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Sri Lanka in the Capital Markets

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CONTENTS: SRI LANKA IN THE CAPITAL MARKETS

Painted ceiling in Isurumuniya Vihara

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Peace pays handsome dividend for Sri Lanka

After years of civil war, Sri Lanka can at last reap the economic benefits of peace. Economic growth of 8% in 2010 and 2011 shines out in a world hampered by low or slowing growth and global bond investors are keen to increase their exposure and support the Sri Lankan story.

Sri Lanka has been nominated by at least one highly-respected travel publication as the number one tourism destination globally for 2013. "Now the... conflict is over, investment is fuelling the tourism industry, and visitor numbers are steadily increasing," said Lonely Planet in its preview of 2013.

Those numbers reached a record 856,000 in 2011, and with about 700,000 tourists arriving by the end of September this year, Sri Lanka is on target to attract 1m visitors in 2012.

With leading hotel operators looking to invest in the market, and with airlines such as British Airways preparing to launch new services to Colombo next year, Sri Lanka's longer-term goals for its tourism industry appear to be within reach. According to a recent presentation from the Central Bank of Sri Lanka, these include an increase in tourism arrivals to 2.5m by 2016, and a rise in tourism earnings from $830m in 2011 to $2.75bn by 2016.

Positioning Sri Lanka as the world's number one destination for investors in 2013 would be an equally impressive achievement. In the equity market, to do so would mean recapturing the stunning performance of the years immediately after the cessation of hostilities. In 2009 and 2010, Sri Lankan equities were among the best performing in the world, before retreating modestly in 2011.

In the bond market, meanwhile, when Sri Lanka launched its debut $500m issue in 2007 via Barclays Capital, HSBC and JP Morgan — which was repaid this October — the five year transaction was priced at 8.25% and was three times oversubscribed. The sovereign's most recent issue, a 10 year $1bn benchmark led in July 2012 by Bank of America Merrill Lynch, Barclays, Citi and HSBC, by contrast, was priced at 5.875%, which was the low end of guidance. In spite of offering no new issue premium, the July 2022 issue generated demand of $10.5bn.

Even at this pricing level, and against the backdrop of an uncertain international economic climate, spreads on Sri Lankan sovereign paper have continued to narrow. "There has been genuine buying interest from real money accounts in the secondary market, which is why the July issue has tightened to 5.3%," says Nick Nicolaou, chief executive of HSBC Sri Lanka and Maldives. "Investors who have been supporting the Sri Lankan story right from the beginning of the government's issuing programme have seen substantial accretion to their portfolio values over the years."

Rating agencies' warm response

It is easy to see why Sri Lankan assets have performed so well in recent years. The peace dividend delivered economic growth of 8% in 2010 and 2011, the first time since independence that Sri Lanka has posted such explosive increases in GDP in consecutive years. Ratings agencies responded warmly, with Moody's changing its outlook on Sri Lanka's B1 rating from stable to positive in July 2011, S&P upgrading the sovereign rating to B+ and Fitch lifting its rating to BB-.

"Sri Lanka is one of the most exciting investment stories in Asia, and an economy in the midst of an important transformation," says Alexi Chan, managing director and head of Asian debt capital markets origination at HSBC. "The country has a strong following among emerging market bond investors globally, who value the highly credible policy framework put in place to enable Sri Lanka to realise the peace dividend fully."

"Investors who have supported the Sri Lankan story right from the beginning have seen substantial accretion to their portfolio values"

Nick Nicolaou, HSBC

The 2011 upgrades from the ratings agencies were fortunately timed, as the announcement came while the government was roadshowing its $1bn 10 year benchmark led by Bank of America Merrill Lynch, Barclays Capital, HSBC and RBS. Demand for the July 2021 issue, priced at the tight end of its 6.25%-6.375% guidance range, reached $7.5bn.

Unsurprisingly, growth is expected to slow in 2012, with a number of economists having revised their forecasts for Sri Lankan GDP growth this year. In July, for example, when it approved the disbursement of the final tranche of a $2.6bn facility for Sri Lanka, the IMF announced that it was trimming its growth forecast for 2012 from 7.5% to 6.75%.

"Following robust growth in the first quarter of 2012, activity has started moderating in response to policy tightening and weakening global demand," the IMF said.

The IMF's forecast is broadly in line with the government's own revised projection. "Growth has been higher than originally expected in each of the last two years," says Central Bank of Sri Lanka governor, Ajith Nivard Cabraal. "Last year's growth rate was 8.3%, which was at least half a percentage point higher than we originally forecast."

"But clearly, global economic conditions have become more hostile and we have seen growth slowing across the board, especially in countries such as India and China, which has an effect throughout the world," Cabraal adds. "Sri Lanka has also been impacted, which is why we are now expecting GDP to grow by 6.8% this year. We are very satisfied with this rate of growth, which we think compares well with the rates forecast for our peers."

