

Domestic Debt Optimization (DDO) of Sri Lanka

Source: Presentation to the Cabinet of Ministers by Governor of Central Bank
(28 June 2023)

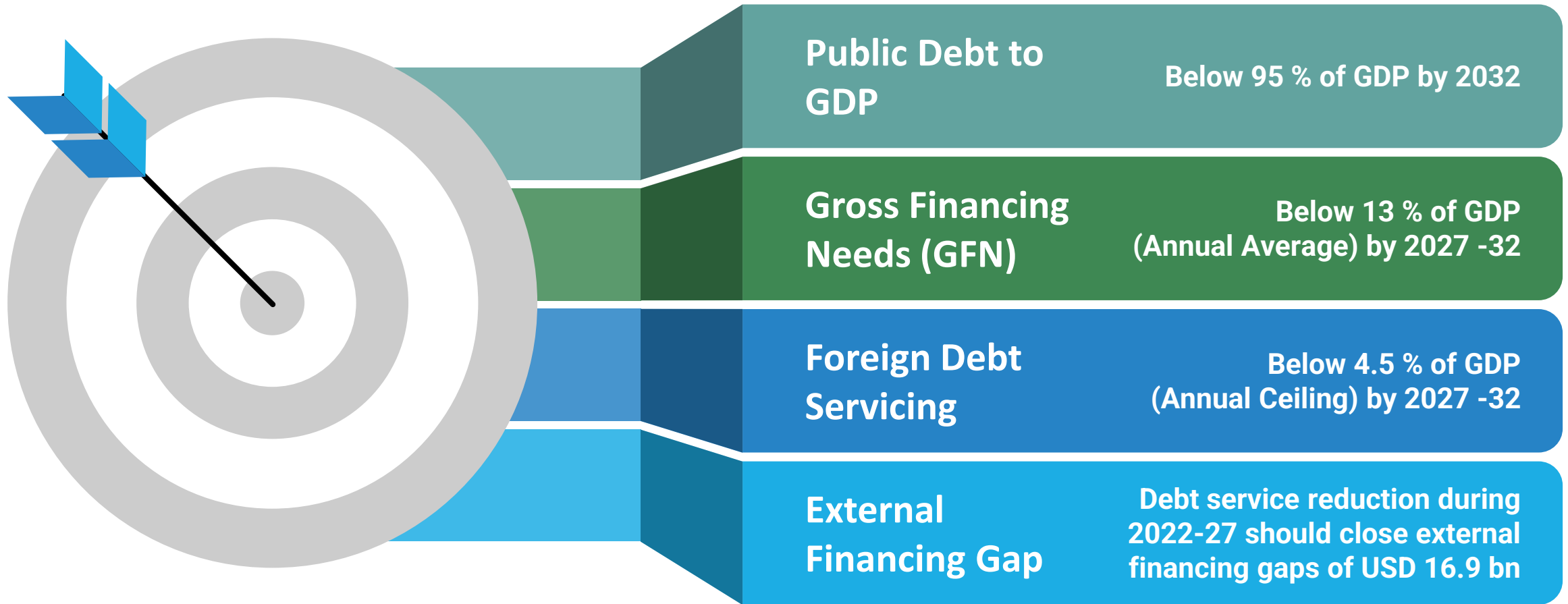


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- The International Monetary Fund (IMF) has advised Sri Lanka to address its debt sustainability concerns, considering the country's current unfavorable debt situation.
- In the IMF staff report, "Restoring Public Debt Sustainability" is emphasized as one of the main objectives.
- The authorities in Sri Lanka are undertaking debt restructuring measures guided by quantitative targets established within the framework of the "IMF Sovereign Risk and Debt Sustainability Framework (SRDSF)".
- This framework serves as a guideline for the country's debt restructuring efforts, aiming to improve debt sustainability and manage sovereign risk effectively.

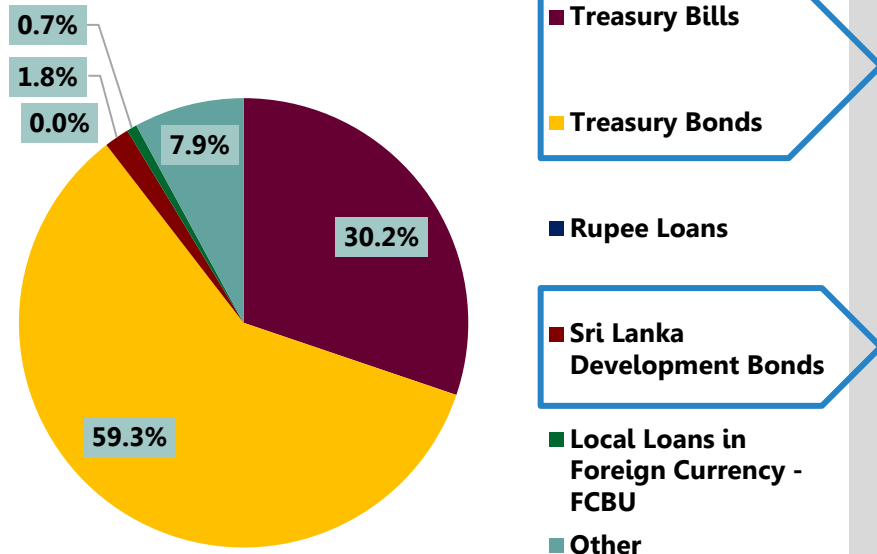


Source: Presentation to the Cabinet by Governor_28 June 2023

Outstanding Domestic Debt

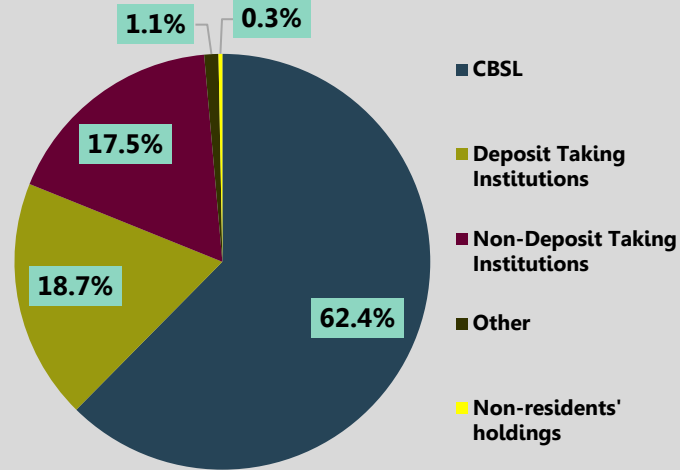
As of 31.03.2023

Domestic Debt

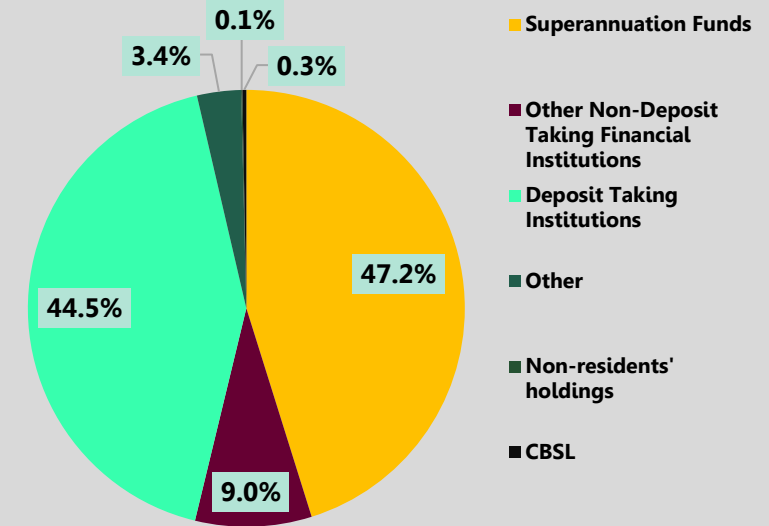


Source: Quarterly Debt Statistics (Ministry of Finance)

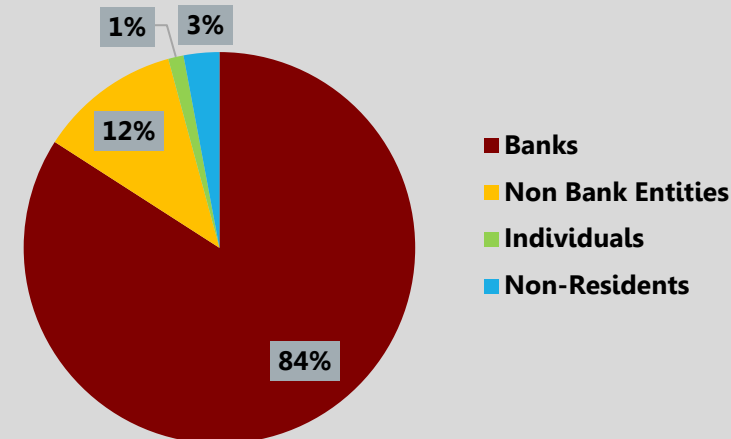
T-Bills holders



T-Bonds holders



Outstanding SLDBs as at 31 March 2023



What are the debt instruments affected by DDO?

