Sri Lanka Macro View

Trip Notes – Improving Sovereign Credit Story

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- **Sri Lanka's growth story increasingly driven by services sector.** Real GDP growth in 2013 surprised to the upside amid accelerating 4Q13 growth of 8.2% – but this rebound doesn't tally well with import contraction in the same period, sluggish private sector credit growth and likely fiscal restraint in order to achieve the deficit targets. Nonetheless, we think prospects for services sector growth – led by tourism-related and transport/logistic services – look promising, and we nudge our 2014F & 2015F growth higher at 7.2% and 7.4%, respectively (versus earlier forecast of 7%).

- **Improvements in external position look sustainable.** The current account deficit appears to have narrowed more sharply than what we (and even the government) earlier projected – we now think CAD falls to about 3.3% of GDP in 2013E and could fall further to 2.5% of GDP in 2014F. Net FDI flows have also improved to help fund half of the CAD, and the government and some SOEs seem to have access to relatively cheap external loan financing. Despite larger debt repayments (to the IMF), CBSL forecasts FX reserves could still gradually rise by another $700-800mn; international bond issuance does not seem to be in the *imminent* pipeline.

- **Monetary policy on a wait and see mode—need to watch weather.** Despite benign inflation, anemic private sector credit expansion and some external improvements, CBSL seems inclined to wait-and-see on monetary policy, and is facing constraints to cut interest rate further given worries over eroding savings of pensioners/retirees. CBSL will be monitoring M2b growth, as well as likely watching whether early signs of a drought are sustained, which would not only impact food prices but likely prompt electricity rate hikes. For now, we still pencil in a 50bps cut in 3Q14 but this *assumes* weather conditions normalize.

- **Slow fiscal improvements, but committed to containing SOE losses.** The MoF projects 2013 budget deficit to hit 5.9% of GDP versus 5.8% target, and weak revenue collection amid generous tax exemptions/narrow tax base is an ongoing concern. Thus, ambitious fiscal consolidation agenda will likely remain at risk of slippages as it will have to rely on compressing spending. Commitment to containing SOE losses via necessary fuel/electricity price adjustment (with a 6M lag) is a plus – we need to watch oil prices (they assume $110/bbl) and how weather impacts hydro.

- **Market outlook:** We think Sri Lanka (B1/B+/BB-) is a credit improving story with positive rating outlook prospects on its high single-B rating from S&P/Moody's if external improvements and gradual fiscal consolidation efforts are sustained. However, the sovereign dollar bonds have already outperformed significantly, and while absence of imminent supply could compress spreads further, we see a bit more value in the quasi-sovereign like NSBLK. On the LKR Treasury front, we are biased to extend duration for carry amid a relatively steep curve, more stable medium-term prospects for LKR and our expected resilient foreign holdings.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Trip Notes – Improving Credit Story

Growth drivers increasingly shifting to services sector

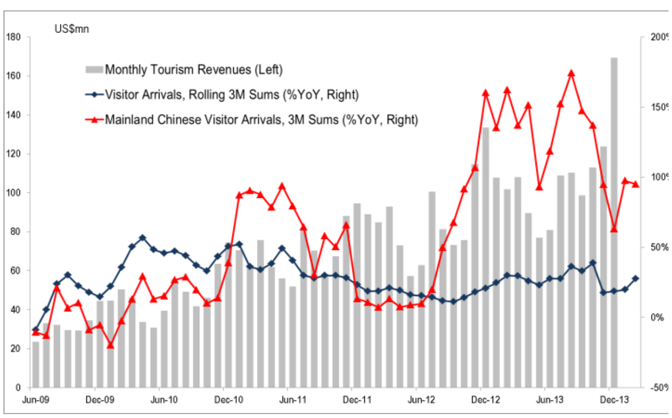
We upgrade our GDP growth forecast – we have been too conservative given our more upbeat assessment now of service sector expansion

Real GDP growth was stronger than expected at 7.3% in 2013 and government is projecting 7-8% growth rate this year. The 4Q13 real GDP growth showed a much stronger than expected acceleration in 4Q13 (+8.2%) led by a sharp rebound in the manufacturing sector and acceleration of services sector growth, though the stronger growth doesn't tally very clearly with the 7.6% contraction in intermediate and investment good imports contracted in the same period, anemic private sector credit expansion and fiscal policy that likely had been restrained to stick to its targets. However, we are now more upbeat about medium-term growth prospects due to what seems to be a more optimistic outlook for continued service sector expansion – we nudge our 2014F and 2015F growth forecasts slightly higher to 7.2% and 7.4%, respectively.