Encouraging long term trends

More important than short term fluctuations in the growth rate, however, are the long term trends in social and economic indicators, which are transforming the quality of life for Sri Lankans, creating sustainable job opportunities and lifting millions of people out of poverty. Unemployment reached a record low of 3.9% by the end of 2011, compared with 15.9% in 1990, while the poverty level — as measured by the head count poverty index — fell from 15.2% in 2006 to 8.9% in 2009/2010.

GDP per capita, meanwhile, which surpassed $1,000 in 2004, reached $2,014 in 2008 and more than $2,800 in 2011. This suggests that Sri Lanka is ahead of the ambitious primary economic goal enshrined in its Vision for the Future (Mahinda Chintana), which is to double per capita income between 2009 and 2016, to $4,000.

"Our assessment is that we are well on track with our aim of becoming a $100bn economy by 2016," says Cabraal. "In fact, our estimates are now slightly more optimistic than they were some years ago. We believe that unless there is a massive and unforeseen global downturn, the necessary conditions are now in place for us to reach a per capita income level of $4,000 by 2015, a year ahead of schedule."

Critically, the increase in GDP per capita that has already been achieved has been evenly distributed across Sri Lanka, rather than being concentrated in the wealthier Western region, which was mostly untouched by the war and has traditionally been Sri Lanka's principal economic base.

"One of the key objectives of this government is to ensure that growth is not concentrated only in the Western province," says Cabraal. "We have been very encouraged by the fact that during the last six years the Western province's share of GDP has diminished from 51% to 45%. This is not because activity in the Western regions has declined in absolute terms, but because of the increase in economic activity in other provinces."

A step-up in economic activity in the less developed regions of Sri Lanka has dovetailed with a striking decline in poverty, which is regarded as a prerequisite for long term economic and political stability. Cabraal says that he attributes the fall in Sri Lanka's poverty level to three key developments. "First, access to finance has been much improved," he says. "Second, electrification has risen from a 72% coverage level in 2005 to 92% today, which represents a massive change in the landscape. And third, concreting of roads throughout rural areas has also created improved economic opportunities."

Rising consumer spending bolsters FDI

Across-the-board rises in per capita income and consumer spending power has been an important driver of inflows of foreign direct investment (FDI) into Sri Lanka. As one recent example, take the acquisition by the Singapore-based Parkson Retail of a 42% stake in Odel, which is recognised as being one of the most conspicuous success stories in Sri Lanka's economic development over the last two decades.

Originally established by Otara Gunewardene in 1990, with a single store in Dickman's Road in Colombo, Odel has rapidly expanded into a chain of 17 retail outlets. Targeted principally at middle to upper income consumers, Odel focused originally on ladies' clothing, but has since expanded into a wide range of household goods as well as jewellery and souvenirs.

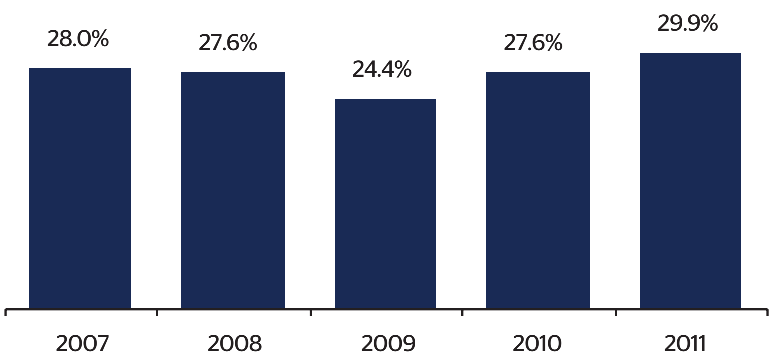
The strength and visibility of the Odel brand was underscored in July 2010, when an IPO of 11.5% of the company's equity chalked up a new record for the Colombo Stock Exchange (CSE) with an oversubscription level of almost 64 times.

Odel's CEO, Otara Gunewardene, says that since the end of the war the group has seen a sharp increase in revenue, driven by a rise in consumer income as well as the tourism boom. "A large number of customers who visit our flagship store in Colombo are tourists, and our store in the departure lounge at the airport has also been supported by the strength of the tourism industry," she says.

Gunewardene adds that Parkson's investment in Odel is a significant vote of confidence in the prospects for the Sri Lankan economy. Parkson Retail Asia — which was listed on the main board of the Singapore Stock Exchange in November 2011 — has an extensive network of 54 department stores in southeast Asia. The Parkson Retail Group, meanwhile, which is quoted in Hong Kong, operates a chain of stores throughout China.

Since the announcement of its

Investment as % of GDP



Source: Central bank of Sri Lanka

original investment in Odel, a mandatory offer has lifted Parkson's share in the company to 45%, and along with an upcoming rights issue injected some $20m of funding into the business which will be used for further expansion.

"We already have about 120,000 square feet of retail space and we are now looking to expand this significantly over the next few years," says Gunewardene. "Adding new capacity will allow us to widen our offer to our customers both with our own brands and by bringing more international brands into Sri Lanka."