Domestic Debt (in USD)	31.03.2023	31.12.2023
Treasury Bills	14.2 Bn	11.4 Bn
Treasury Bonds	27.9 Bn	23.9 Bn
Sri Lanka Development Bonds	843.3 Mn	1,078.8 Mn
Local Loans in Foreign Currency - FCBU	343.7 Mn	361.8 Mn

Debt subjected to DDO (USD)	Proposed Debt treatment
Only CBSL's T-Bills and Provisional Advances to Government (62.4%)	USD 7.1 Bn Converted into T-Bonds

Debt subjected to DDO (USD)	Proposed Debt treatment
Only Superannuation Funds' T-Bonds (36.5%)	USD 8.7 Bn Exchanged against longer term maturity T-Bonds

Proposed Debt Treatment for all holders: 03 Options explained on [page 7](#)

Source: Presentation to the Cabinet by Governor_28 June 2023

Treasury Bills

CBSL's T-Bills and Provisional Advances to Government

Option: Converted into T-Bonds

A basket of 10 instruments maturing from 2029 to 2038 for a total equivalent to the tendered instruments' nominal value (no haircut).

- Composition of the basket of instruments:
 - 4 instruments maturing between 2029-2032, each equal to 4% of tendered amount
 - 6 instruments maturing between 2033-2038, each equal to 14% of tendered amount
- Bullet repayment
- Step down coupon profile:
 - 12.4% up until 2024 (incl.)
 - 7.5% up until 2026 (incl.)
 - 5.0% until maturity

Treasury Bonds

Superannuation Funds' T-Bonds

Option: Exchanged against longer term maturity T-Bonds

A basket of 12 instruments of equal amount maturing from 2027 to 2038, for a total equivalent to the tendered instruments' nominal value (no haircut)

- Bullet repayment
- Step down coupon profile:
 - 12.0% up until 2025 (incl.)
 - 9.0% until maturity

Authorities may consider increasing income tax to 30% from the current special treatment at 14% for Superannuation Funds that do not meet the minimum participation requirement, set at 50% for outstanding bonds maturing in 2023 and 100% of bonds maturing between 2024 and 2032 (incl.)

Coupon payments accrued up to the settlement date will be settled in LKR (cash)

SLDB holders are allowed to choose one of the following three options. The first two options include exchanging new USD instruments against the current outstanding while 3rd option includes an exchange of LKR instruments. Past due interest and interest accrued up to the settlement date will be settled in LKR (cash) under all the options.

USD Option 01 – (“ISBs-like”)

- ❖ Nominal haircut: 30%
- ❖ 6-year final maturity (2029), no grace period (first amortization: 2024)
- ❖ Amortization profile: linear
- ❖ Interest rate: 4.0% (fixed)

USD Option 02 – (“official creditors-like”)

- ❖ No nominal haircut
- ❖ 15-year final maturity (2038), 9-year grace period (first amortization: 2033)
- ❖ Amortization profile: linear
- ❖ Interest rate: 1.5% (fixed)

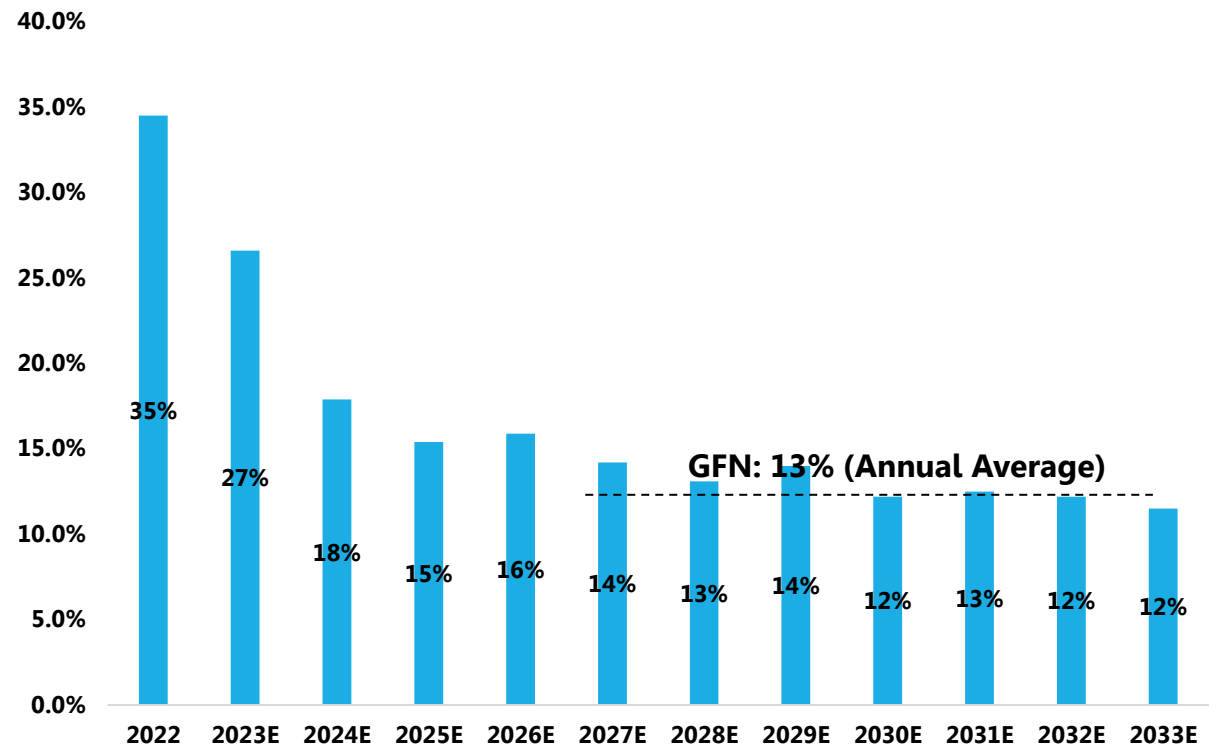
LKR Option

- ❖ No nominal haircut
- ❖ 10-year final maturity (2033), no grace period (first amortization: 2024)
- ❖ Amortization profile: linear
- ❖ Floating interest rate: SLFR (policy rate) + 1.0%

The IMF anticipates a reduction in Gross Financing Need (GFN) to 13% of GDP through the implementation of Domestic Debt Optimization measures.

- The average GFN target is influenced by the intended handling of the Central Bank of Sri Lanka's Treasury Bills and advances to the Government, resulting in an average GFN of 13% throughout the IMF program.
- The average GFN target will be influenced by the anticipated treatment of the Superannuation Funds' T-bonds, resulting in an average GFN of 13.7% during the IMF program period, representing a decrease of 0.5% points compared to the original projection of 14.2%.
- The average GFN target demonstrates less sensitivity to the intended treatment of SLDBs and FCBUs, resulting in an average GFN of 14.1% throughout the IMF program, which is a slight decrease from the initially projected 14.2%.

Gross financing need (GFN)



Source: Presentation to the Cabinet by Governor_28 June 2023 and IMF Country Report No. 23/116

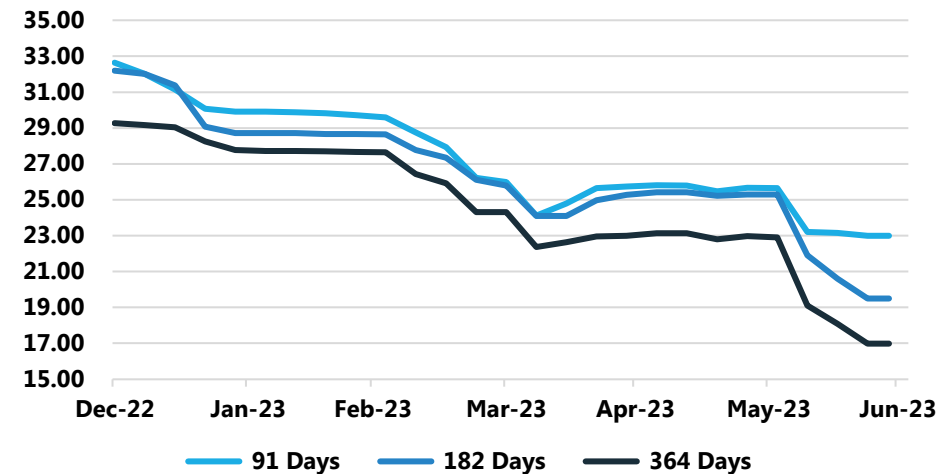
The expected outcomes of the DDO include a potential decline in interest rates reducing the gap between market rates and policy rates.

This can be attributed to two significant factors.