Tourism prospects look bright as capacity and infra build out expands, with an increasingly larger role played by the private sector

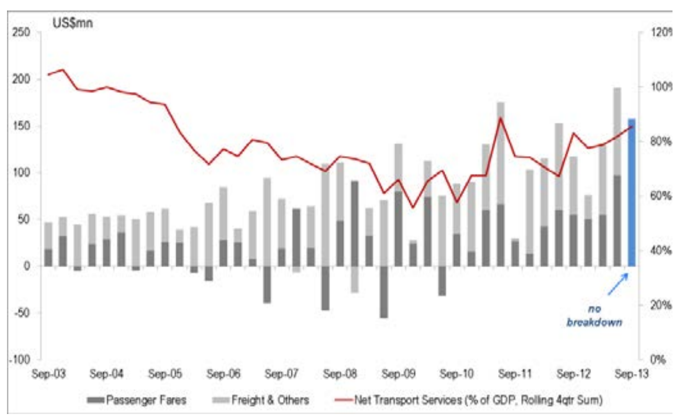
The major growth driver in the economy continues to be focused on the services sector with tourism being a bright spot. Tourism revenues (and arrivals) were up 35% YoY (and 26.7%YoY) in 2013 (See Figure 1) and a number of flagship hotel projects are still in the pipeline -- particularly Shangri-la and Hyatt, plus three integrated (i.e., including casino) resorts in the pipeline, one by James Packer's Crown Development ($350mn development)), another by top local conglomerate, John Keells ($850mn) and another from tycoon-backed Queensbury ($350mn). There is also a large 233-hectare Port City development in the heart of Colombo waterfront that is largely being financed by a private sector Chinese company ($1.4bn worth of direct equity investment, thankfully not debt financing) that is meant to be a mixed-use commercial-retail-residential area with even ambitious plans to build a Formula 1 racetrack so Colombo could rival Singapore.

Figure 1. Sri Lanka – Monthly Tourism Revenues and Growth Rate of Visitor Arrivals (Total & from China, 3-Month Sums), %YoY



Source: CBSL, CEIC, Citi Research

Figure 2. Sri Lanka – Transportation Services Receipts, Sep 2003 to Sep 2013



Source: CBSL Roadmap, Citi Research

Colombo port expansion is yielding significant transport receipts, but the jury is still out on Hambantota port project where opinions on longer-term assessment is far more mixed

The ongoing port expansion in Colombo also seems to be yielding significant increases in transport services receipts last year (CBSL's 2014F Roadmap presentation projected a 31% increase in net transportation services receipts in 2013) with Sri Lanka Port Authority (SLPA) aiming to add capacity from its 4.3mn TEU (twenty foot equivalent units) per annum to about 13.5mn TEU containers by 2018, as well as accommodating larger vessels (from 10,000 TEU ships to 18,000 TEU ships). Sri Lanka says that given both costs and geography, their Colombo ports (ranked 32 in the world) appear to be effectively diverting cargo traffic from Salalah (Oman) and Dubai ports, and "a little bit" from Singapore, with Colombo port's capacity utilization currently running at 83%. They believe they still have a

long way to go, and their ultimate aim is to model development akin to other world class Asian ports (Singapore, Shanghai), and be the major conduit of cargo traffic between South Asia (SLPA official estimates 65% of their cargo traffic is Indian) and East Africa with the rest of the world. However, people we met were much more circumspect about the prospects for the government-financed (largely via China Eximbank loans) Hambantota port, whose Phase 2 development is scheduled to finish this year (Phase 1 and Phase 2 to cost about $1.6bn) and where capacity is still significantly underutilized. Plans to make it an industrial free port zone has yet to bear fruit.

