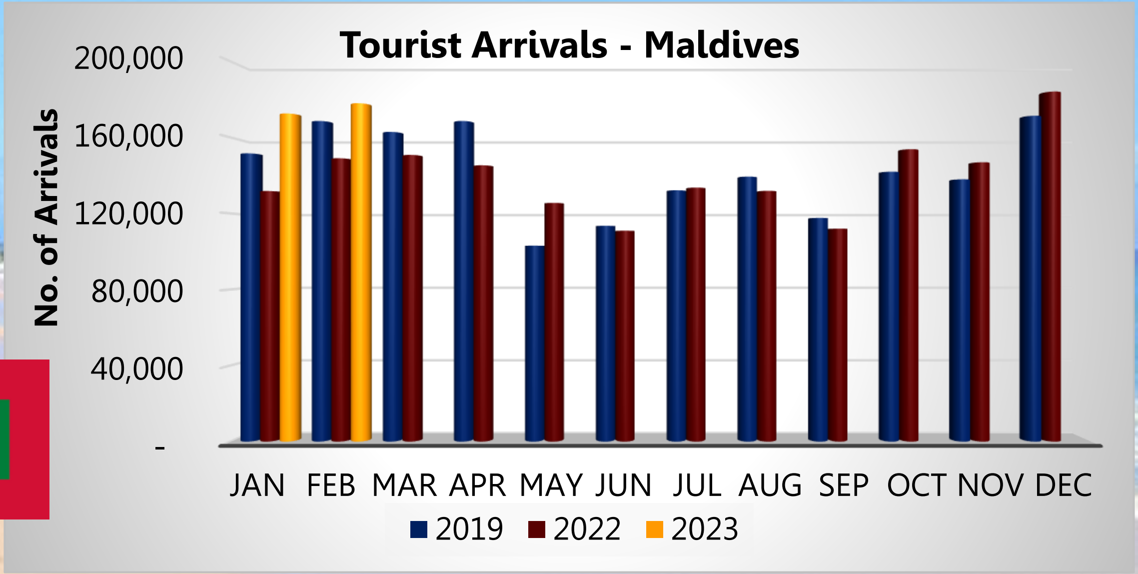


Source: CSE & BRS Equity Research

Hopeful Revival of Tourism to Slowdown the Bleeding

Revival of tourism in Sri Lanka delayed due to the difficulties of power cuts, fuel shortages, social unrest and political instabilities painting a negative picture towards Sri Lanka while Maldives tourism rebounded to pre pandemic level. Given the positive turnaround in terms of handling fuel shipments and uninterrupted power supply, we believe tourism in Sri Lanka will gradually pick up albeit remaining below pre pandemic level. Moreover, counters with exposure to Maldives will aid in posting higher earnings amidst higher occupancies. Further, Sri Lanka will be focus on attracting tourists with cheaper product offerings while higher finance and operational costs are likely to add pressures on earnings. Hence, we do not expect Sri Lankan tourism earnings to reach pre pandemic level in 2023E.





Source: SLTDA, Ministry of Tourism Republic of Maldives, BRS Equity Research

Low Geared Companies

Ticker	Total Debt(LKR Mn)	AWPLR (%)	Implied Cost (LKR Mn)	TTM Earnings (LKR Mn)	Debt to Assets (%)	Debt to Equity (%)	As a % of TTM Earnings
RENU	1.2	24.2	0.3	4,180.5	0.0	0.0	0.0
RCH	1.6	24.2	0.4	3,668.3	0.0	0.0	0.0
TAFL	3.1	24.2	0.8	659.0	0.0	0.1	0.1
BOGA	4.3	24.2	1.0	664.3	0.2	0.3	0.2
CABO	1.2	24.2	0.3	136.1	0.1	0.1	0.2
TSML	5.0	24.2	1.2	345.0	0.2	0.3	0.4
APLA	15.3	24.2	3.7	926.9	0.5	0.5	0.4
CTC	488.0	24.2	118.3	20,273.0	1.2	2.8	0.6
ASPH	11.2	24.2	2.7	262.6	0.8	0.9	1.0
SHAW	25.0	24.2	6.1	503.3	0.4	0.5	1.2
VPEL	42.6	24.2	10.3	555.7	1.1	1.4	1.9
HBS	54.8	24.2	13.3	633.7	2.0	2.6	2.1
KCAB	284.1	24.2	68.9	3,059.1	2.6	3.3	2.3
LLUB	393.1	24.2	95.3	3,670.7	3.0	6.4	2.6
CTEA	1,197.3	24.2	290.2	10,462.0	4.0	5.0	2.8
DIST	2,074.5	24.2	502.9	15,917.3	6.9	30.8	3.2
CSD	32.6	24.2	7.9	239.0	0.5	0.6	3.3
TPL	322.8	24.2	78.2	2,007.7	3.7	6.4	3.9
AGST	314.1	24.2	76.1	1,751.1	2.7	4.5	4.3
ACL	1,350.7	24.2	327.4	7,512.6	3.9	5.9	4.4
WATA	642.2	24.2	155.7	3,390.1	7.3	9.7	4.6
NAMU	531.2	24.2	128.8	2,726.5	5.2	6.9	4.7
ECL	12.9	24.2	3.1	65.5	2.3	3.2	4.8
SOY	133.7	24.2	32.4	587.5	2.5	5.6	5.5