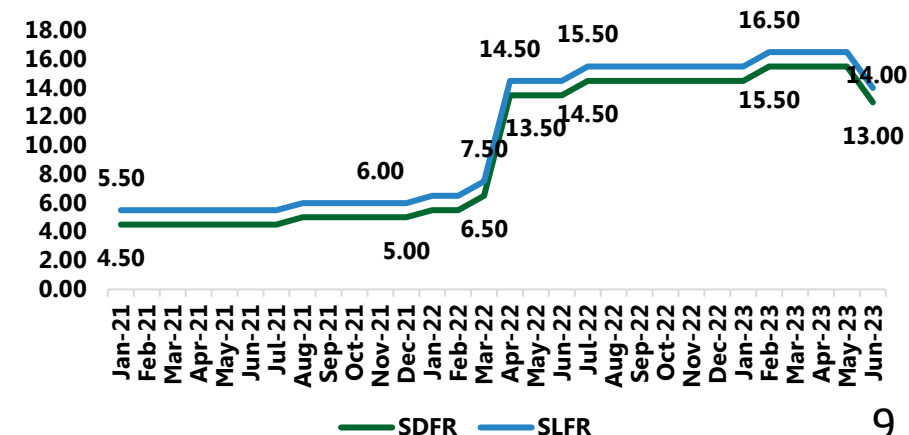
1. Firstly, the reduced risk premia on government bonds from the debt restructuring measures are likely to create a more favorable environment for investors. As the perceived risk associated with government debt decreases, investors may demand lower interest rates, to a downward trend in borrowing costs.
2. The current rate of inflation, can also exert downward pressure on interest rates. As inflation moderates, the central bank will have flexibility to implement monetary policies aimed at reducing interest rates, stimulating economic growth, and encouraging investment.

Source: CBSL and BRS Equity Research

T bill rates



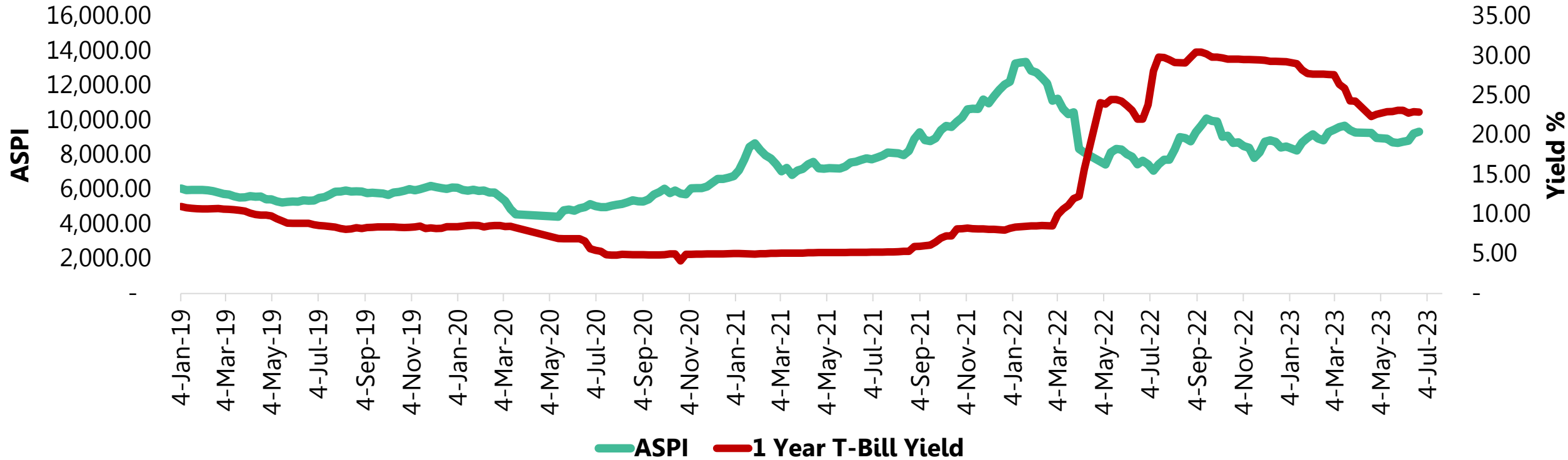
Central Bank Policy Interest Rates



Impact on Equities

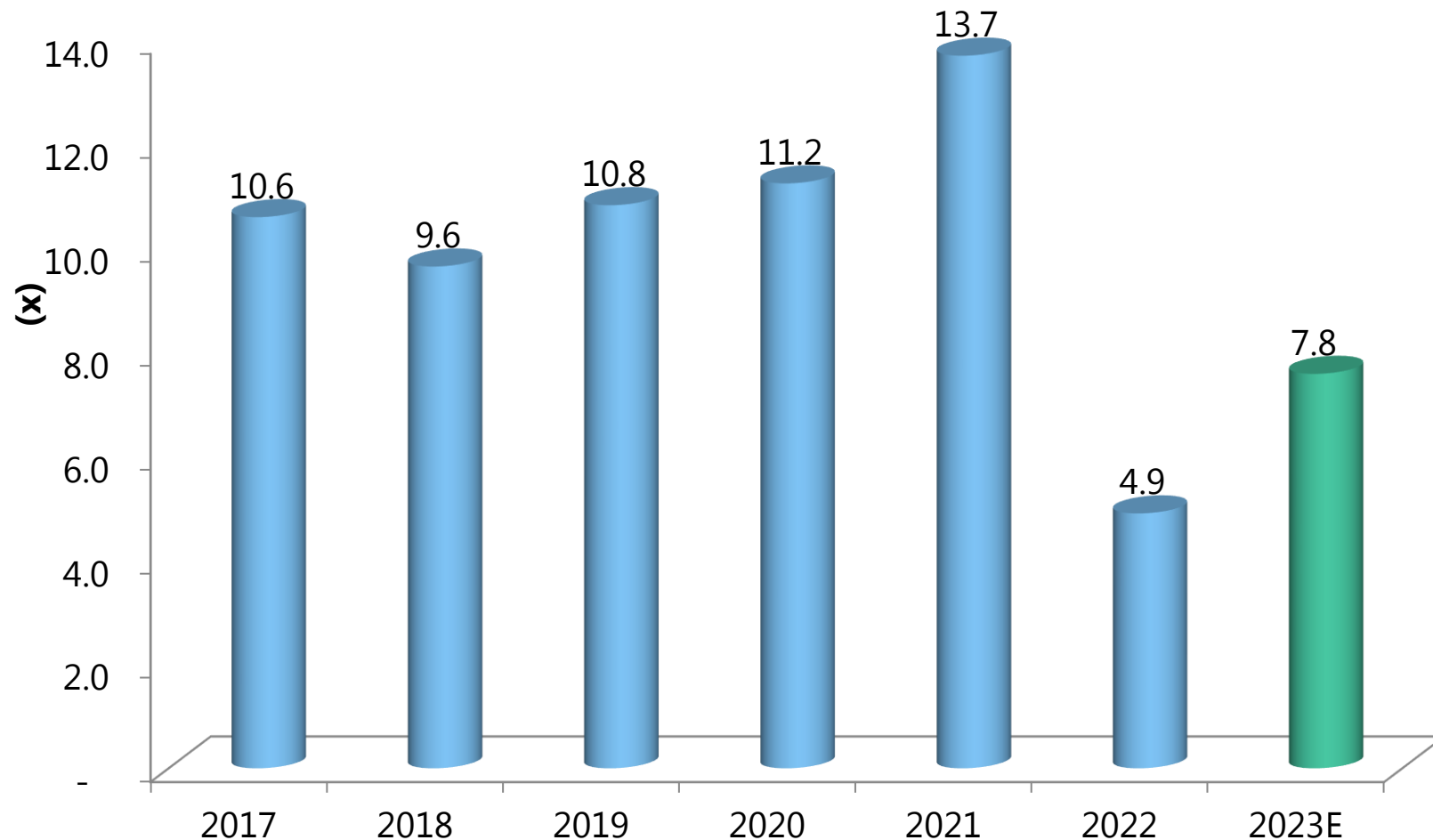


ASPI vs Interest Rates



As visible in above graph, there is a negative correlation between ASPI and yields of treasury bills (market interest rates). Given the debt reprofiling and policy actions of CBSL towards lowering the market rates bodes well for the equity market.