Manufacturing outlook is more challenging given lack of diversification out of traditional strength in garment/textile, less competitive labor costs, and low value added of its agri exports

The outlook for the manufacturing sector looks more challenging. Two issues that have been raised in our meetings is the shortage of skilled labor and the much higher cost of electricity, especially vis-à-vis other countries in ASEAN. While the top tier textile/garment companies in Sri Lanka are considered to be world-class and have developed a niche market for higher value-added garments (e.g., "garments without guilt"), there is a growing sense even among top players in this sector that the industry is relatively mature given their higher labor costs and less production scale as China. They are thus aiming to shift their model towards that of Turkey and Eastern European garment manufacturers, with greater mechanization, and offshoring its labor intensive components to Bangladesh or India. Unfortunately, we don't see signs that Sri Lanka has effectively diversified its manufacturing base to other products (textile/garments still account for 43% of total exports in 2013) – and there is risk that drought conditions could impact Sri Lanka's second largest export, tea (15% of exports)

Overseas worker deployment will likely remain an important source of foreign currency earnings

Thus, like the Philippines, without a broader industrial/ manufacturing base, Sri Lanka will likely remain reliant on overseas job creation to absorb some of its surplus labor that isn't absorbed by the domestic services sector, with robust remittance growth (+10.6% YoY in 2013) likely continuing to be an important source of domestic demand support. In fact, Sri Lanka's remittance per capita and remittance-to-GDP ratio already exceeds that of the Philippines.

Note that in the short term, garment exports could suffer from the US weather-driven pullback of garment sales

In the short term, there is risk that the pronounced garment export bounce in 4Q13 which may have sustained itself in Jan could weaken significantly recently as there is anecdotal evidence that US garment orders (which account for ~38% of Sri Lanka's garment exports) have weakened amid the adverse impact of severe winter weather on US retail sales that will hit their shipments with a lag.

Improvement in external position looks sustainable

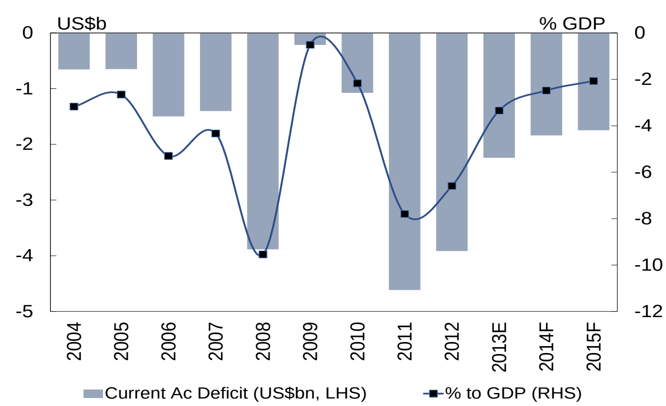
We revise down our CAD forecast in 2013-2015F as we have underestimated the strength of its services sector receipts, though our forecasts are slightly less optimistic than the government's

Improving current account position looks sustainable…. The government projects the current account deficit in 2013 closed at 3% of GDP, far lower than their earlier forecast of 3.9% of GDP just a few months ago – but if this were true, this would have to imply that Sri Lanka ran a current account surplus in 4Q13 (since Jan-Sep 2013 cumulative current account deficit hit $2.2bn or already about 3.3% of full-year forecast GDP). While figures are being finalized, we are not as optimistic – nonetheless, it seems services receipts were far stronger than what we had earlier envisioned towards the end of the year, and we revise down our conservative 2013 CAD forecast of 4.0% of GDP to about 3.3% of GDP, as well as subsequently revising down our CAD forecast to 2.5% of GDP and 2.2% of GDP in 2014F and 2015F, respectively, versus an earlier forecast of about 3% of GDP. FDI is estimated to have exceeded $1bn last year (we forecast 1.7% of GDP) and financed half of the CAD. We likely need to see more FDI-related financing vis-à-vis debt financing in the capital account to support upward ratings momentum, but given the narrowing CAD (alongside improved macro stability), we think there is still room for positive ratings outlook change for either S&P and Moody's this year.