Source: CSE & BRS Equity Research

*** Sorted based on implied cost as a % of TTM earnings**

High Dividend Yielding Companies

Rank	Stock	MPS (LKR)	YTD Change	TTM EPS (LKR)	TTM PER (X)	BVPS (LKR)	P/BV (X)	ROE (%)	DPS (LKR)	DY %
1	HPWR	13.70	16.10%	2.97	4.61	21.92	0.62	14.26	3.00	21.90%
2	TILE	45.20	-1.95%	15.08	3.00	52.17	0.87	30.88	6.50	14.38%
3	LITE	14.20	-0.70%	2.74	5.18	10.42	1.36	26.84	2.00	14.08%
4	CTC	680.00	8.80%	108.22	6.28	93.41	7.28	155.30	89.00	13.09%
5	NEST	1,073.00	18.56%	113.09	9.49	199.95	5.37	65.75	130.00	12.12%
6	DIST	21.10	59.85%	3.46	6.10	1.46	14.42	245.91	2.20	10.43%
7	TPL	81.90	-16.26%	42.27	1.94	106.71	0.77	42.70	8.00	9.77%
8	TYRE	58.10	0.17%	4.53	12.84	75.40	0.77	5.72	5.00	8.61%
9	PACK	15.70	19.85%	4.51	3.48	7.60	2.07	64.07	1.35	8.60%
10	ASIY	4.20	2.44%	0.94	4.45	3.77	1.11	25.33	0.35	8.33%
11	WATA	72.00	-2.70%	16.67	4.32	32.45	2.22	51.02	6.00	8.33%
12	SAMP	57.00	66.67%	12.29	4.64	118.45	0.48	10.85	4.60	8.07%
13	OSEA	15.50	4.03%	4.89	3.17	41.67	0.37	12.07	1.25	8.06%
14	KVAL	69.60	-14.81%	39.88	1.75	103.88	0.67	40.65	5.50	7.90%
15	SEYB(X)	26.20	61.73%	7.92	3.31	198.80	0.13	8.42	2.00	7.63%
16	DIPD	29.50	1.37%	13.48	2.19	45.86	0.64	31.65	2.25	7.63%
17	COMB(X)	60.20	45.76%	19.21	3.13	168.47	0.36	12.22	4.50	7.48%
18	HASU	50.10	16.78%	12.20	4.11	51.99	0.96	25.53	3.65	7.29%
19	HAYC	59.00	2.43%	22.64	2.61	75.80	0.78	31.74	4.25	7.20%
20	PARQ	15.80	0.64%	(0.31)	nm	19.40	0.81	(1.43)	1.10	6.96%
21	MELS	60.00	29.87%	19.33	3.10	83.98	0.71	24.36	4.05	6.75%
22	HPL	22.40	-7.44%	9.21	2.43	16.54	1.35	57.63	1.50	6.70%
23	COLO	75.20	12.07%	(33.36)	nm	228.16	0.33	(15.06)	5.00	6.65%
24	COMB	70.10	39.64%	19.21	3.65	168.47	0.42	12.22	4.50	6.42%
25	REXP	561.50	-6.42%	182.31	3.08	388.62	1.44	50.50	35.00	6.23%

Source: CSE & BRS Equity Research

Contributors to ASPI Movement in 2023 YTD

Top 20 Positive Contributors			
Rank	Stock	Points	Index Mov %
1	TL	71.05	9.22
2	DIST	63.65	8.26
3	SAMP	47.65	6.18
4	COMB	41.70	5.41
5	MELS	36.51	4.74
6	CTC	30.15	3.91
7	HNB	28.37	3.68
8	BUKI	27.39	3.55
9	NEST	20.36	2.64
10	LION	16.47	2.14
11	HAYL	14.68	1.90
12	SPEN	12.93	1.68
13	PLC	12.54	1.63
14	UAL	12.20	1.58
15	DFCC	10.96	1.42
16	LFIN	10.84	1.41
17	HEMS	10.59	1.37
18	SINS	10.51	1.36
19	VONE	10.11	1.31
20	NTB	9.36	1.21

Top 20 Negative Contributors			
Rank	Stock	Points	Index Mov %
1	NIFL	129.13	16.75
2	LOFC	89.52	11.61
3	BIL	29.43	3.82
4	EXPO	14.46	1.88
5	SFCL	12.42	1.61
6	CARG	8.50	1.10
7	HUNA	7.30	0.95
8	RICH	7.19	0.93
9	CIC	6.30	0.82
10	LIOC	4.24	0.55
11	JETS	4.18	0.54
12	NHL	4.17	0.54
13	CCS	3.67	0.48
14	LGILN	3.55	0.46
15	CRL	3.47	0.45
16	BRWN	2.90	0.38
17	CTEA	2.90	0.38
18	COOPN	2.63	0.34
19	CINS	2.57	0.33
20	AGST	2.31	0.30

Source: Bloomberg & BRS Equity Research

BRS Top Picks

	MPS (LKR)	TTM EPS (LKR)	TTM PER (X)	2023E EPS (LKR)	Forward PER (X)	BVPS (LKR)	P/BV	ROE (%)	DPS (LKR)	DY
AHPL	40.30	(0.44)	nm	1.52	26.57	70.40	0.57	(0.62)	-	0.00%
CINS	2,100.00	478.65	4.39	619.17	3.39	2,863.17	0.73	17.47	-	0.00%
CINS(X)	1,074.75	478.65	2.25	619.17	1.74	2,863.17	0.38	17.47	-	0.00%
CTC	680.00	108.22	6.28	140.48	4.84	93.41	7.28	155.30	89.00	13.09%
DIST	21.10	3.46	6.10	3.70	5.70	1.46	14.42	245.91	2.20	10.43%
HASU	50.10	12.20	4.11	16.59	3.02	51.99	0.96	25.53	3.65	7.29%
KHL	18.10	(0.04)	nm	0.86	21.09	22.04	0.82	(0.17)	-	0.00%
LIOC	200.50	63.65	3.15	66.18	3.03	100.67	1.99	86.09	-	0.00%
LION	694.75	89.86	7.73	115.11	6.04	277.08	2.51	35.05	13.60	1.96%
NEST	1,073.00	113.09	9.49	198.50	5.41	199.95	5.37	65.75	130.00	12.12%

Source: CSE & BRS Equity Research

Core Coverage Update

TJL

We believe the medium-term outlook for TJL to be positive despite sluggish global demand weighing down on near term earnings. TJL will be geared to cater to improved demand particularly in synthetics with their expanded capacity as global conditions improve from latter part of 2023. China plus one strategy also stands to benefit TJL in the medium to long term. While the company maintains a strong balance sheet we believe near term risks are already factored into the current price.