However, Parkson has also indicated that it sees Odel as potentially providing a springboard into a number of other markets in Sub-continental Asia.

A place to do business

That is an important endorsement of the progress that Sri Lanka has made in the World Bank's ease of doing business index. In its recently published ranking for 2013, Sri Lanka is the highest-positioned South Asian country, having risen from 98th spot in 2011 to 81st today.

Sri Lanka's projected increase in consumer spending, twinned with the improved outlook for tourism following the 2009 ceasefire, has also underpinned the strategy of a company such as Lanka Orix Leasing Co (LOLC), which dates back to 1982.

Then, its principal shareholders were the IFC and Bank of Ceylon, which between them held 70% of the equity, with Japan's Orix owning the balance. "The company was originally set up in order to support the liberalisation of the economy by providing the SME sector with leasing and hire purchase opportunities," explains Kapila Jayawardena, LOLC's group managing director and CEO.

The IFC and Bank of Ceylon soon exited, leaving Orix as the majority shareholder, and for the best part of the next two decades the company's focus remained on leasing. From 2000 onwards, says Jayawardene, the group expanded into the market for broader financial services, and today Lanka Orix Financial Services (LOFIN) has a deposit base of Rs25bn and is one of the largest non-bank companies in the sector. "LOFIN is the only non-bank with approval from the regulator to undertake foreign currency business and to access the interbank market to do foreign exchange swaps," says Jayawardene.

LOFIN, he adds, has been a pioneer in areas such as secured vehicle financing, a very profitable market that has posted strong growth mirroring the expansion of the economy and the rise in per capita income and spending. In the capital market, meanwhile, LOFIN has been the standard bearer for the small but growing securitisation market.

The next phase in the LOLC diversification story, Jayawardene says, came five years ago, when, in anticipation of a ceasefire, the company made a strategic decision to expand into the leisure sector. "We compared the growth of the industry in Sri Lanka to Thailand, where between 1983 and 2011, the number of tourist arrivals rose from about 600,000 to over 15m," he says. "In Sri Lanka over the same period they rose from about 450,000 to 800,000."

"I'm not saying we can attract 15m tourists a year, as Thailand does, but we can easily go from 1m to 3m, which would create a completely new paradigm in terms of occupancy levels, revenues, profits and IPO opportunities for companies in the tourism sector," Jayawardene adds.

Rather than base its tourism strategy on creating its own brand, as some local operators have done, Jayawardene explains that LOLC will be passing the management of its range of leisure properties over to internationally-recognised operators. "Although Shangri-La and Hyatt will be opening in Colombo, amazingly none of the global operators are yet active in the resort business," he says.

"A large number of customers who visit our flagship store in Colombo are tourists"

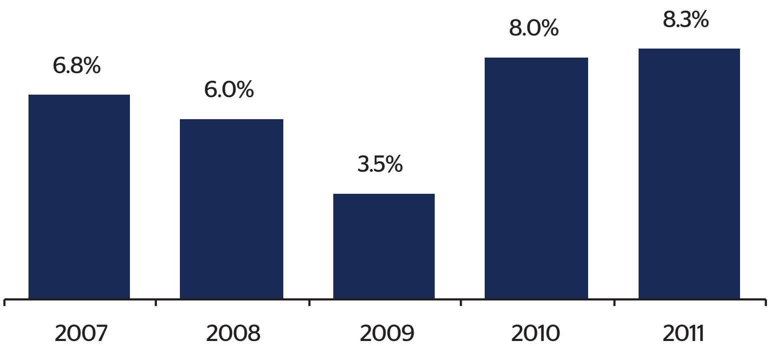
Otara Gunewardene, ODEL

That, says Jayawardene, will begin to change in late 2014 or early 2015, which is the target date for the opening by LOLC of a 450-room, five star tourist resort on the Golden Mile, which will be the largest of its kind in Sri Lanka and the first to be managed by a multinational hotel company.

With LOLC adopting a similar strategy in the fast-growing construction industry, gaining exposure by acquiring stakes in well-established operators rather than creating its own company, the group is now resembling a conglomerate rather than a narrow financial services company.

Today, financial services accounts for about 70% of LOLC's earnings, and Jayawardene says he expects this share to come down to about 60% as profits from the company's activities in other sectors start to gather momentum. ▲

Real GDP growth



Source: Central bank of Sri Lanka

Ensuring economic growth is sustainable

Vibrant economic growth is, inevitably, bringing Sri Lanka a number of associated dangers that investors and ratings agencies caution will need to be carefully monitored and managed by the local authorities.

Sri Lanka has many positive messages, one of the most positive being explosive economic growth. However, unsurprisingly, given the speed with which the country has rejoined the global system, it also has many economic challenges.

