

A Foreign Investor’s Guide to Sri Lanka

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Why Sri Lanka? In this introductory paper we look to provide some high-level insights for foreign investors on Sri Lanka’s economy, political anatomy and capital markets. Although Sri Lanka outperforms other South Asian and lower middle-income bracket countries on several social and human development measures, the country has underperformed from an economic growth standpoint. This has been primarily due to political instability that has led to a lack of structural economic growth friendly reforms that was expected post the end of a 26-year civil war in 2009. We acknowledge that this paper comes at a very difficult time for Sri Lanka, given that the general consensus is that Sri Lanka’s economy is precariously positioned given concerns around Balance of Payments issues, excessive indebtedness to China, burgeoning trade deficit driven primarily from a lack of tourism revenue given the pandemic and downgraded economic growth forecasts. Whilst some of the new concerns this time are warranted, contrary to consensus, we feel there are few levers they can pull in the case such dire forecasts come to fruition and that with the right reforms in place, the country can enjoy its inherent fundamental tailwinds, providing a catalyst to unlocking its currently attractive priced capital markets.

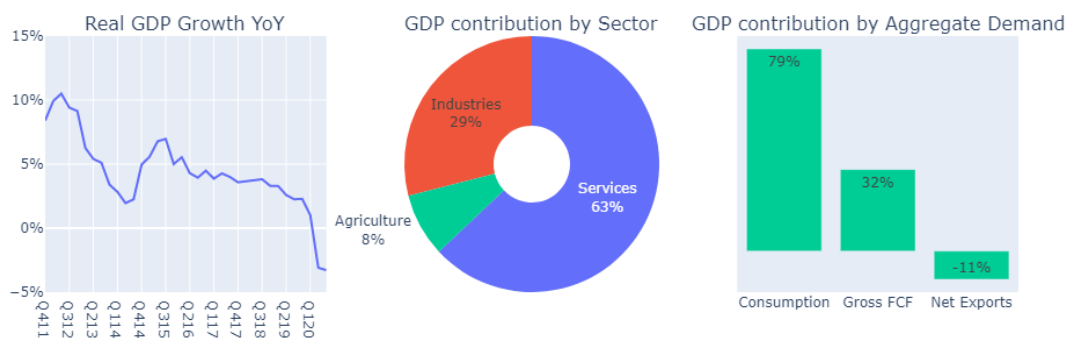
ECONOMY

Sri Lanka’s economic size today is only US\$84bn. Real GDP Growth has averaged around 4.3% over the last 10 years and around 4.8% over the last 50 years¹. In terms of what drives GDP, on average over the last 5 years, consumption accounts for the majority at around 79% and by sector, services account for 63, with Agriculture at only 8% despite employing a quarter of the workforce.

Favourable Geographic Location

Sri Lanka’s economy holds significant potential given its favourable location in one of the most dynamic regions in the world. Sri Lanka remains focused on its vision to become a hub for trade and foreign investment into South Asia as part of its growth strategy. With global trade accounting for 44%¹ of World GDP and Colombo port being one of world’s major ports², it is unsurprising why it is one of the key hubs in China’s One Belt One road initiative linking China with Europe and Africa. Furthermore, Sri Lanka has deepening ties with India with a significant proportion of trade having India as its end destination. With India likely to be the fastest growing major economy over the next decade, Sri Lanka is likely to be a key beneficiary from given the existing bilateral trade agreements and close proximity.