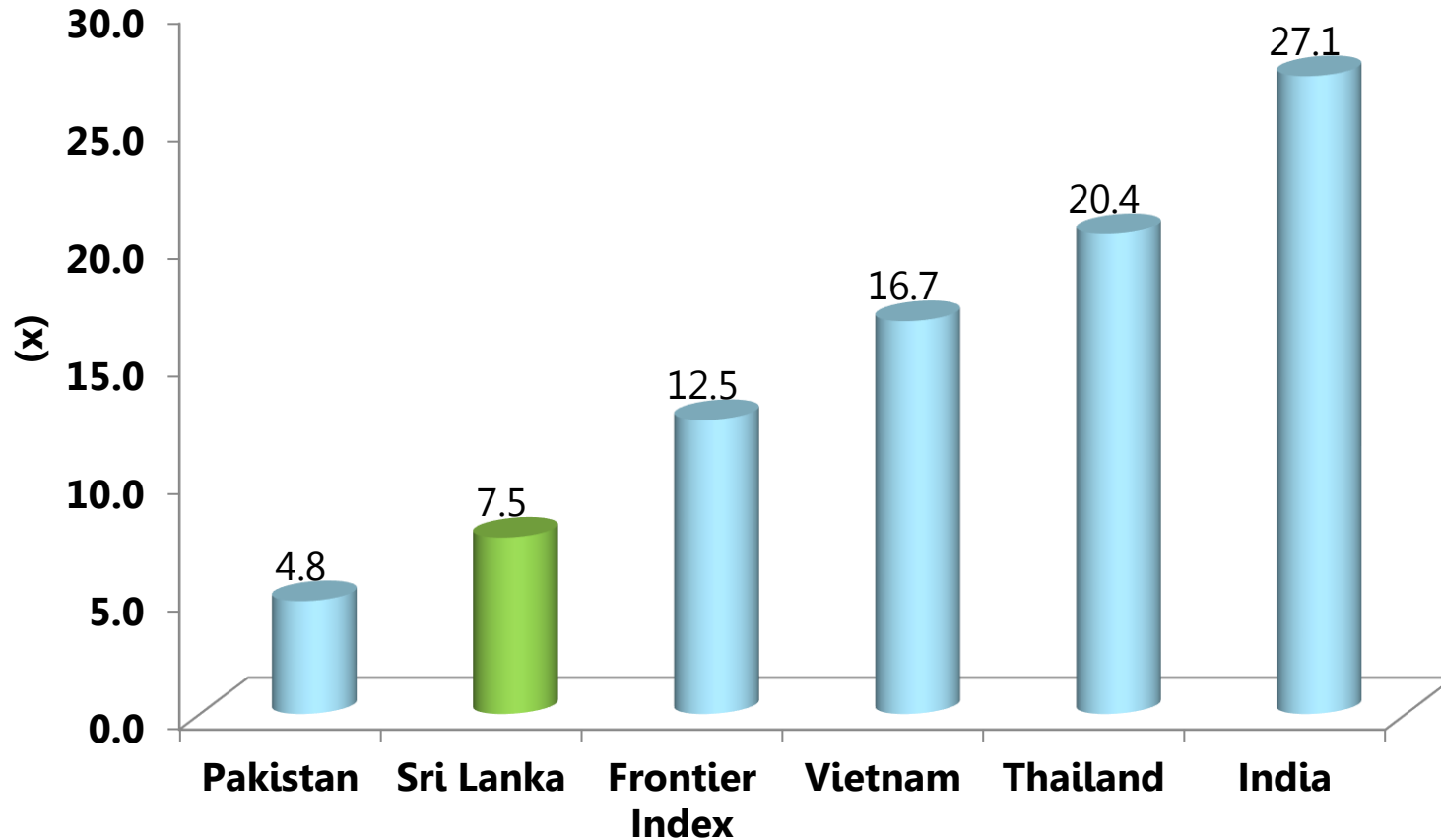
Forward PE Stands at a Discount to Historical



The market PE stands at 7.8x on projected earnings for 2023E trading at a 30% discount to 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 the easing of 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

Market PE

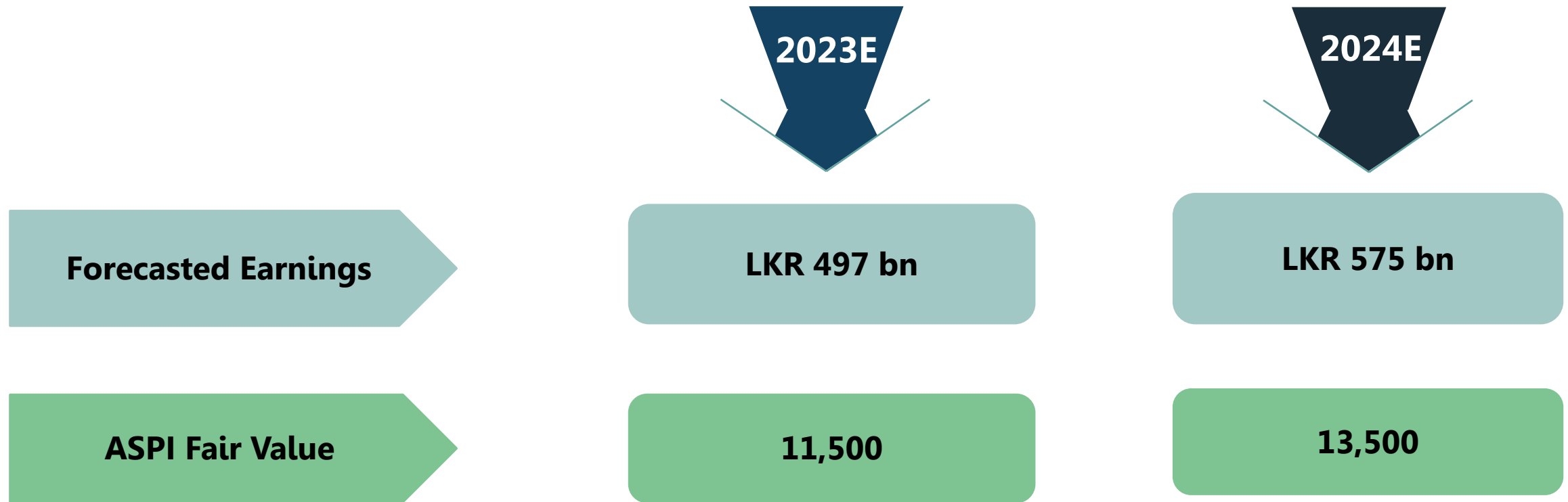


Sri Lanka is among the cheapest in terms of valuations in the region where forward PE (2023E) trades at a ~55% discount to the regional average of 16.3x. While better performing economies are traded at premium multiples, we believe a justified multiple of 10x is fair for Sri Lanka as reflected by the frontier index which includes markets with weak macro fundamentals.

Source: Bloomberg & BRS Equity Research

We Continue to be Bullish on Overall Market Valuations

We maintain our earnings forecast for 2023E, aided by the decline in interest rates, amidst debt reprofiling. Our ASPI fair value remains unchanged for 2023E presenting a 22% upside potential.



Technically Poised with Bullish Sentiment



Improved sentiment amidst the nearing of DDO has brought renewed positivism to the market. As a result, 11 days moving average remains above the long-term moving average indicating bullish sentiment.

Technical Indicators Point Bullish Sentiment

CSE All-Share, Sri Lanka, Colombo:CSE, D

EMA (11, close, 0)
EMA (22, close, 0)