Foremost among these is the budget deficit, which Central Bank of Sri Lanka governor, Ajith Nivard Cabraal, acknowledges to be a concern. "The budget deficit is something that has been worrying us for a while," he says. "However, in the last few years since the conflict ended, the government has shown a great deal of discipline. Last year the budget deficit was 6.8%, compared with 7.8% the previous year, and this year the government is committed to reducing it further, to 6.2%."

Weak revenue to GDP has also been identified by ratings agencies as an associated vulnerability. As Moody's notes in its most recent review: "While tax reforms as part of the 2011 budget have improved prospects for widening the tax base, expenditure restraint has been a larger contributor to fiscal consolidation thus far.

"This includes benefits from lower debt servicing costs resulting from the tightening of yields on government bonds in line with lower post-war inflation. However, the budget has yet to gain fully from the end of the conflict as defence expenditure remains high."

A second challenge arising from growth is inflation, which the central bank is committed to keeping within single digits. It has met this goal consistently in recent years, with inflation in 2011 reaching 4.9%, which was well inside the Bank's target for the year of between 4%-6%. It is also a very far cry from the early 1980s, when inflation reached more than 30%.

Nevertheless, over the course of 2012 inflation has been creeping higher, rising from just 2.7% in February to 9.8% in July, before declining again to 8.9% in October. This has not prompted a tightening of monetary policy, with interest rates left unchanged in October, with the central bank comfortable that the spike has been the result of one-off factors.

"Some of the rise in inflation has been driven by higher oil prices and by our increased flexibility on the exchange rate," says Cabraal. "However, we have compensated for this by managing demand more effectively. For example, we have brought in a credit ceiling of 23% over the last year, which has had a dampening effect on demand without jeopardising our projected growth for this year of 6.8%.

"We think this is an effective way of controlling inflation and inflation expectations. We've enjoyed 45 months of single digit inflation, which is by far the longest period of low inflation in our history, and this is something we want to safeguard jealously."

A third factor identified as a challenge by ratings agencies is Sri Lanka's external debt, although as Cabraal points out, the public debt to GDP ratio in 2011, of below 80%, is the lowest recorded in the last 30 years. It is also appreciably below the recent peak of 105.6% in 2002.

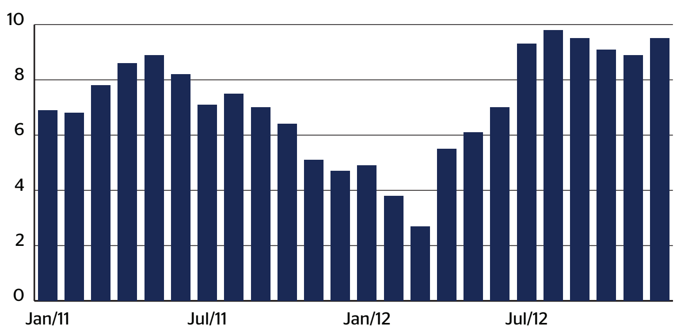
"In the context of a global environment in which many other countries are increasing their debt, we think this is a very good achievement," he says. As of the end of 2011, total debt outstanding amounted to a little over Rs5.1tr, of which Rp2.8tr was in domestic debt, with Rp2.32tr in foreign debt.

Sri Lanka is committed to delivering further declines in the size of its debt burden as well as in its debt servicing costs — which reached 5.45% of GDP in 2011 — over the coming few years.

As the central bank explains in its recently published debt management review, the overall objective of the Medium Term Macro Fiscal Framework (MTMF) is to bring down the debt to GDP ratio to 60% by 2016, as well as to "further strengthen debt dynamics over the medium term and the overall financial system stability."

Cabraal emphasises that the challenge of debt management in Sri Lanka is about much more than reducing the overall size of the debt relative to GDP. Equally important, he says, is managing the structure of the debt to minimize rollover risk, lower the proportion of

Inflation rate: within target but on the rise



Source: Department of Census and Statistics, Sri Lanka short-term government debt and decrease the share of foreign currency denominated debt.

Progress was made in a number of these areas in 2011, with a large volume of shorter dated T-bonds replaced with medium to long term issues. According to the central bank's review, issuance of T-bonds with a maturity of less than two years was reduced from 25.11% of the total in 2010 to 11.68% in 2011, while the share of T-bonds with maturities of six years or longer increased "significantly" to 42.51%, compared with 17.32% in 2010. This helped the average term to maturity of the total debt to be extended from 5.25 years at the end of 2010 to 5.41 years by the end of 2012.

As Cabraal acknowledges, however, the key to debt sustainability over the coming years will be remaining vigilant about the threat of inflation. "If we can keep inflation to within single digits we will be able to keep interest rates low and minimise the costs of debt servicing," he says.

An additional macroeconomic cause for concern, in the view of some economists, has been the weakness of the Sri Lankan currency over the last 12 months. The rupee has depreciated by about 15% since November 2011, which Cabraal believes represents an overshoot on the downside. "We're expecting to see a surplus in our balance of payments this year which would support a strengthening of the currency," he says.