SUN

While shrinking consumer spending will continue to impact SUN's Healthcare and Tea volumes in the near-term, confectionary segment will remain steady benefitting from scarcity of foreign products in the market. Healthcare volumes particularly in the chronic care segment will remain more resilient while pharma manufacturing volumes are expected to improve in the backdrop of decreased pharma imports. Tea export business is expected to improve on margins as tea auction prices settle down towards mid 2023. Albeit global CPO prices have been range bound as of late, local prices will continue to be cushioned by the SCL placed on imports and LKR depreciation.

Source: CSE & BRS Equity Research

Core Coverage Update

HHL

Healthcare and Consumer segments the largest contributors to HHL's top and bottom line will continue to be steady performers as displayed by resilient earnings amidst tough conditions. Local drug manufacturing by subsidiary Morison adds medium to long term potential in the backdrop of the shortage of imported pharmaceuticals in the local market. We believe the consumer segment will come back stronger with resumption in economic activity whilst easing of both global commodity prices and inflationary pressure will aid their margins in the near term.

Hemas Holdings PLC

JKH

Revival of tourism in both Maldives and Sri Lanka will ease off the leisure sector bleeding although challenging macro conditions will keep majority of the sectors under pressure. Regularization of Casino industry paves the path for Cinnamon Life gaming facility and positioning Cinnamon Life as a commercial hub. Retail and Financial Services are likely to remain resilient with essential nature of the products. However, lower consumer disposable income may lower demand for consumer foods. Transportation sector may experience challenges due to weak global trade activities and rupee appreciation. Higher interest rates to elevate finance costs putting further pressure on earnings.

John Keells Group

Source: CSE & BRS Equity Research

Core Coverage Update

EXPO

The transportation sector, predominantly led by EXPO has seen a contraction in bottom line during 2Q and 3Q FY23, after an undeterred stint since 2020. With the pandemic led hype easing off and pressure on capacities plummeting, freight rates have seen a free fall almost nearing pre pandemic levels. We believe, the global recessionary environment will keep demand subdued during the year, albeit EXPO's continuous strategic investments in the North American market will reap intended benefits in the medium term.

Freightos Baltic Index

Global Container Index

Global Air Index

Core Coverage Relative Valuation

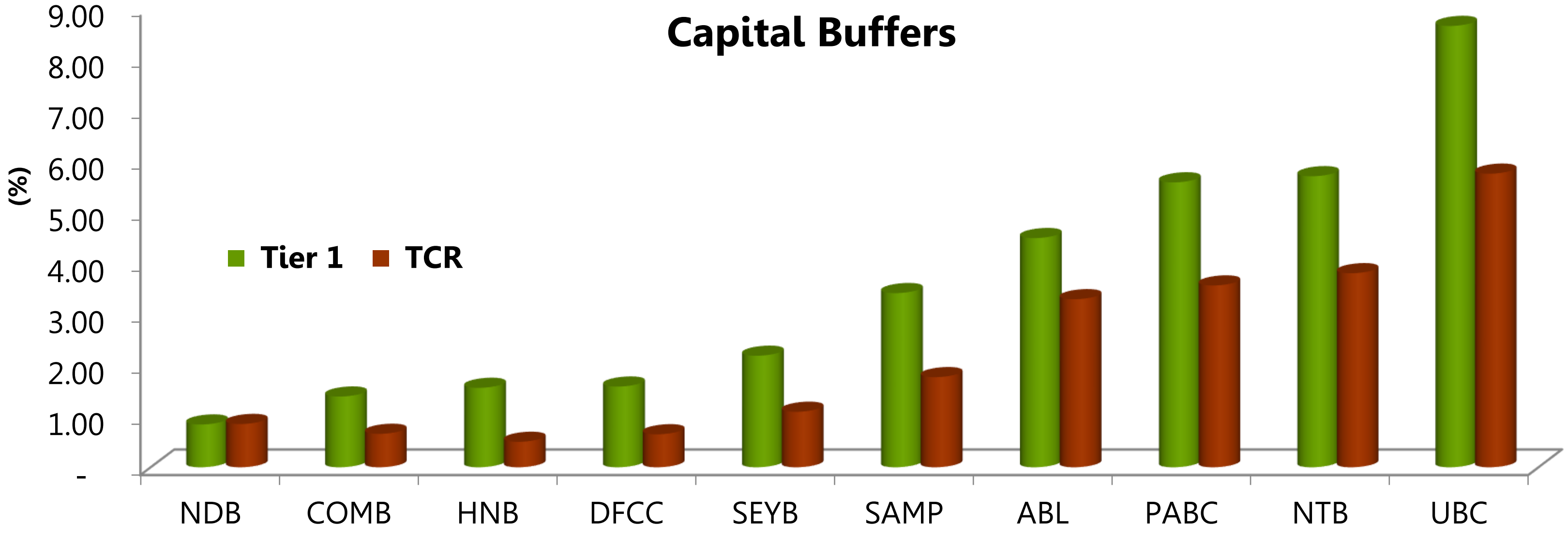
	MPS (LKR)	TTM EPS (LKR)	TTM PER (X)	2023E EPS (LKR)	Forward PER (X)	BVPS (LKR)	P/BV	ROE (%)	DPS (LKR)	DY
EXPO	150.75	32.47	4.64	6.73	22.41	82.72	1.82	42.90	8.19	5.43%
HHL	67.90	7.16	9.48	10.42	6.52	59.70	1.14	12.17	0.40	0.59%
JKH	140.25	18.61	7.54	10.69	13.12	262.97	0.53	7.43	1.50	1.07%
LLUB	95.00	15.29	6.21	19.59	4.85	25.68	3.70	60.89	5.00	5.26%
SUN	44.40	6.32	7.03	5.65	7.85	32.42	1.37	20.94	2.25	7.68%
TJL	33.70	3.91	8.62	5.93	5.68	50.52	0.67	8.18	1.25	8.28%