Signal of technical indicators

EMA: **Bullish**

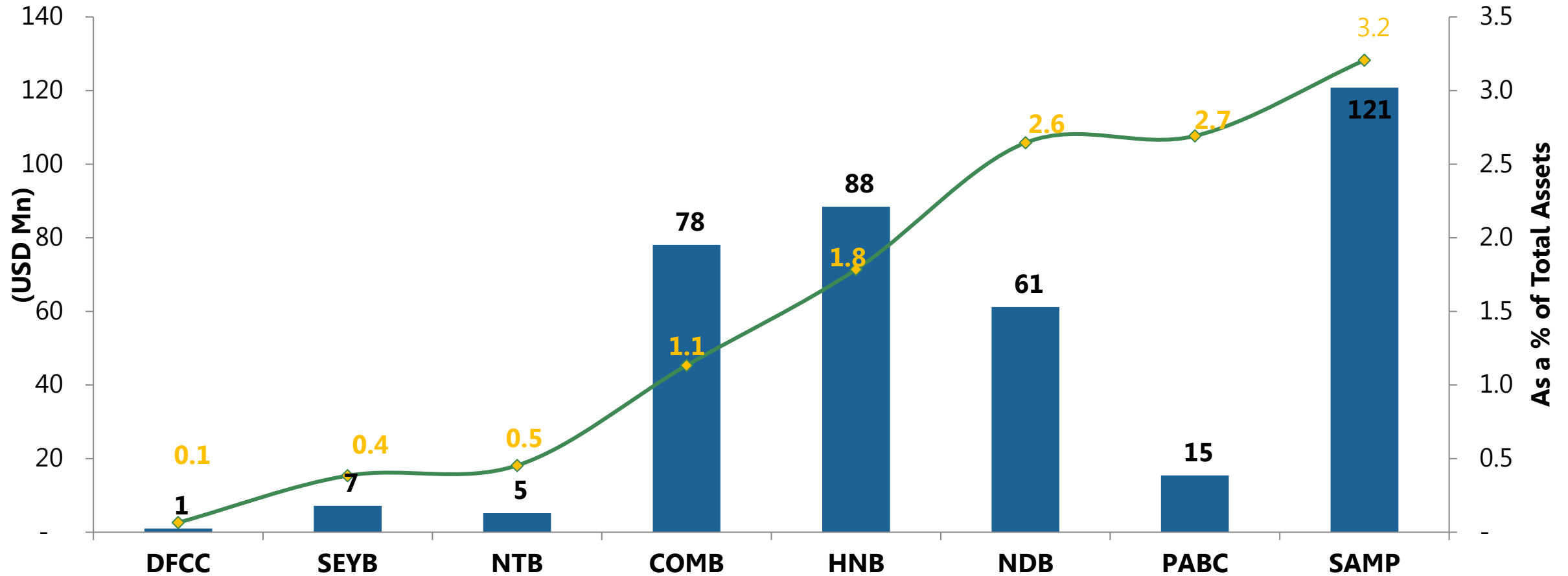
MACD: **Bullish**

RSI (68.58): **Bullish**

Impact on Banks



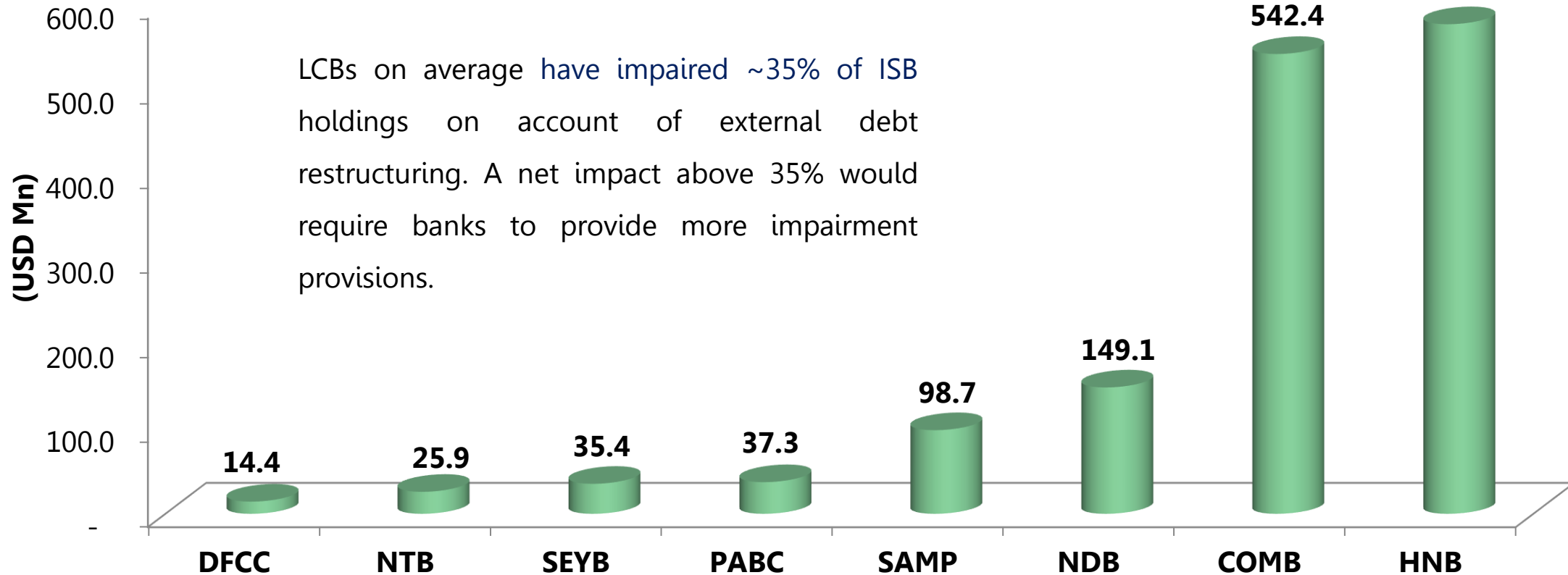
SLDB Exposure of Listed LCBs



Converted at an exchange rate of 363 as of 31.12.2022

Source: CSE & BRS Equity Research

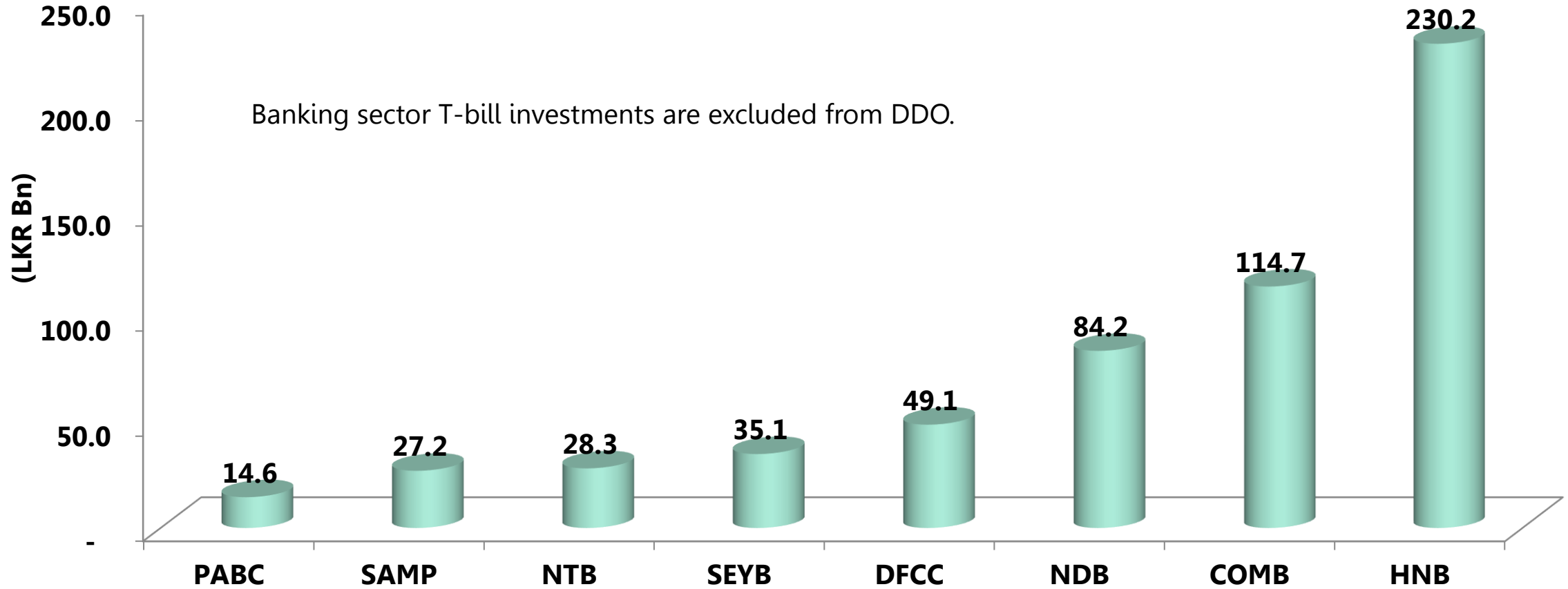
ISB Investments



Converted at an exchange rate of 363 as of 31.12.2022

Source: CSE & BRS Equity Research
20

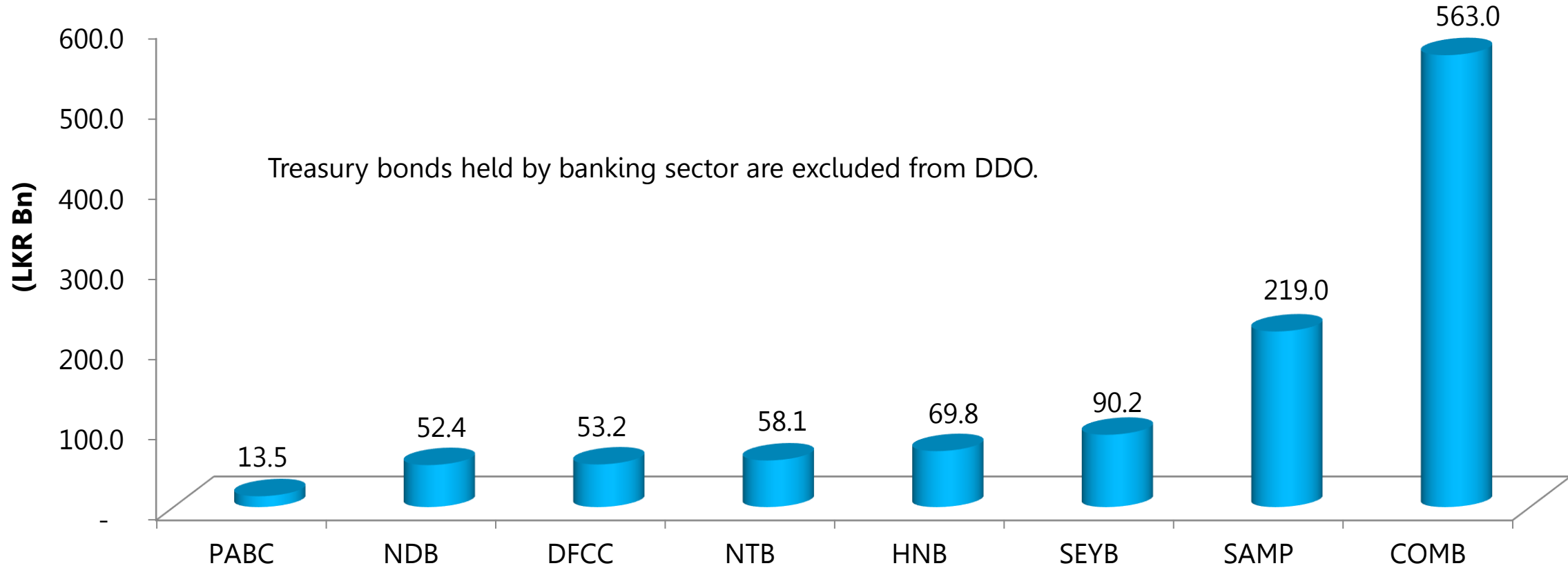
Treasury Bills Exposure of Listed LCBs



*as of 31.12.2022

Source: CSE & BRS Equity Research
21

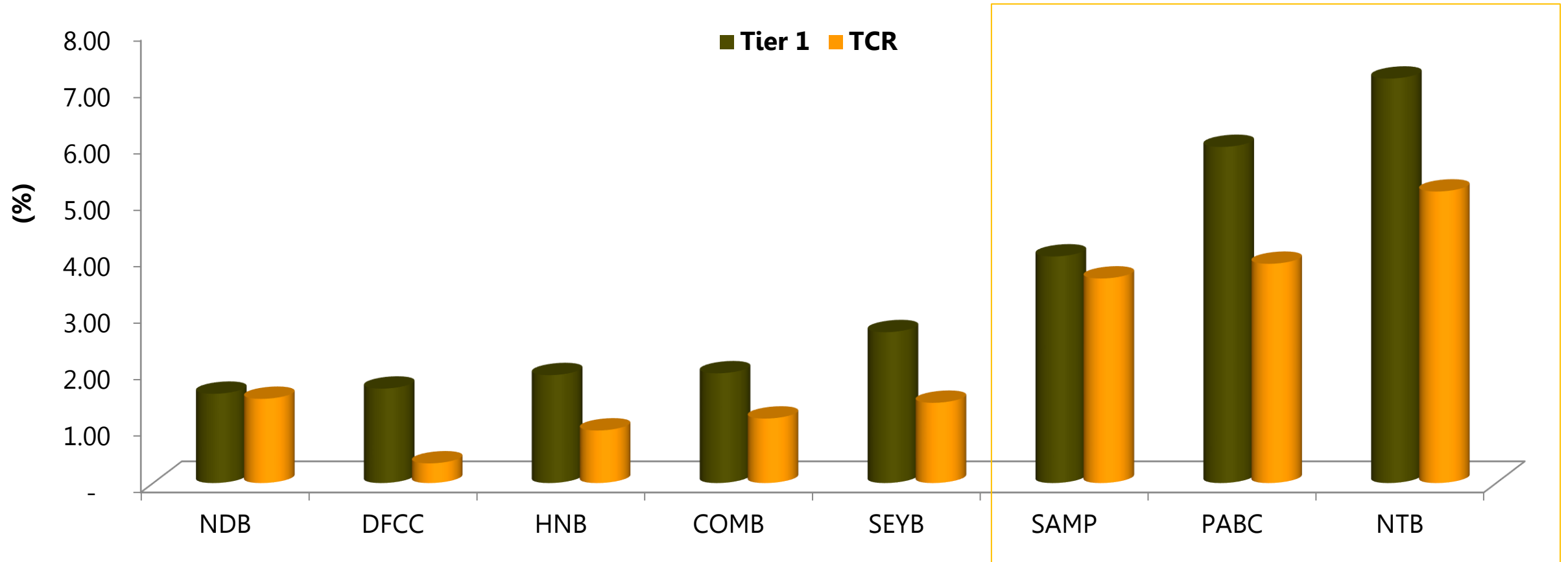
Treasury Bonds Exposure of Listed LCBs



*as of 31.12.2022

Source: CSE & BRS Equity Research