Although Sri Lanka runs a substantial trade deficit, this is more than offset by huge inflows of workers' remittances, which contributed 8.5% of total GDP in 2011. "Remittances continue to be very strong," says Cabraal. "We expect to see growth of about 20% this year, which will build on an already very strong base of $5bn."

While maintaining this heavy flow of remittances would be one important source of stability for the currency, another would be an increase in inflows of foreign direct investment (FDI). Volumes of inward investment — say some Colombo-based observers — have been slightly disappointing in recent years, given the opportunities that were opened up when the guns fell silent in 2009. Inflows of FDI reached just over $1bn in 2011 and the government is projecting a near-doubling this year to $2bn, or 5% of GDP.

To date, the showcase examples of FDI into Sri Lanka have been concentrated principally in the tourism sector, with hotels and restaurants accounting for 20% of FDI in 2011. Some 197 hotel and other tourism-related projects are now underway, led by international operators such as Shangri-La and Sheraton, which are investing $400m and $300m respectively in landmark developments in Sri Lanka. ▲

FDI driver: upgrading the infrastructure

FDI will be encouraged to flow into Sri Lanka as the much-needed rehabilitation of its infrastructure gathers momentum. A wide range of key transportation projects are underway which will underpin growth in the tourism sector, bolster international trade and enhance Sri Lanka's credentials as a key trans-shipment hub ideally positioned between the Gulf and southeast Asia.

These include a number of road development projects, the expansion of Colombo's existing airport and the construction of a new international airport at Mattala. Key port development initiatives, meanwhile, are the South Colombo Harbour project (due for completion in 2014), the Hambantota Port scheme (by 2014) and projects at Oluwil, Galle and Kankasanthurei.

It was not just the development of transportation infrastructure that was neglected during the war. Much-needed investment in Sri Lanka's energy sector was also a casualty of the hostilities, as Ravindra Pitigalage explains. He is chief financial officer of the engineering company, LTL Holdings, which is a leading player in the Sri Lankan power generation sector.

In 2008, its West Coast subsidiary won a number of awards for the €152.5m financing package arranged by HSBC for Sri Lanka's largest independent power project, a 300MW combined cycle plant supported by seven export credit agencies (ECAs).

The success of this project, says Pitigalage, speaks for itself, because since it was commissioned power cuts in Sri Lanka have become a thing of the past. "Had it not been for this project our power sector would have encountered some serious problems when demand began to rise from 2009 onwards," he says.

Critically, however, Pitigalage adds that the ceasefire has meant that Sri Lanka can now turn its attention to the renewables sector, and in particular to wind power, the greatest potential for which lies on the north-east coast, which was off-limits to investors during the war. "We've had a vibrant small hydro sector for the last 10 years or so, but most of the economically viable sites have already been developed," he says.

"The exciting newcomer is therefore wind power. About 70MW of

"The government is planning to borrow the necessary funding to build up the system"

Ravindra Pitigalage, LTL Holdings

capacity has already been developed, but according to some projections wind power could provide as much as 300MW."

Pitigalage says that West Coast itself is now developing a 10MW wind power plant, but that the main constraint for investors in the renewables sector — now that political risk is no longer a concern — is the inadequacy of the transmission system. "The government is planning to borrow the necessary funding to build up the transmission system over the next two to three years," he says. "Once the necessary transmission infrastructure is in place, investors will be encouraged to focus more on the potential of renewable energy." ▲

Time to meet the credit challenge

The Sri Lankan central bank has high hopes for the domestic capital markets, projecting that the volume of corporate bonds outstanding will increase 10-fold, to Rs1,000bn, by 2016.

A key challenge that the Sri Lankan government is eager to address is the underdevelopment of the domestic capital market, which was identified as a credit challenge by Moody's in its most recent analysis.

Central Bank of Sri Lanka governor, Ajith Nivard Cabraal, acknowledges that this is a weakness that needs to be addressed if Sri Lanka is to deliver on its potential. "The domestic capital market certainly has potential, but is an area where we have been lagging behind, especially in the corporate bond market," he says.

The Bank has thrown down a gauntlet to the domestic corporate sector in projecting that the volume of corporate bonds outstanding will post a 10-fold increase, from Rs100bn to Rs1000bn, by 2016.

Nick Nicolaou, chief executive of HSBC Sri Lanka and Maldives, points to at least four reasons why a growth of this magnitude may be within reach. First, there is a very high demand for funding within the corporate sector, given the number of investment plans that have been given the green light since the end of the civil war.

"There is a clear need for additional funding in Sri Lanka and equity alone won't be able to satisfy this demand, so there is certainly a need for a deeper corporate debt market," says Sumith Perera, fund manager at Guardian Fund Management in Colombo. Its emphasis to date has been on equity investment, but Perera says that he expects the expansion of the local bond market to create more opportunities for fixed income investment in Sri Lanka over the next few years.

Second, the anti-inflationary restrictions that have been put on bank lending are expected to lead corporates to explore alternative funding sources. "Increasingly, the banks have been encouraging their corporate clients to go to the bond market and develop their own investor bases," says Cabraal.