Source: CSE & BRS Equity Research

Situational Update

Resilient Banking Sector to be Tested Again

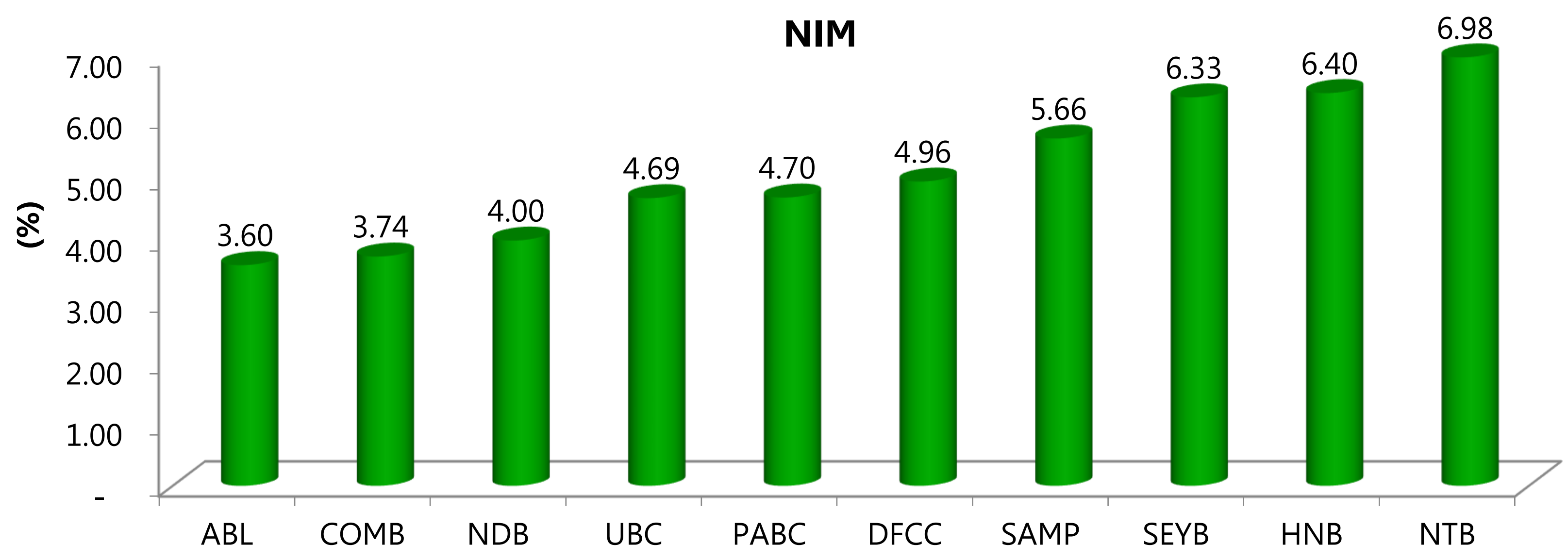
Banking sector made heavy impairment provisions led by foreign debt default by GoSL along with weak asset quality. However, higher topline through net interest income and other operating income partially offset the negative effect. We believe banks have taken prudent measures in terms of impairing ISB investments although a possibility of a domestic debt restructuring (DDR) cannot be completely ruled out. Hence, uncertainty of debt restructuring process remains a key bottleneck while private sector credit growth is expected to remain muted in 1H 2023E and gradual easing of monetary tightening will aid a recovery in 2H 2023E. Capital ratios are under pressure in the event of further deterioration in asset quality and domestic debt restructuring. Although current prices present attractive entry points for medium to long term, banking sector is set to be tested again amidst debt restructuring and economic crisis.