But FX reserve accretion this year is likely to remain modest given sizeable debt repayments

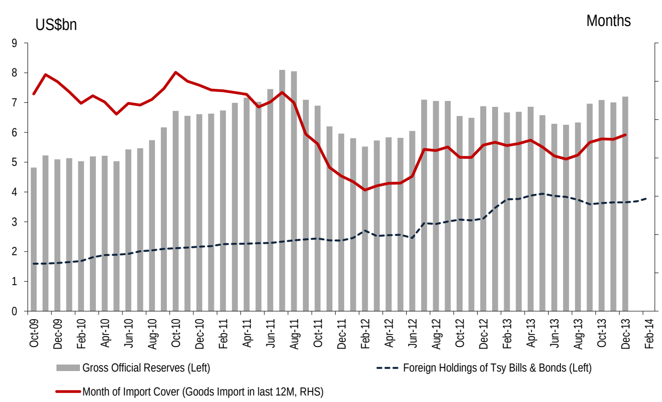
…but CBSL expecting only modest FX reserve accretion this year given rising debt repayments. CBSL projects a BoP surplus of about $1.5bn this year but given increased debt repayments (to the IMF), they estimate FX reserves will only rise by about $700-800mn (vs. ~$7.2bn in Dec 2013), in line with our forecast, and would suggest that FX reserves, which we estimate covers <1x short-term external debt, will still look relatively vulnerable though has benefited from very resilient foreign holdings of LKR-denominated Treasury securities (See Figure 4). CBSL has recently released its FX reserve position following IMF's special data dissemination standards (SDDS) template of international liquidity position, revealing that FX reserves were slightly above $7bn as of Nov (vs. earlier reported $6.9nn) but that CBSL had *net short position in the forward book of $2bn*, which may suggest usable FX reserves are a lot lower than we think at only $5bn. However, upon further inquiry , we found out that the net short position is largely attributed to the Sri Lankan banks which had borrowed offshore (Bank of Ceylon, National Savings Bank and DFCC together issued $1.85bn since 2012) but had been entitled to hedge their FX borrowings with the CBSL. Thus, the rollover rate of such short-term FX swap is likely close to 100% and does not seem to represent a significant short-term drain to CBSL's reserves until these dollar bonds mature.

Figure 3. Sri Lanka – Our Revised Current Account Deficit Forecast



Source: CBSL, CEIC, Citi Research

Figure 4. Sri Lanka – Gross Official FX Reserves, Foreign Holdings of Bonds & Bills and Months of Imports of Goods in the Last 12 Months



Source: CBSL, CEIC, Citi Research

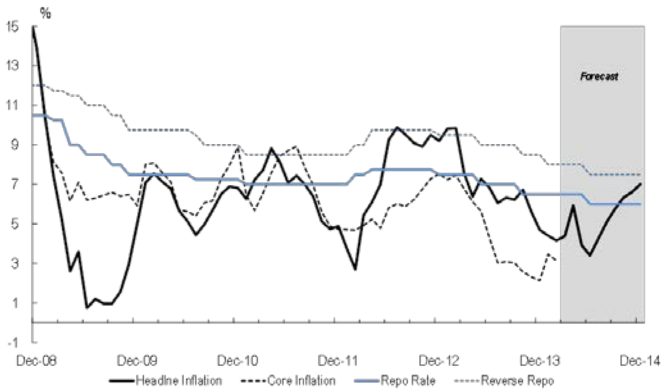
Monetary policy on a wait-and-see mode

CBSL will likely remain on hold in 1H but we still see one last cut by early 3Q14

Monetary policy on a wait-and-see mode—removing our rate cut call for now. After cutting rates by 175bps since Dec 2012 and SRR rates by 200bps in June 2013, CBSL sees "less space for further interest rate cuts", given the need to also protect savings (contrary to others, CBSL seems to face some political pressure when deposit rates fall given lack of social safety net to protect pensioners). Nonetheless, it acknowledges that inflation developments have been benign, at the lower end of their target, and that private sector credit expansion has remained very sluggish (though public sector borrowing seems to have surged in Dec), expanding 7-8% recently (Figure 6). People we met attribute this to sluggish demand, and may also be partly due to lags in monetary policy, especially when it comes to lending rate adjustment, so one official from a large local bank expects private sector credit growth will pick up in 2H2014. CBSL also believes that alternative sources of private sector financing, via corporate debentures as well as more liberalized rules on foreign currency borrowing, may have also played a role in the slowing domestic bank credit intermediation. Going forward, CBSL seems to be on a wait and see mode -- they believe that if M2b growth still stays at around 16% or picks up (it was