Third, adds Cabraal, although the corporate bond market has been slow to gather traction, there is a well developed fixed income culture in Sri Lanka. "We enjoy the advantage of having a strong, transparent and liquid government debt market," he says.

Fourth, while yields in the government debt market remain attractive, they have been falling in recent years. The overall average yield in the T-bill market fell from 18.59% in 2008 to 7.77% at the end of 2011, according to the government's latest public debt market review, while in the T-bond market the yield declined over the same period from 18.59% to 8.64%. "There is likely to be plenty of demand among insurance companies, provident funds and other institutional investors for higher yielding corporate bonds," says HSBC's Nicolaou.

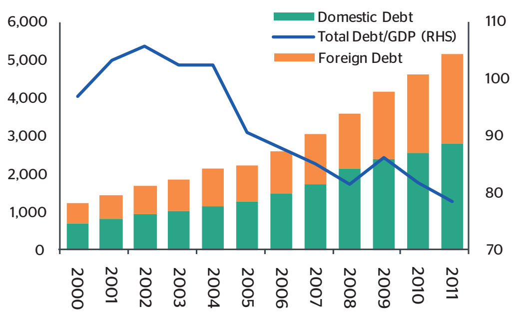
International issuance is also expected to gather pace, now that the government has established an increasingly liquid yield curve in the dollar market and has emphasised a demonstrable commitment to the market, having issued in public benchmark format almost each year since 2007. "We have given a clear indication to international markets that we are committed to regular issuance," says Cabraal. "One of the reasons why our bonds have tightened so sharply is that we have been able to build confidence among investors through an interactive dialogue. This is a process which has brought a very important discipline to our debt management, because we are now evaluated by international investors who benchmark us against other sovereign borrowers." Cabraal says that competitors in the international capital market include borrowers such as the Philippines, which have longer track records than Sri Lanka.

"Sri Lanka's success in the international bond market not only reflects its robust and improving credit story," says Alexi Chan, managing director and head of Asian debt capital markets origination at HSBC. "It is also a credit to the continuous efforts of the central bank and ministry of finance teams in engaging with international investors to keep them regularly updated on the latest developments in the country."

Aside from continuing to build a yield curve in the international market, another initiative that is under consideration at the central bank is the issuance of internationally-targeted Sri Lankan rupee-denominated bonds. "We have already seen growing confidence in the currency among some big international investors, which means that in the near future we may be able to issue international bonds in rupees, which would minimise our exposure to exchange rate movements," says Cabraal.

There is no shortage of demand for exposure to Sri Lan-

Government debt — domestic and foreign (Rp bn, % GDP)



Source: Central Bank of Sri Lanka

kan domestic government debt among international fixed income investors. Quite the reverse. The central bank's most recent public debt review advises that "foreign investments in Sri Lanka rupee denominated government securities continued in 2011 with foreign investors' demand being very high. Foreign investment in government securities had reached its 10% limit, reflecting investor confidence [in] the Sri Lankan economy supported by attractive yields." In response, at the start of December 2011 the central bank raised the limit on foreign holdings of T-bills and T-bonds from 10% to 12.5%.

The government has no intention of relaxing its focus on cultivating closer interactive relationships with the international investor community, nor on endeavouring to make the Sri Lankan credit more attractive to fixed income investors. "We take our rating very seriously and have

"Sri Lanka's success in the international bond market reflects its robust and improving credit story"

Alexi Chan, HSBC

set ourselves the ambitious target of ensuring that we have an investment grade rating within the next three to four years," says Cabraal. "This would benefit existing holders of our long term bonds, but it would also pave the way for us to borrow at a much lower price in the future."

Bankers point out that in the secondary market Sri Lanka is already trading close to a number of investment grade sovereigns. But elevation to investment grade status would also benefit other Sri Lankan borrowers eyeing up the potential of the international capital market.

The combination of a well established sovereign yield curve in the international market, along with robust demand among international fixed income investors for exposure to Sri Lanka, ought to provide the ideal platform for other borrowers to access the international bond market.

Cabraal says that until recently he was disappointed that no other Sri Lankan borrower had capitalised on the sovereign's initiative by issuing in the international market. "When we first went to the market I remember telling investors that we hoped to see other borrowers following us," he explains. "That did not happen for a number of years, which was disappointing because we had established a benchmark and there was clearly international appetite for Sri Lankan paper." ▲

Bank of Ceylon establishes non-sovereign benchmark

In April Bank of Ceylon became the first Sri Lankan borrower other than the sovereign to access the international bond market for seven years.

The $500m five year issue led by Bank of America Merrill Lynch, Citi and HSBC, was priced at the tight end of guidance to yield 6.875%, which was the equivalent of 65bp over the sovereign.