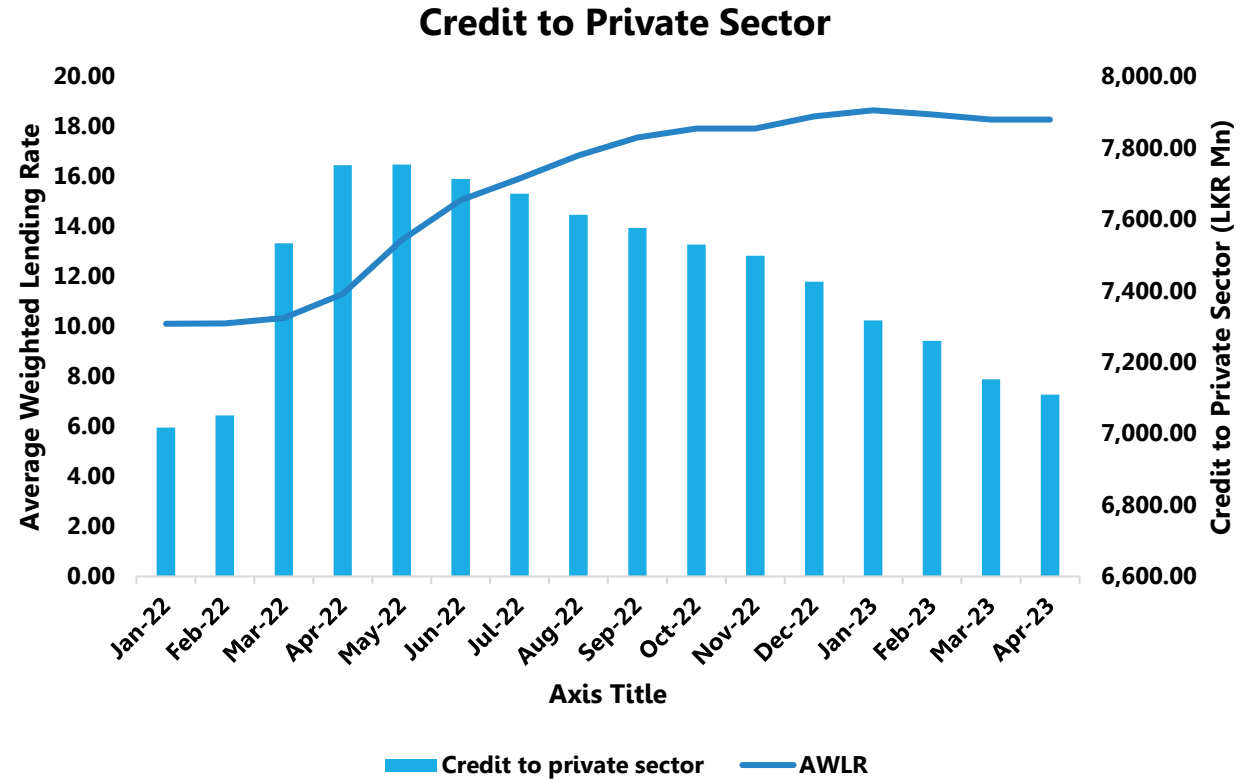
Capital Buffers of Listed LCBs



NTB, PABC and SAMP had the highest capital buffers as of 31st March 2023.

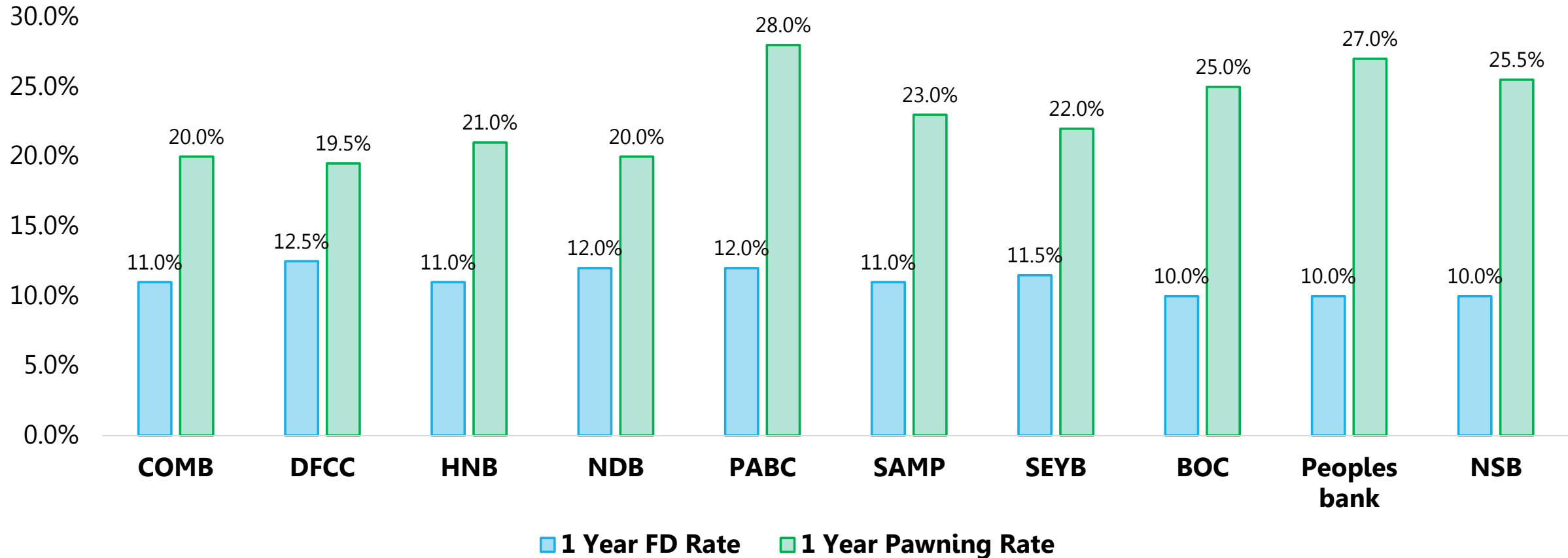
Source: CSE & BRS Equity Research

The anticipated reduction in interest rates resulting from the implementation of domestic debt optimization measures is expected to have a positive impact on the availability of credit for the private sector. As interest rates decrease, banks are likely to be more inclined to provide loans and credit facilities to businesses at lower costs. This favorable lending environment is expected to stimulate private sector demand, leading to increased investment, expansion of businesses, and overall economic growth.