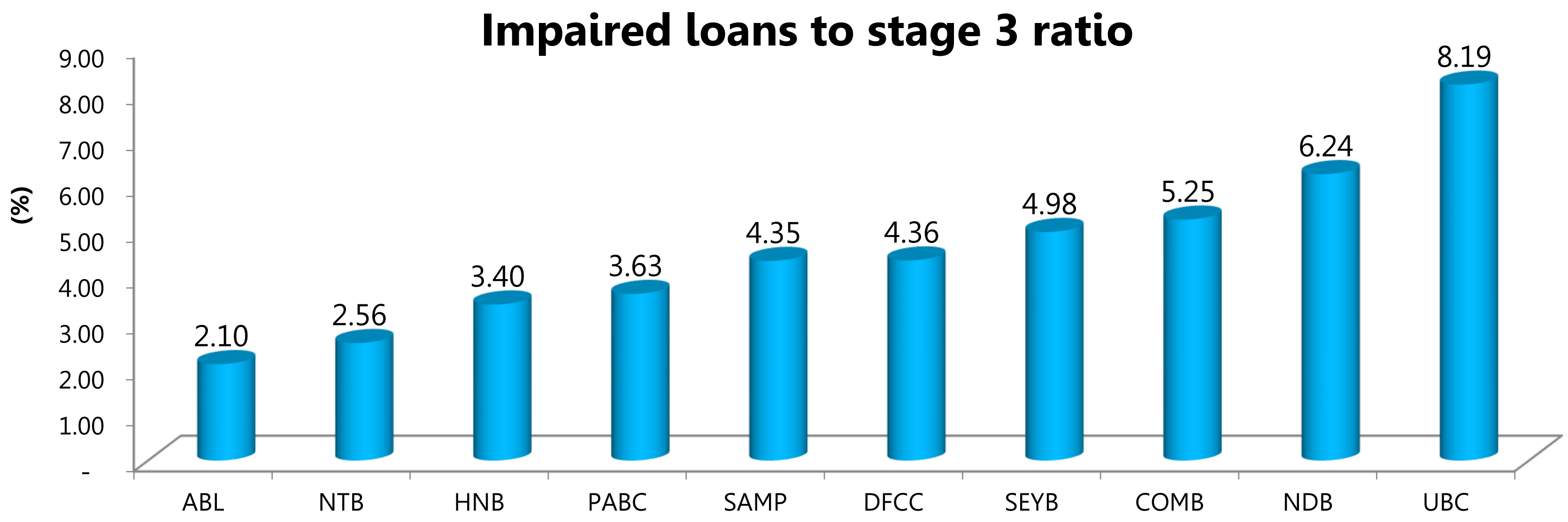
Capital buffers of listed licensed commercial banks above minimum requirements. NDB, COMB and HNB had the lowest capital buffers as of 31st December 2022.

Source: CSE & BRS Equity Research

Banking Sector Asset Quality vs Profitability



NIM remained higher amidst higher interest income albeit the rising deposit costs.

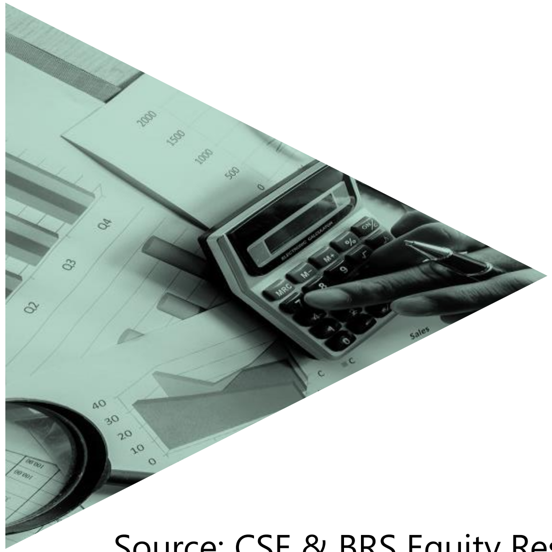


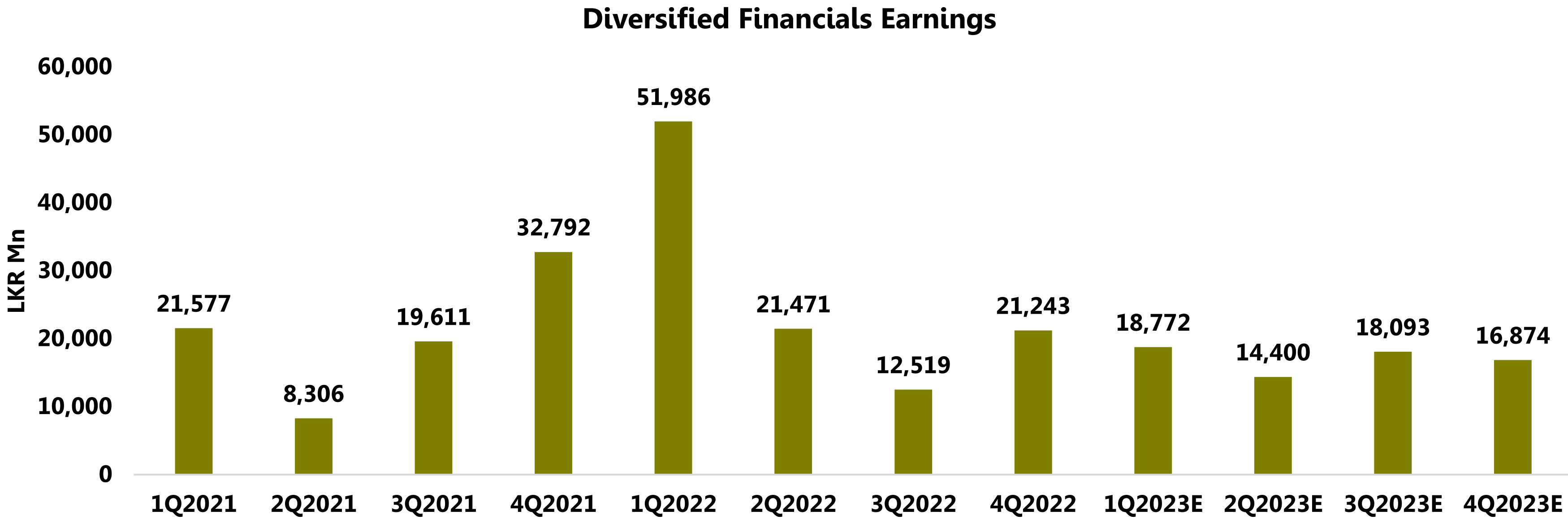
Asset quality continues to deteriorate amidst weak macro conditions led by lower consumer disposable income, tightened fiscal and monetary stances.