Figure 1. GDP and Contribution to GDP



Source: Department of Census and Statistics, Sri Lanka

¹ World Bank Open Data, <https://data.worldbank.org/>, 2019, GDP Growth (annual %) & Merchandise Trade (% of GDP)

² Colombo port, 24th largest port in the world, <https://www.worldshipping.org/about-the-industry/global-trade/top-50-world-container-ports>

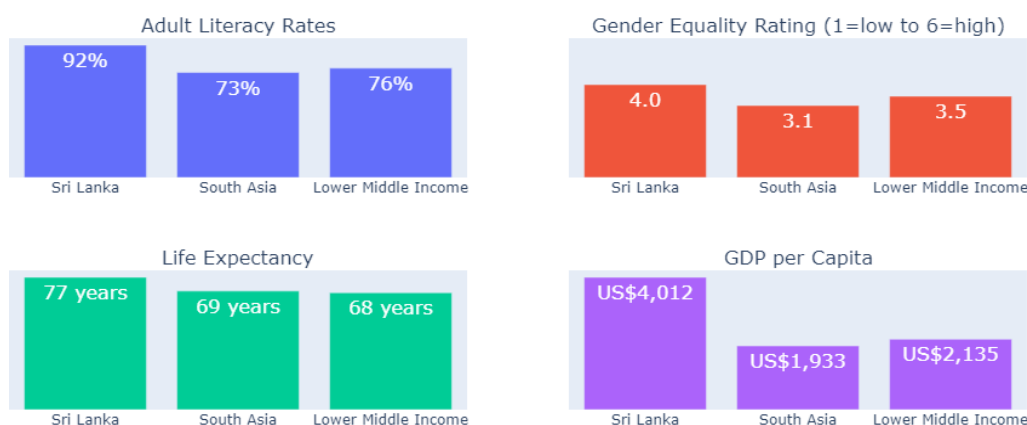
Foreign Investment

Although the country has languished in FDI flows over the last few years, the ongoing Chinese-led infrastructure projects boom is aiming to create sustainable growth through increasing long-term productivity and enhancing logistics and services to propel Sri Lanka above the middle-income category over the next decade. For example, the \$1.4 billion Colombo Port City project is being co-developed by the Sri Lankan Government and China Harbour Engineering Company Port City Colombo Pvt Ltd under the Belt and Road Initiative. India and Japan are also investing heavily in Sri Lanka and have recently taken a JV stake in Colombo port's West Container Terminal to develop and modernise it further and create higher capacity.

Human Capital

Sri Lanka has excelled in human capital which is critical for moving economies into higher income categories. One global measure of this is the Human Development Index (HDI) which is a summary measure of achievement in key areas such as life expectancy, education and decent standard of living. Sri Lanka is ranked 72nd in the world and is categorised as a high human development country with a score of 0.782. To put this into perspective, India has a score 0.645, China 0.761 and Brazil at 0.764³. Figure 2 looks at a few measures where Sri Lanka has excelled vs its peers.

Figure 2. Human Development Metrics



Source: World Bank Data

Potential Growth Catalyst

Historically, Sri Lanka, has had success in implementing progressive economic reforms and liberalisations which have opened up the economy to foreign investment and moved towards greater participation from the private sector. However, post the end of the civil war, the then incumbent party largely became complacent, resting on their laurels and subsequently lost the next general election in 2015. The last 5-10 years has seen political gridlock and policy paralysis which has prevented any significant reforms. Today, the incumbent political party, the SLPP now controls two-thirds of the legislature, and has the ingredients to lead a strong, stable, single-party ruled Government and push the country towards a much-needed sustainable growth path. We feel Sri Lankan politics is in a similar situation to what India went through in 2014 and subsequently in 2019, when the BJP won in a landslide and over the next 6-7 years was able to implement significant, revolutionary reforms.

GOVERNMENT

Political System

Sri Lanka is a democratic republic with an executive presidency, the head of state and government as the President. Two major elections take place every five years, namely, the Presidential Election and the General Election. The Presidential Election is to select the Executive President, limiting the presidency to two terms. Each term has a five-year tenor. General elections are held to select 225 members of parliament to a single chamber. Both cabinet and

³ Human Development Report 2020, United Nations, <http://hdr.undp.org/en/content/human-development-index-hdi>

state ministers are appointed by the President out of the above 225 members, also the President chairs the cabinet and appoints an independent judiciary.