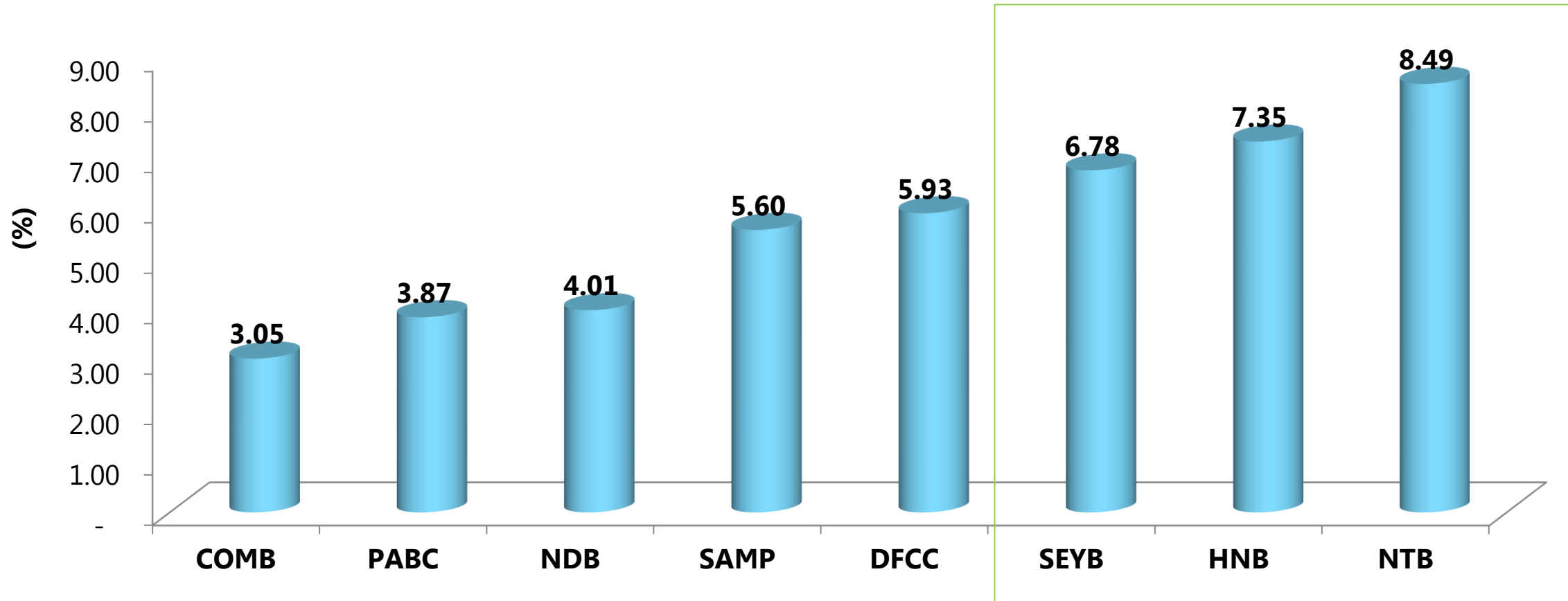


Source: CBSL and BRS Equity Research

Banking Sector Lending vs Deposit Rates

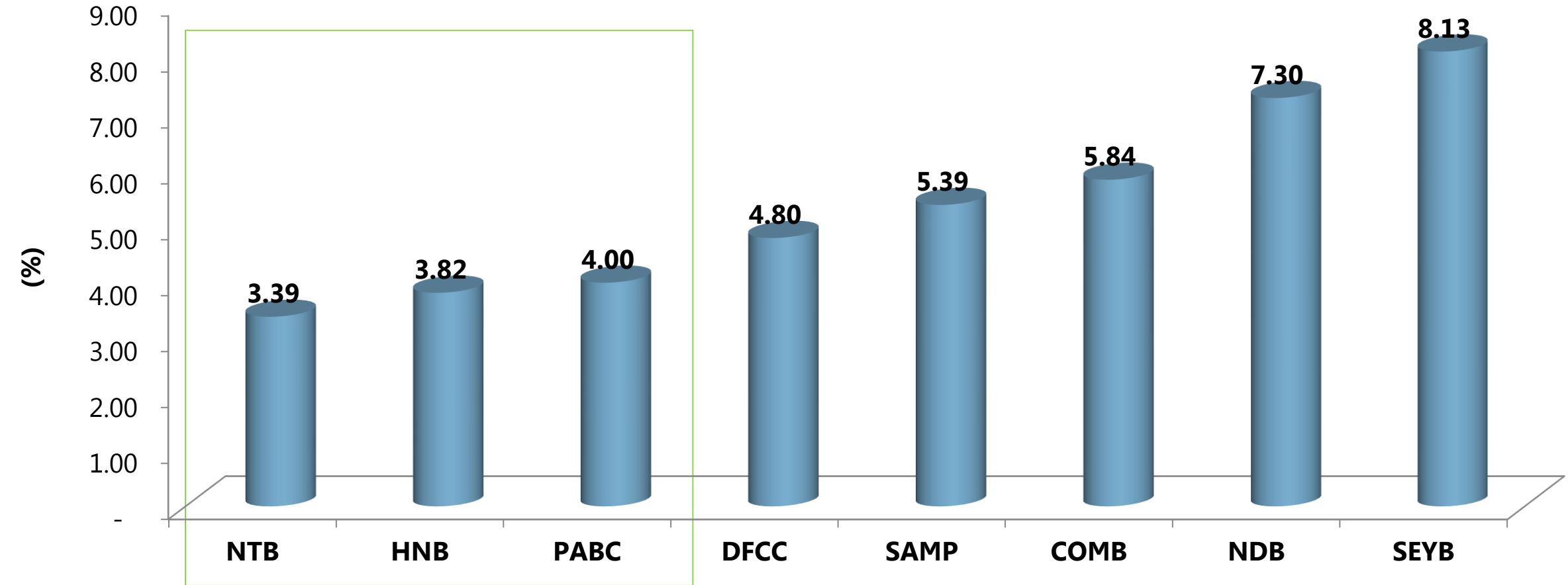


The gap between 1 year FD rate and 1 year pawning rate ranges from 800bps to 1,700bps indicating that there is further room for lending rates to go down. However, quicker repricing of deposit rates than lending rates may keep NIMs intact although further decline in lending rates are crucial for revival of private credit.



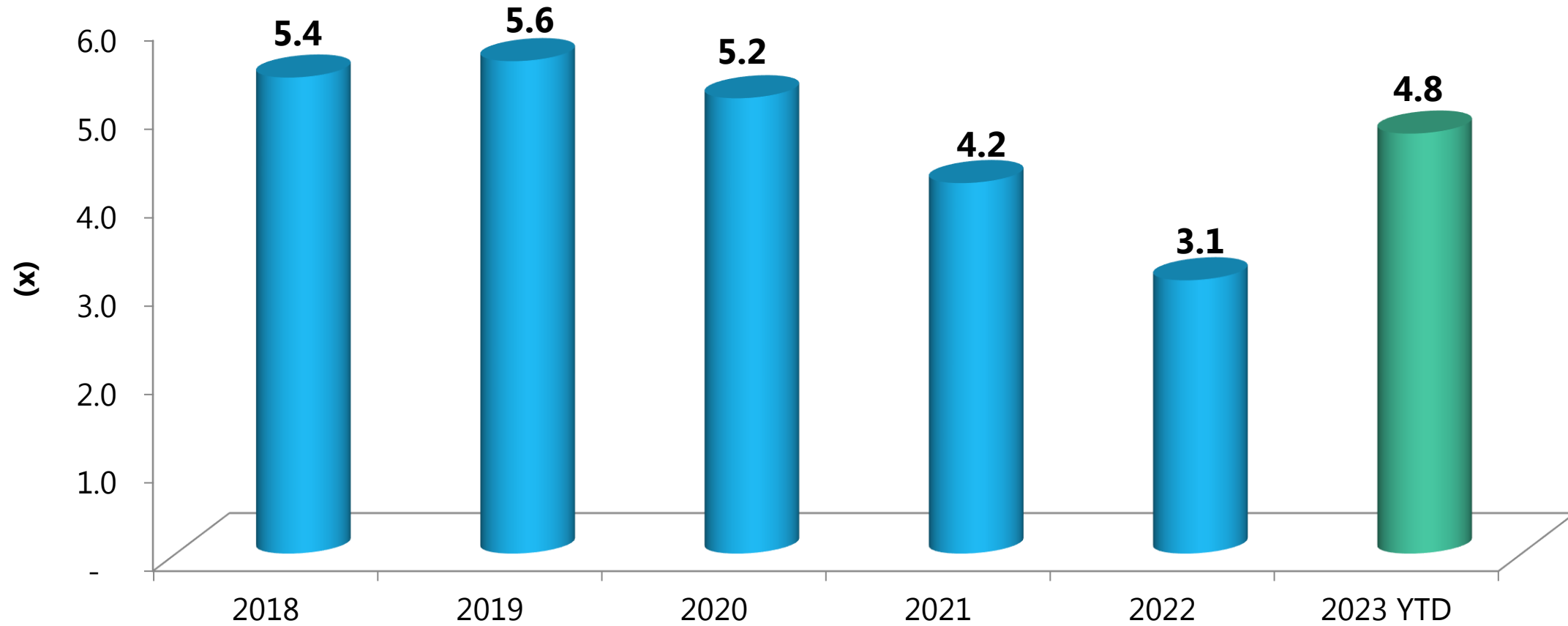
NIMs continued to remain high while NTB, HNB and SEYB showcased the highest NIMs as of 31st March 2023.