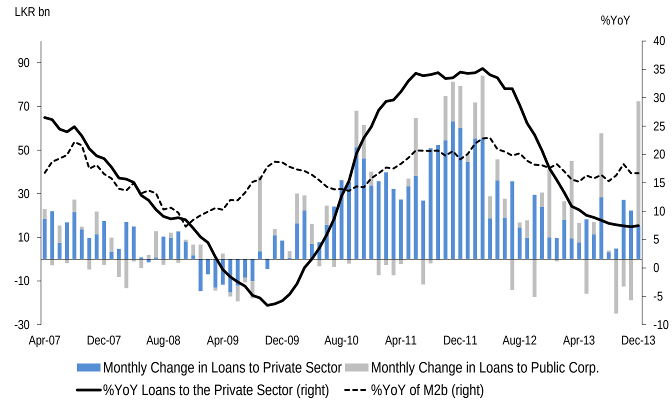
16.7% in Dec 2013), then they don't need to do anything more, but if inflation continues to move on a low path (we need to watch the weather – there seems to be early indications of a drought) and fiscal policy remains tight, then they still have space for monetary easing. We think easing may not be over, but we delay our last 50ps rate cut call to early 3Q14, given our view that headline inflation readings will remain benign in the near term and there is risk that private sector credit growth will continue to disappoint this year, but this assumes weather conditions normalize.

Figure 5. Sri Lanka Inflation has been surprisingly subdued



Source: CEIC, Citi Research

Figure 6. Private Sector Credit Growth has been subdued but the spike in lending to public sector in Dec bears some watching



Source: Citi Research

Fiscal consolidation going slow

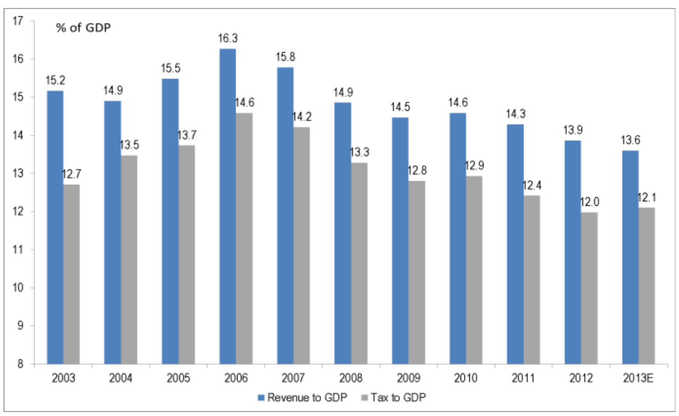
Weak revenue mobilization with desire to keep tax rates low is a source of fiscal weakness – government looks committed to fiscal consolidation, though the primary engine seems through spending restraint.

The MoF projects the 2013 budget deficit reached about 5.9% of GDP, a small slippage from the original 5.8% of GDP deficit target but a steady improvement from 6.4% of GDP deficit in 2012. One weakness is Sri Lanka's weak revenue mobilization, with pervasive tax leakages and relatively low buoyancy that IMF estimates at around 0.67ppts for every 1ppt increase in real GDP growth.Despite a relatively low revenue- and tax- to GDP ratio of 13.6% and 12.1%, respectively in 2013E (declining since 2006, see Figure 7), there is still significant policy reluctance to raise tax rates given the risk that it would undermine the government's credibility as a low tax jurisdiction. In fact, one official proudly mentioned Sri Lanka's maximum income tax rate for professionals is at 16%, 1ppt lower than HK's (even though HK has negative net government debt). Instead, authorities are focused on expanding the tax base via reducing the exemptions (e.g. lowering the turnover threshold for application of VAT on supermarkets), ending tax holidays and compressing recurrent expenditures, aided by their anticipated lower interest expense this year, and deferral of spending arrears. However, this less aggressive approach to fiscal consolidation has risks –government is aiming to reduce the deficit to 5.2% of GDP this year and 3.8% of GDP by 2016F, but we see risk of continued fiscal slippage (we forecast 5.5% of GDP deficit this year) given government's optimistic revenue assumptions, their continued desire to keep capital spending close to 6-6.5% of GDP and recurrent spending at 13-15% of GDP (we are already at 14% of GDP in 2013E). Thus, public debt reduction will likely remain gradual, and an ongoing source of vulnerability (Figure 8).