The President heads the Government, and has all the executive powers. The legislative power is with the Government and the parliament. Post-independence in 1948, a multi-party system was introduced. This has been dominated by the two major coalitions, the socialist Sri Lanka Freedom Party, now Sri Lanka Podujana Peramuna (SLPP) and the conservative United National Party. In recent times, we have seen the two major coalitions working closely together to implement major reforms, but previously this has been troubled by large bureaucratic and regulatory obstacles. The conservative party (UNP) tries to align with the West while socialist SLFP tries to align with the East. We do not expect this to change in the near future, and in fact, the current President, Gotabaya Rajapaksa, who was elected on 18th Nov 2019 from the Sri Lanka Podujana Peramuna (SLPP) is already trying to work closely with the East.

Reform Agenda

Significant reforms or amendments may be drafted into the constitution, subject to at least a two-thirds majority in Parliament. Other reforms can be made by a simple majority of the parliament. In practice however, almost all the reforms or laws are proposed by the President as per the mandate. Unfortunately, if history is a guide, we have seldom seen the ruling party MP's object to the President. Thus, if you know the direction of the President, then there is reasonable reform visibility over the next five years.

Some of the changes and reforms which are likely to happen over the next five years;

- Government to take a bigger role in infrastructure spending towards highway construction and road development to improve logistics⁴
- Promote Sri Lanka as a major supply, trade and services hub in South Asia by Colombo's Port city, Port Hambantota and Hambantota international Airport.
- Key changes in direct taxes such as lowering the corporate tax rate from 28% to 18% over the next five years

Fiscal Policy

The major medium term fiscal objective of Sri Lanka is to suppress the fiscal deficit to 4% of GDP and debt to GDP ratio to around 75.5% by 2025 from the current 86% today⁵. In addition to that, the Government is aiming to achieve at least 6% economic growth, maintain unemployment at less than 4%, while keeping inflation at 5% or less. The Government also expects the tax revenue to reach 14% of GDP in 2025 from the current level of 10% as well as maintain its public investment spending at an average of over 5-6% of GDP during the period 2021 - 2025. As an initial step, the Government has committed to implementing revenue based fiscal consolidation and by increasing tax revenue and lowering its foreign debt to GDP, which has previously put significant pressure on Sri Lanka's BoP situation and weakened the country's monetary sovereignty. We note that these are all ambitious targets and in fact the Government admits that these key metrics will get worse over the next few years before settling towards their targets by 2025. Nonetheless, we feel the desire for forward planning and maintaining some form of prudence should help with foreign investor confidence.

Monetary Policy

The Central Bank of Sri Lanka's (CBSL) main role is to manage monetary policy through a flexible inflation targeting (FIT) framework. The FIT framework aims to stabilise inflation at around the mid-single digit levels over the medium term whilst supporting economic growth. Policy decision making is typically made at the Monetary Policy Committee (MPC) which occurs eight times per year. CBSL has a few policy instruments at its disposal to manage short term interest rates, support economic growth and manage macroeconomic risks. We highlight a few of them in the table 1.

⁴ Ranked 94th in the World in 2018 from 81st in 2012 as per the World Banks' Logistic Performance Index, <https://lpi.worldbank.org/>