Impaired Loans (Stage 3) Ratio – Listed LCBs



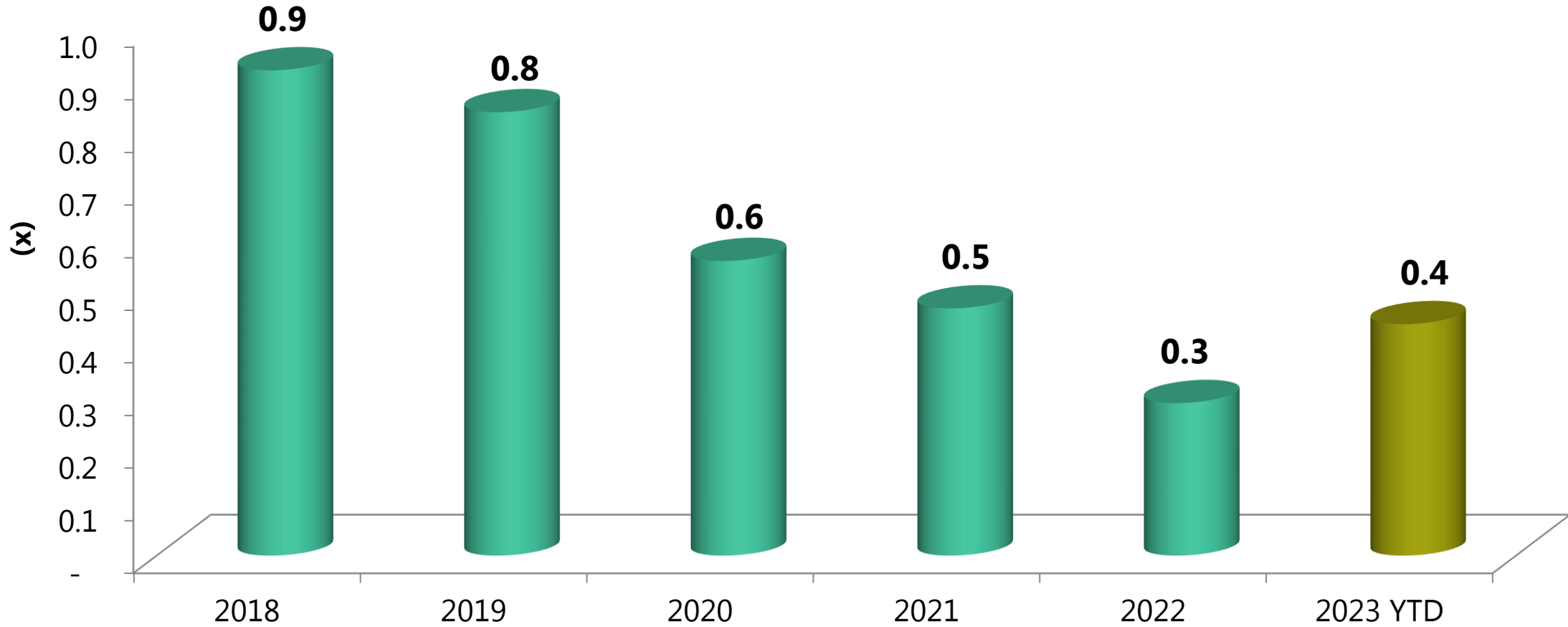
Asset quality remains a concern for the banking industry given the weak economic conditions. Although there is a rising trend of impaired loans (stage 3) ratio, NTB, HNB and PABC were able to record a ratio below 4% as of 31st March 2023.

Banking Sector Historical PER



Source: CSE & BRS Equity Research

Banking Sector Historical PBV



Relative Valuation – Banking Sector

	MPS (LKR)	YTD Change	TTM EPS (LKR)	TTM PER (X)	BVPS (LKR)	P/BV	ROE (%)	DPS (LKR)	DY
Banks									
ABL	2.50	-13.79%	0.27	9.18	5.24	0.48	5.31	0.10	4.00%
COMB	68.10	35.66%	12.44	5.47	156.18	0.44	8.05	4.50	6.61%
COMB(X)	54.10	30.99%	12.44	4.35	156.18	0.35	8.05	4.50	8.32%
DFCC	46.60	45.63%	10.57	4.41	144.05	0.32	8.85	2.00	4.29%
HNB	139.00	76.17%	31.59	4.40	341.10	0.41	9.71	5.00	3.60%
HNB(X)	108.00	54.29%	31.59	3.42	341.10	0.32	9.71	5.00	4.63%
HDFC	27.60	-0.72%	2.38	11.62	107.16	0.26	2.22	-	0.00%
NDB	50.00	56.25%	8.32	6.01	173.65	0.29	4.92	2.50	5.00%
NTB	70.70	53.03%	26.42	2.68	153.71	0.46	18.77	4.00	5.66%
NTB(X)	67.90	18.29%	26.42	2.57	153.71	0.44	18.77	4.00	5.89%
PABC	12.90	35.79%	4.77	2.71	47.32	0.27	10.62	-	0.00%
SAMP	55.90	63.45%	10.42	5.37	114.77	0.49	9.29	4.60	8.23%
SDB	29.20	36.45%	(0.58)	nm	85.27	0.34	(0.69)	-	0.00%
SEYB	34.90	10.44%	7.52	4.64	93.29	0.37	8.35	2.00	5.73%
SEYB(X)	24.10	48.77%	7.52	3.20	93.29	0.26	8.35	2.00	8.30%

We believe the banks are looking attractive at existing entry points, as the pressure eases on the hype surrounding the DDO on treasury bonds. This would be a re-rating catalyst for better valuations.

No Impact on NBFIs, Insurance and Primary Dealers



Since only CBSL treasury bills and superannuation funds investments on treasury bonds are reprofiled, there is no impact on exposure of treasury bills and bonds invested by NBFIs, Insurance and Primary dealers.

	MPS (LKR)	YTD Change	TTM EPS (LKR)	TTM PER (X)	BVPS (LKR)	P/BV	ROE (%)	DPS (LKR)	DY
Diversified Financials									
ALLI	67.50	18.42%	16.34	4.13	210.23	0.32	8.05	-	0.00%
CDB	210.00	10.53%	23.29	9.02	259.75	0.81	9.15	5.00	2.38%
CDB(X)	68.30	27.90%	23.29	2.93	259.75	0.26	9.15	5.00	7.32%
LOLC	363.00	-8.79%	47.16	7.70	536.15	0.68	8.06	-	0.00%
LFIN	58.40	46.00%	15.44	3.78	69.17	0.84	24.46	5.00	8.56%
PLC	8.10	62.00%	1.72	4.72	21.80	0.37	8.13	-	0.00%
VFIN	32.50	44.44%	5.64	5.76	46.96	0.69	12.78	1.00	3.08%
COCR	25.40	12.89%	8.17	3.11	64.01	0.40	13.43	-	0.00%

	MPS (LKR)	YTD Change	TTM EPS (LKR)	TTM PER (X)	BVPS (LKR)	P/BV	ROE (%)	DPS (LKR)	DY
Primary Dealers									
CALT	33.00	65.83%	8.61	3.83	16.70	1.98	72.28	-	0.00%
CFVF	32.20	15.41%	5.77	5.58	15.04	2.14	48.33	2.25	6.99%
FCT	25.80	12.66%	4.68	5.51	8.87	2.91	59.48	1.50	5.81%

Insurance Sector Relative Valuation

	MPS (LKR)	YTD Change	TTM EPS (LKR)	TTM PER (X)	BVPS (LKR)	P/BV	ROE (%)	DPS (LKR)	DY
Insurance									
CINS	2,300.00	2.24%	479.65	4.80	3,047.88	0.75	16.53	45.00	1.96%
CINS(X)	936.25	-8.81%	479.65	1.95	3,047.88	0.31	16.53	45.00	4.81%
HASU	47.00	9.56%	11.98	3.92	50.73	0.93	24.44	3.65	7.77%
PINS	20.90	3.47%	3.97	5.27	24.37	0.86	16.84	1.00	4.78%
ATL	11.00	-9.84%	0.53	20.89	13.82	0.80	3.83	-	0.00%
ATLL	30.00	-5.06%	0.07	459.00	11.10	2.70	0.61	-	0.00%
AINS	18.10	-20.26%	3.25	5.56	30.32	0.60	10.55	-	0.00%
COOP	3.20	-20.00%	0.66	4.86	3.58	0.89	19.02	-	0.00%
JINS	26.50	-16.40%	2.39	11.08	53.99	0.49	5.45	2.65	10.00%
LGIL	6.10	-24.69%	1.17	5.19	3.53	1.73	38.16	-	0.00%
SCAP	10.00	-0.99%	(2.44)	nm	3.51	2.85	(51.00)	-	0.00%
AAIC	80.60	-6.93%	7.15	11.27	27.39	2.94	26.18	3.50	4.34%
UAL	30.60	9.68%	5.05	6.06	25.75	1.19	21.71	-	0.00%

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