Source: CSE & BRS Equity Research

Economic Contraction to Keep NBFI Sector Subdued

NBFI sector felt earnings pressure due to rising deposit cost amidst higher interest rate environment while loan book remained broadly flat given the distressed business and leasing segments. Although NBFI sector do not have large exposure to ISBs and SLDBs, effects of an DDR could be severe on the sector. Further, growth of loan book is correlated with economic activities as NBFI sector has relatively larger exposure towards SMEs which is feeling the pinch of higher interest rates, lack of demand and supply chain disruptions. We believe slowdown in economic activities along with higher interest rates will keep NBFI sector subdued although revival of economic activities in 2024E likely to aid the sector bouncing back. Therefore, we recommend relatively larger finance companies with proven track record for long positions, however at attractive entry points. We believe PBV could be employed as an appropriate valuation methodology for the sector.





Source: CSE & BRS Equity Research

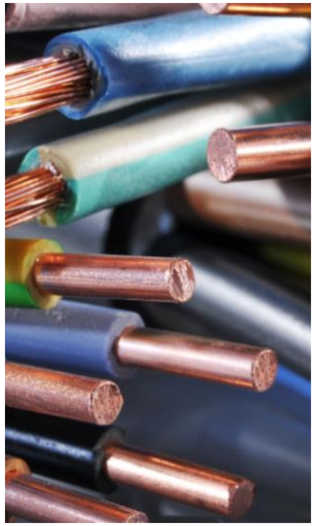
Construction Related Sectors

Tile Sector

Despite the import restrictions still in place for ceramic tiles, an overall contraction in domestic market has impacted sales. We believe the higher ASP aided revenue growth in the previous quarters, albeit, market contraction coupled with costs escalations, higher finance costs and tax expenses will hamper margins during the year. The introduction of Social Contribution Levy (2.5% of revenue), higher VAT (12% to 15%) and corporate tax (18% to 30%) added to demand contraction. We believe, RCL, TILE and LWL will focus on the export market, with special emphasis on mosaic tiles for the US market. However, domestic sales still make up over 90% of revenue, with the immediate impact being inevitable. .

Construction/Cement/Aluminium and Cable Sector

An overall contraction in the local market (due to higher inflation, interest rates and taxes) coupled with a standstill or discontinuation of large-scale government projects has hampered demand, reflecting in the 3Q FY23 results of construction related counters (TKYO, AEL, TILE, LWL, RCL, ACL, KCAB, ALUM and PARQ) albeit previously receiving a cushion from higher ASP. We believe, the construction industry will remain muted with activity to gradually pick up towards the latter part of the year. AEL performance too will remain subdued, impacted by larger ongoing project cashflows coming in smaller tranches while progression in development will be directly linked to economic growth.



Source: CSE & BRS Equity Research

Construction Related Sectors Cont…

Cement demand which is directly inked to construction activity, will continue to see slower demand, despite absorbing the increase in taxes (3% in VAT and 2.5% of SCL) while prices have been reduced gradually adjusting for global freight charges and production costs. This outlook is to continue in the short to medium term.

The Aluminium and cable sector too will look at the export market favourably, although operating in a highly competitive space. Higher finance costs and taxes will have an overall impact on most companies. ALUM and PARQ (swisstek Alumimium) have higher capacities and believe penetrating regional markets will be an option, although results to be reaped in the medium term. ACL although seeing a topline contraction has managed costs while also partially reducing the debt exposure, which will aid in minimizing margin contraction.

The recent appreciation in rupee will augur well for most companies in terms of declining raw material (aluminium, copper and clinker) and energy (LPG and kerosene) import costs, which will aid in controlling margin contraction in the near term. Medium term benefits could include re pricing to better suit consumer affordability with a possible uptick in demand anticipated.