Government looks committed to containing SOE losses via the necessary fuel/electricity price adjustments, which is a positive – we need to watch global oil price developments and drought worries.

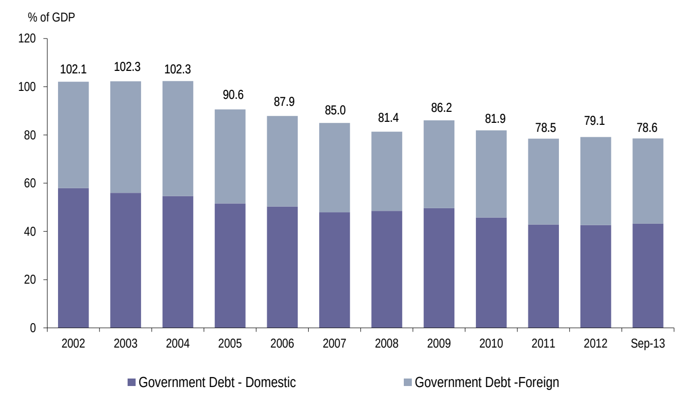
Nonetheless, SOE balance sheet improvements are encouraging. On the positive front, the balance sheet of SOEs, especially the country's two largest, have improved with the help of better pricing structure (on fuel and electricity) -- Ceylon Electricity Board (CEB) is expected to have turned a small profit last year while Ceylon Petroleum Corp (CPC) has dramatically cut its losses. These improvements on CPC and CEB are expected to be sustained as long as world oil prices stay within the range of their oil price assumption of $110/bbl, but we also need to monitor whether drought-like conditions they are experiencing currently, which is seasonal, will persist for longer. If this drought persists, another belated electricity rate hike is likely. MoF says that the government's efforts to both increase power generation capacity and diversify power generation sources by investing in more coal plants (wherein power costs would be only 28% that of thermal power) should help reduce reliance on hydropower. Others observe that Sri Lanka's electricity rates are still globally expensive, that new China-built coal power plants have quality issues (already facing periodic shutdowns) alongside the need to upgrade older plants. Nonetheless, MoF says that the government remains committed to pursue the necessary price adjustments (by around 6M lag) if cost structure on both fuel/electricity were to change as they remain committed to containing SOE losses.

Figure 7. Sri Lanka – Revenue and Tax to GDP Ratio on the decline



Source: MoF, CBSL, Citi Research

Figure 8. Sri Lanka – Government Debt (% of GDP)



Source: Citi Research

Other issues: Financial sector & politics

Financial sector consolidation remains a key focus, and government support for some of the larger state-owned banks looks strong.

Financial sector consolidation remains a key focus. The government is pushing for a Master Plan on Consolidation of the Financial Sector, particularly anchoring the banking sector around the top 5 banks, as well as reducing the number of non-bank financial institutions from 58 to about 20. Fitch sees this as a positive development – bank consolidation could improve efficiency and allow the banking sector to provide larger loans. Four of the top five banks are likely to include Bank of Ceylon, People's Bank, Commercial Bank, HNB Bank – the NSB is likely to have some special development role and the merger of NDB and DFCC is part of the process to strengthen the state-owned banks. Moreover, Bank of Ceylon is expected to receive government capital injection in the next 1-2 months to bring its Tier-1 capital ratio up from 9% to 12%, and improving SOE finances should also help state-owned banks that have significant exposure to them. Recent rise in non-performing loans last year (to around 5+% in 2013 from 3.7% in end 2012) has been attributed to gold-based lending (estimates range in the 6-7% of GDP), which had been a driver of private loan expansion and facilitated by zero-risk weighting, but we sense the risks as being manageable.