Total demand for the Bank of Ceylon transaction reached close to $3.9bn, reflecting the issuer's leadership in the local banking sector, which makes it a good proxy for investors looking for exposure to the broader Sri Lankan growth story at a pick-up to the sovereign. As PA Lionel, deputy general manager of international, treasury and investment at Bank of Ceylon says, by virtually any yardstick the bank is the recognised standard-bearer for the Sri Lankan financial services industry. At the end of 2011, the state owned bank accounted for 22.8% of the industry's total assets, for 20.72% of all loans and 21.31% of advances.

Lionel says that Bank of Ceylon is also a clear leader in terms of revenue and efficiency. "It has been a good year for all the major financial institutions, and we have led the way by becoming the first Sri Lankan bank with an asset base of Rs1tr, which we reached in June," he says. "We achieved a profit of Rs11.4bn in the first half of this year. Last year our NPL ratio was below 2%, compared with an average for the industry of between 4% and 5%."

This made Bank of Ceylon an ideal candidate to break the ice in the international bond market for Sri Lankan borrowers. So too did the overseas visibility it already enjoyed from its borrowing in the syndicated loans market. "HSBC has arranged a number of offshore syndicated loan transactions for Bank of Ceylon over the last five years, enabling it to tap into the bank market across Asia and the Middle East," says N Kartik, director, debt capital markets, Asia Pacific at HSBC. "Accessing the international bond market was the logical next step and also the best way for the bank to term out its debt maturity profile."

Lionel confirms that its debut transaction helped Bank of Ceylon to address maturity mismatches in the bank's balance sheet. "We thought we might be able to generate demand

"It demonstrates how much confidence investors have in the Sri Lankan economy and in Bank of Ceylon"

PA Lionel, Bank of Ceylon

of $1bn or $1.5bn, but we were very pleasantly surprised that the issue was 7.8 times oversubscribed," he says. "It demonstrated how much confidence investors have both in the Sri Lankan economy and in Bank of Ceylon."

Market participants believe that the Bank of Ceylon transaction will pave the way for other borrowers to come to the international market. "Sri Lankan companies have been too inward-looking in the past, so I was particularly pleased that Bank of Ceylon took the plunge," says Central Bank of Sri Lanka governor, Ajith Nivard Cabraal. "The bonds have tightened quite sharply which should encourage others to look at the market." ▲

At the double, equity market sets out its ambition

Given the mixed performance of some of Sri Lanka's recent IPOs, the Sri Lankan central bank's prediction that the stock market is set to grow to a value of 70% of GDP by 2016 could be seen as over-ambitious.

While the Sri Lankan bond market has very clear growth potential *(see separate chapter)*, one of the more striking predictions made in a recent presentation by the central bank is that the stock market is projected to grow to a value of 70% of GDP when GDP reaches $100bn by 2016.

That is quite a statement, given that even after the explosive performance of Sri Lankan equities in 2009 and 2010, the market capitalisation still amounted to just $16.3bn as of October 2012. At the end of 2011, market capitalisation was a modest 33.8% of GDP, down from 39.5% at the end of 2010.

The chances of doubling the size of the equity market in the next four years also look ambitious in light of the chequered performance of some of Sri Lanka's recent IPOs. The largest of these, in November 2011, was the Rp7bn sale of a 25% stake in People's Leasing, Sri Lanka's biggest leasing company, which generated demand of Rp9.5bn. By November 2012, however, the shares were trading at Rp12.40, sharply down from the IPO price of Rp18 a share.

Investors say that this disappointing performance was a product of external influences rather than a commentary on the fundamental strength of the company. "I don't think the IPO was overpriced," says Niloo Jayatilake, fund manager at the Sri Lanka Fund. "The problem was that soon after the listing, interest rates rose, which made it hard for the company to meet its earnings targets. We believe the long term prospects for People's Leasing remain bright."

There are a number of promising indications to suggest that there is potential for further growth in the Sri Lankan equity market. One of these is the range of initiatives that the Colombo Stock Exchange (CSE) and others are taking to bolster supply and demand in the market. A spokesman for the CSE says that one of the measures recently discussed by a number of stakeholders has been a move to require more companies in the financial services sector to list on the CSE. "For example," he says, "there are 19 insurance companies in Sri Lanka, only seven of which are listed on the CSE."

Colombo Stock Exchange: bolstering supply and demand

Encouraging more companies to come to the market would help address the issue of concentration in the Sri Lankan equity universe. As the CSE spokesman points out, the largest listed company, the John Keells conglomerate, accounts for about 7% of the entire market, while the top 50 companies contribute some 75% of total capitalisation.

So too would encouraging more listed companies to increase the size of their free float, which in some instances is vanishingly small. Although the minimum initial free float for companies on the main board is 25%, few companies maintain this minimum, and in some very extreme cases the free float is as low as 1%. For the market as a whole, the free float remains low by international standards, at just 27%.

The CSE is also exploring a number of ways of attracting more investment into the equity market by, for example, organising a range of investor awareness programmes for private individuals, fewer than 1% are active investors in equities.