Source: CSE & BRS Equity Research

Renewable Energy the Way Forward

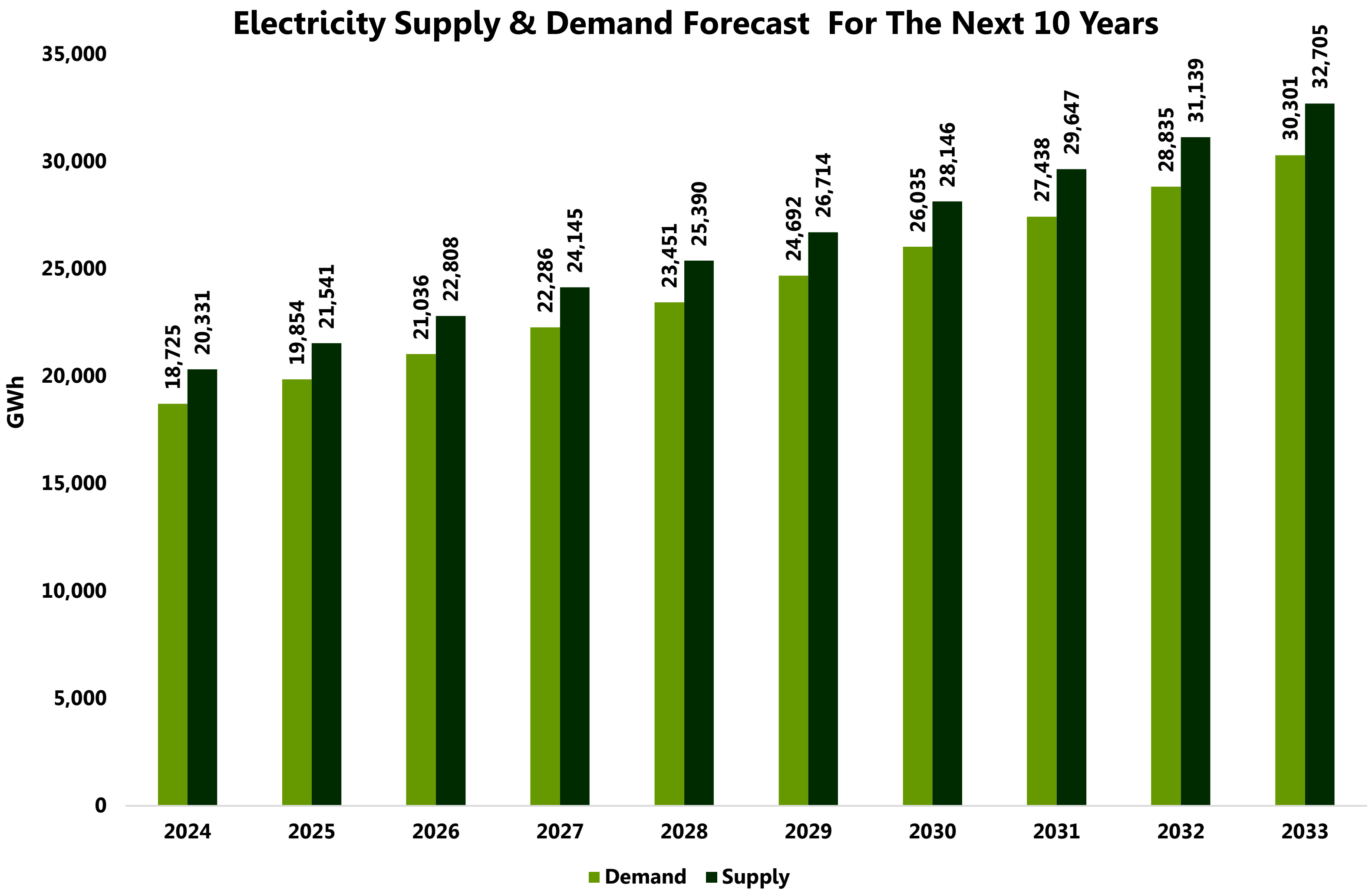
Despite local renewable power producers grappling with escalating dues from the CEB, we believe the sector would be resilient in 2023 aided by contributions from renewable companies with foreign exposure. LVEF, WIND and VLL have diversified portfolios and believe this would ease the pressure on performance.

We believe, the successive hikes in consumer electricity tariffs in August 2022 (+75%) and February 2023 (+67%) would ease payment pressures from the CEB to Independent Power Producers (IPP), albeit, the payments are lagging over one year. According to industry sources, the substantive hike may slowdown the collection and consumption initially due to the present economic conditions, however, believe this situation will gradually improve during the year ahead.

Sri Lanka is facing a power crisis and needs larger renewable projects to cater to the growing demand at comparatively affordable prices. While the government is reaching out to local and domestic investors, we believe these pave opportunities for local companies to diversify into wind and solar projects. However, the success of rolling out projects would depend on the timelines initiated by the Government, which has been a bottleneck for the industry in the past.

Source: CSE & BRS Equity Research

Renewable Energy the Way Forward



****The above Supply & Demand chart prepared considering the base demand forecast of the 2022-2046 Expansion Plan**

When preparing the Electricity demand forecast CEB consider the following determinants :

- National economic development
- National population growth
- Increase in Electricity tariff consumer account
- Increase of per capita income etc.

When Preparing the electricity demand forecast CEB also consideres the phase development of large-scale projects. Ex: Port City

Electricity demand forecast is revised once in two years with the revision of Long Term Generation Expansion Plan.

Source : CEB Long Term Generation Expansion Plan 2022 - 2041

Materials Sector

Increased operational costs particularly energy costs will pose a greater risk for the manufacturing counters in the sector.

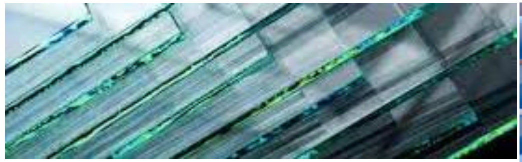
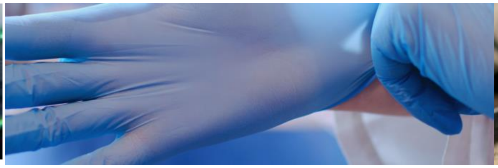
CIC: Impaired purchasing power and decline in consumption will impact the demand in all key sectors. However, we remain optimistic on the Agri and Crop care segments as cultivation levels improve for the next season. Livestock and Health & Personal Care will also be positive contributors whilst a slowdown can be expected in the industrial segment.

GLAS: Diversified industry client base and market monopoly will bode well for GLAS.

DIPD: Seeking new markets and diversification strategies in the face of slowing global demand. Plantation earnings expected to moderate.

HAYC: Potential for higher margins in value added activated carbon solutions across a range of industries and applications. Environmental engineering segment expected to return to profitability with improved economic conditions towards latter part of 2023 or early 2024.

LLUB: Near term volume contraction with depleting consumer income and vehicle import restrictions. Exports expected to see a gradual expansion (currently 6% of revenue). Maintain market leadership position.


Plantations

The outlook remains neutral for the sector following a slowdown in exceptional earnings recorded in mid 2022. While topline has been impacted in all key plantation crops, high finance costs and elevated tax expenses have weighed down further on bottomline performance. Strengthening of the Rupee will also be a decisive factor in maintaining high earnings from the sector.