President Rajapakse and his UPFA party will likely remain a dominant force in Sri Lanka politics for the foreseeable future

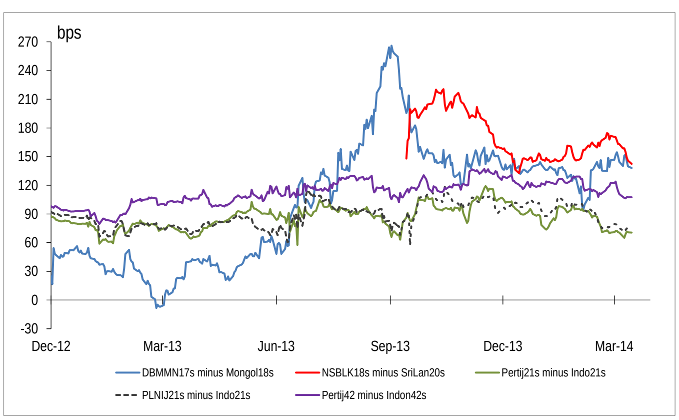
Political stability remains firmly entrenched. Sri Lanka will be having its Western provincial council elections on March 29, and President Mahinda Rajapakse can call for early elections to run for a third term as early as this year (his current term doesn't end until November 2016 and he can run for unlimited times based on the 18th Amendment of the Constitution) but people we met believe a Presidential election will more likely be held next year. Everyone we met believes the President remains very popular, opposition parties increasingly weak and that an election outcome will likely continue to reaffirm the overwhelming parliamentary majority of his UFPA party, with one observer noting that some opposition politicians are reportedly looking to defect to the ruling party. The long-term outlook for political succession in Sri Lanka looks likely to be a dynastic one (the President has three sons) and the stable and centralized decision-making process will likely persist for the foreseeable future.

Market Outlook

On the external debt front, would look for spread pick up on Sri Lanka quasi sovereign like NSBLK, while on the local front, we think investors should extend duration on the LKR Treasury bonds given steep curve.

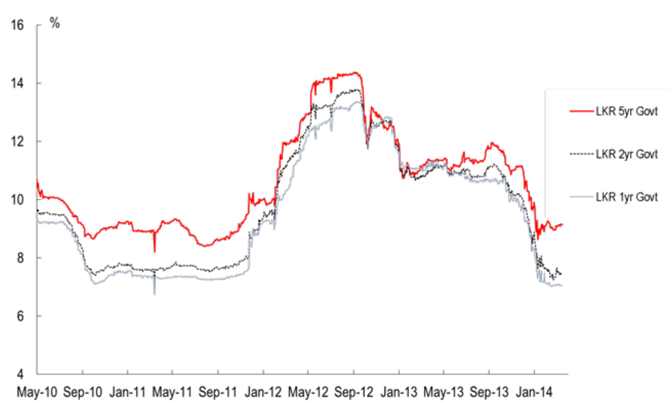
We think Sri Lanka (B1/B+/BB-) is a credit improving story, especially if both external and fiscal improvements are sustained, with the former looking more pronounced than the latter. However, in the last three months, Sri Lanka dollar sovereign spreads have already outperformed Indonesia by around 70bps and Vietnam by around 60bps, with its spread gap on the latter narrowing to about 58bps. In the near term, the absence of supply out of Sri Lanka (the sovereign may issue another bond later in the year to refinance the maturing US$500mn 2015 bond; it wasn't clear to us that the banks or other quasi-sovereigns were coming to the market in the next 6 months, with some SOEs like Sri Lanka Port Authority getting very cheap loan financing; CBSL notes that there is a $1.2bn interbank lending arrangement for Sri Lankan banks from Qatar, Abu Dhabi and Emirates amounting to about $1.2bn at relatively low cost) versus more supply out of Indonesia quasis could yield a bit more spread compression, but we are neutral Sri Lanka sovereign at these levels. We think the NSBLK's have a bit more juice at around 140bps z-spread pick up to the sovereign, which should narrow if underlying sentiment on the credit quality of the sovereign improves. On the local currency front, we are now more constructive over LKR over the medium term amid forecast CAD improvements (and more modest fiscal improvements) and with LKR treasury curve being historically steep, we would extend duration towards the 5yr part of the curve for carry and modest yield compression.