Another recent initiative that the CSE hopes will create more demand for equities among local and international investors is the recent launch of the S&P Sri Lanka SL20 Index, which, says the CSE, paves the way for index-based products such as Exchange Traded Funds (ETFs).

Another positive signal for the market is that overseas investors, who were hesitant about the Sri Lankan recovery story in the immediate aftermath of 2009's ceasefire, are now net buyers. "Although our market was up so strongly in 2009 and 2010, we still saw outflows from foreign investors who weren't fully convinced by the Sri Lankan story," says Jayatilake. "This year, we have seen huge inflows coming into the market from overseas investors."

Specifically, according to data published by the CSE, in the year to October 2012, foreign investors accounted for 22.7% of turnover, compared with 18.5% in 2010 and 10.9% in 2011. This year's positive inflows need to be interpreted with caution, however, given that much of the total is accounted for by a single transaction in March. This was the acquisition by Malaysia's state investment arm, Khazanah Nasional, of an 8.9% stake in the conglomerate, John Keells Holdings (JKH), which is comfortably the largest and most liquid quoted Sri Lankan company. Khazanah paid just under $120m for the stake in JKH, which gives it exposure to a group with interests in areas ranging from food and beverages to financial services, hotels and leisure, IT, property, transportation and plantations.

Nevertheless, Ruvini Fernando, CEO of Guardian Fund Management, says that there are plenty of signals suggesting that foreign investors are looking for opportunities in the Sri Lankan equity market, which she says now looks undervalued, on a P/E ratio of below 15 as of October 2012, which compares with 25 in 2010. "As an institutional investor," she says, " we see this market as cheap and we're now looking to deploy our funds in the market."

Fernando concedes that persuading foreign investors to use the Sri Lanka Fund as their entry point into the market — rather than investing on a direct basis or via more broadly-based Asian funds — has been an uphill struggle. "However, we have had enquiries from investors in Europe, the Middle East and Asia, many of which are now doing their due diligence on the market, so are confident that we will see more participation in the Fund from overseas," she says. ▲

Resilience pays off for the banking industry

Of Sri Lanka's 24 licensed commercial banks, 12 are branches or subsidiaries of foreign banks, with players such as HSBC having had a presence in the market for over 100 years. International as well as local banks, however, have proved their resilience in the face of the global economic slowdown. According to the central bank's recent presentation, in 1989/90 13 finance companies were wound up. By contrast, between 2006 and 2011: "There was not a single bank or registered finance company that closed in Sri Lanka although there was a huge global financial crisis."

External analysts have also expressed their comfort with the solidity of Sri Lanka's banks. The country's "relatively sound banking system" is cited as one of the country's credit strengths in the latest update from Moody's.

This resilience continues to be evident in the performance of the Sri Lankan banking industry. As a recent Bank of Ceylon presentation comments: "The banking system's exposure to credit, market, liquidity and operational risks [are] maintained at a manageable level." System-wide, banking sector assets rose at a compound annual growth rate (CAGR) of 14.1% between 2007 and 2011, while total deposits and gross loans and advances increased by 15.2% and 14.2% respectively over the same period. Gross NPLs, meanwhile, have tumbled from 8.5% in 2009 to 3.8% in 2011.

The Sri Lankan banking sector, adds Bank of Ceylon, has benefited from a supportive regulatory framework, which has focused on sound corporate governance and risk management standards, as well as prompt implementation of Basel II and IFRS guidelines. "Implementation of measures such as the Deposit Insurance Scheme are expected to further reinforce the resilience of the banking sector," adds the Bank of Ceylon presentation.

A resilient banking system is viewed as a prerequisite for supporting the growth of small and medium-sized enterprises (SMEs), which are re-emerging as an important source of economic activity and job creation in Sri Lanka. Their contribution to sustainable growth could be further enhanced if they had greater access to finance, according to external observers such as the IFC, which has been developing an innovative model to channel remittances into SME lending.

Central Bank of Sri Lanka governor, Ajith Nivard Cabraal, agrees that SME lending needs to be prioritised by the local banks. "We are certainly satisfied with the stability of the banking system," he says. "But while we've seen some increase in SME lending, we believe more could be done. We have been encouraged by the initiatives that the banks have taken in the Northern and Eastern provinces, where many have started operations from scratch and opened new branches. If they were to replicate this commitment throughout the country it would give the SME sector a big boost."

"While we've seen some increase in SME lending, we believe more could be done"

Ajith Nivard Cabraal, governor, Central Bank of Sri Lanka

PA Lionel, deputy general manager, international, treasury and investment at Sri Lanka's largest lender, the state-owned Bank of Ceylon, agrees that supporting the growth of the SME sector is pivotal to his bank's strategy. "There is plenty of liquidity in the banking market to support the SME sector," he says. "But for SMEs, it is lack of expertise rather than access to funding which is the main issue.

This is why we have been setting up specialised SME centres throughout the country to help smaller companies draw up business plans, prepare their accounts and undertake project analysis." ▲