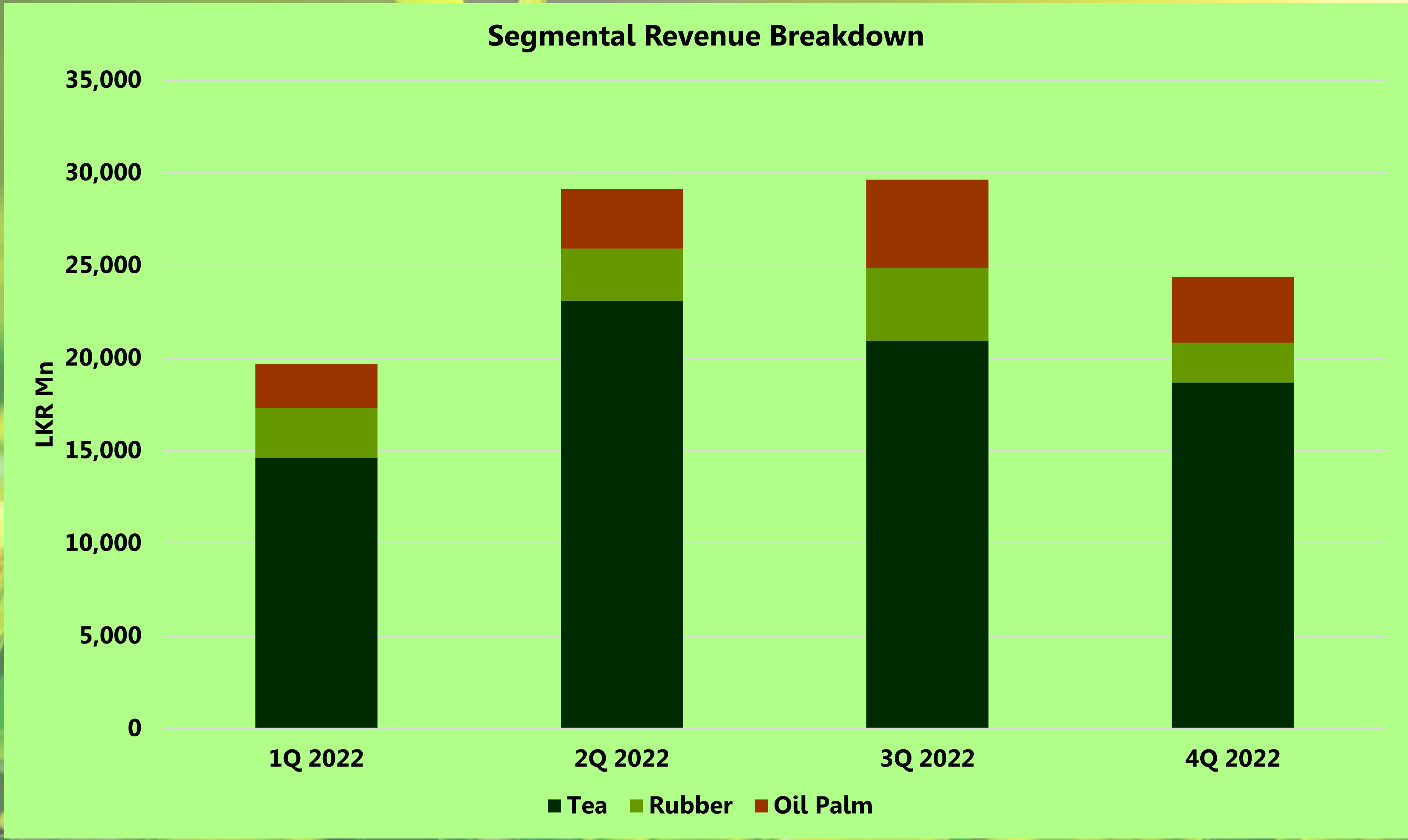
- Tea production output is expected to bounce back in 2023 following a rather dismal performance in the preceding year. While the industry does not expect Tea prices to show a drastic change for the 1H 2023 and for demand supply dynamics are expected to determine prices largely thereafter.

- Rubber prices which hit all-time highs mid 2022, saw a steep correction during the final quarter. NSAs dropped in the face of decreased demand from industries also reflecting the slowdown in global demand. Prices are expected to stabilize in 2023 with latex crepe prices having the possibility of slightly improving on the back of demand conditions.

- Palm oil prices are expected to be range bound following a year of volatility. Despite the easing of global prices local players have continued to benefit from taxes on oils and a weaker Rupee and a change in these factors would be key concerns for the sector. Ban on palm oil replantation continues to remain a bottleneck for the sector.

Source: CSE & BRS Equity Research

Plantations Revenue Breakdown



Source: CSE & BRS Equity Research

Telecommunication Sector Update

The prospects for Telecommunication sector slowed down as it underwent multiple price revisions passing down the increase in Telecommunication levy (from 11.25% to 15%), LKR depreciation, increase in VAT (from 8% to 15%) and imposition of Social Security Contribution Levy (SSCL) of 2.5% on turnover. Operational costs of providing IDD facilities and Pay TV escalated drastically following the Rupee depreciation.

The mobile density data issued by the TRCSL affirm that telecommunication usage was impaired to some extent. We believe, the two main telco players Dialog Axiata PLC (DIAL) and Sri Lanka Telecom PLC (SLTL) may experience a reduction in revenue, due to aggressive price promotions coupled with product bundling offered by smaller telecommunication providers. Direct costs of service providers will gain some relief from stabilization of local currency.

Sri Lanka Telecom PLC

News on a possible restructuring, heightened investor interest on SLTL. We believe, SLTL's extensive marketing campaigns and continuous technological upgrades on fixed broadband services will boost up revenue in the long term.

Dialog Axiata PLC

We believe, the appreciation in rupee will benefit DIAL, as ~52% of direct costs are in foreign currency. Plans to reduce foreign currency debt by more than 50%, will ease finance expense pressures towards the latter part of the year (2023), improving overall bottom-line performance. CAPEX we believe will stay elevated, due to network expansion and technological upgrades.

Source: CSE & BRS Equity Research

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