Figure 9. On the dollar bond spreads, there may be more juice in the Sri Lanka quasi-sovereign spreads



Source: Bloomberg, Citi Research

Figure 10. We would extend some duration on the LKR Treasury curve



Source: Bloomberg, Citi Research

Figure 11. Sri Lanka Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Sri Lanka									
Nominal GDP, US$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.9	74.3	85.3
Nominal GDP, local currency bn	3,579	4,411	4,835	5,604	6,544	7,582	8,659	9,727	11,081
GDP per capita, US$	1,617	2,014	2,057	2,400	2,836	2,923	3,314	3,596	4,100
Population, mn	20.0	20.2	20.5	20.7	20.9	20.3	20.5	20.6	20.8
Unemployment, % of labour force	6.0	5.4	5.8	4.9	4.2	4.0	4.3	4.3	4.2
Economic Activity									
Real GDP, % yoy	6.8	5.9	3.5	8.0	8.2	6.3	7.3	7.2	7.4
Real investment growth % yoy	8.0	4.2	2.1	14.5	7.7	6.6	--	--	--
Real consumption growth % yoy	4.5	7.9	3.6	7.6	12.9	5.5	--	--	--
private consumption growth % yoy	3.9	7.5	0.9	9.2	14.7	6.8	--	--	--
Real export growth, % yoy	7.3	0.4	-12.3	8.8	11.0	0.2	--	--	--
Real import growth, % yoy	3.7	4.0	-9.6	12.6	20.0	0.5	--	--	--
Prices, Money & Credit									
CPI, % yoy	18.8	13.9	5.0	6.8	4.9	9.2	4.7	7.0	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	5.1	6.5
Credit extension to private sector, % yoy	19.3	7.0	-5.8	24.9	34.5	17.6	7.5	13.0	10.0
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	7.50	8.00
1 month inter-bank rate, % eop	19.46	17.88	9.52	8.37	9.46	12.50	8.88	7.60	8.10
Long term yield, % eop	19.96	19.20	11.50	9.24	10.00	11.81	9.91	9.50	9.00
lc/US$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	131.0	129.0
lc/US$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	131.0	129.9
Balance of Payments, US$ bn									
Current account	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-2.3	-1.8	-1.7
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-3.3	-2.5	-2.0
Trade balance	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-8.4	-8.6	-9.4
Exports	7.6	8.1	7.1	8.6	10.6	9.8	10.4	11.3	12.3
Imports	11.3	14.1	10.2	13.5	20.3	19.2	18.8	19.9	21.7
Service balance	0.3	0.4	0.4	0.7	1.1	1.3	1.8	2.2	2.6
Income balance	-0.4	-1.0	-0.5	-0.6	-0.6	-1.1	-1.5	-1.8	--
FDI, net	0.5	0.7	0.4	0.4	0.9	0.8	1.2	1.1	1.2
International reserves	3.1	1.8	5.1	6.6	6.0	6.9	7.2	8.0	9.4
Total Amortisations	0.8	1.4	1.7	1.2	0.9	1.8	1.7	2.2	--
Public Finances, % of GDP									
Consolidated government balance*	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-5.9	-5.5	-5.2
Consolidated gov primary balance*	-1.8	-2.2	-3.4	-1.7	-1.4	-1.1	-1.1	-1.0	-0.8
Public debt	85.0	81.4	86.1	81.9	78.4	79.1	78.6	77.0	76.0
of which Domestic	47.9	48.5	49.7	45.8	42.9	42.6	42.3	41.5	40.9
Foreign Assets & Liabilities, US$ bn									
External debt	16.5	17.8	20.9	24.8	29.4	33.7	37.3	41.3	48.0
Private	4.3	5.0	5.5	6.6	9.2	11.5	11.8	12.0	--
Public	12.2	12.8	15.4	18.2	20.2	22.2	25.5	29.3	--
External debt / GDP	50.9	43.6	49.7	50.1	49.7	56.7	55.0	55.7	56.3
Short-term debt	2.5	2.7	3.1	3.4	4.5	5.1	5.4	5.6	--
Short-term debt/International Reserves (%)	81.3	152.1	60.7	51.5	75.0	73.4	74.7	70.1	--

Source: CEIC Data Company Limited, Central Bank of Sri Lanka, Moody's and Citi Research estimates
*Note: Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Appendix A-1

Analyst Certification

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