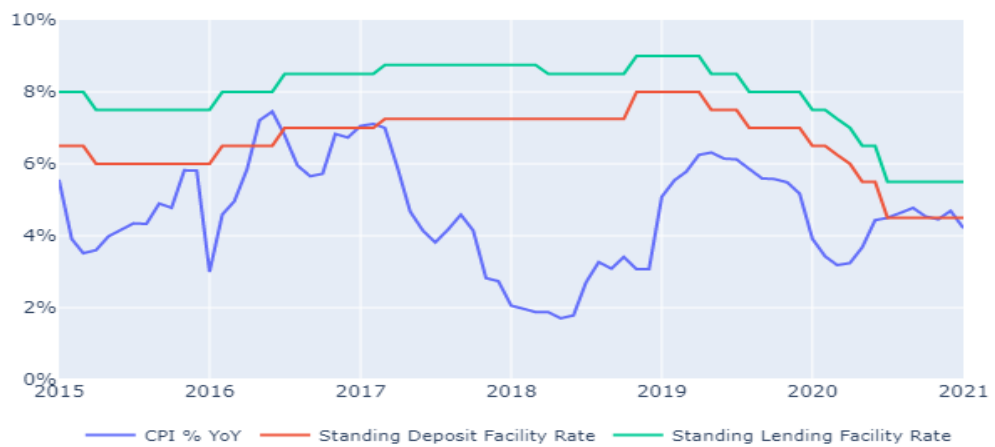
⁵ Fiscal deficit at 6.8% in 2019 and debt to GDP of 86% as per CBSL website <https://www.cbsl.gov.lk/en/statistics>

Table 1. Policy instruments for Monetary Policy Management

Consideration	Policy Instrument
Setting lower and upper bounds for the overnight interest rates	Standing Deposit and Lending Facility Rates
Expand or contract the amount of money in the inter-bank money market	Open Market Operations to buy /sell government securities
Emergency loans to commercial banks	Bank Rate
Managing financial stability and liquidity in the system	Statutory Reserve Requirement Ratio
Managing LKR during excessive foreign exchange volatility	Purchase/Sale of Foreign Exchange
Macro-Prudential Policy	LVR limit, Margin Requirements, Restrictions on corporate actions

An example of CBSL monetary policy in action was the reduction in the Standing Deposit Facility Rate and Standing Lending Facility Rate by 100bps each to 4.50% and 5.50% respectively on July 2020. CBSL also conducted macro-prudential policies during the pandemic by ordering local banks to delay paying dividends until after their 2020 accounts have been audited. Domestic banks were also asked to refrain from buying back shares.

Figure 3. CBSL’s Key Monetary Policy Rates vs Inflation



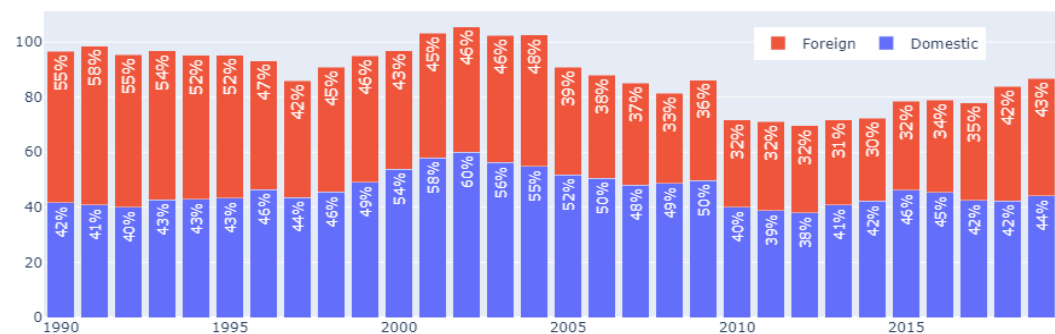
Source: Central Bank of Sri Lanka

EXTERNAL POSITION & TRADE

External Debt

Sri Lanka’s reliance on foreign funding for growth and development is not a new phenomenon. This has helped Sri Lanka to increase its pace of development and migrate from low income to a middle-income country despite being held back by a lack of policy direction and reforms to create a more sustainable economy (e.g., diversify sectors, promote export businesses and attract more FDI). As a result, the reliance on foreign debt is unlikely to reduce significantly in the short to medium term, without significant reforms to promote sustainable growth. As at 26 February 2021 the government of Sri Lanka has \$70b of debt outstanding which is 86% of GDP. The history of public debt to GDP can be seen in figure 4.

Figure 4. Foreign and Domestic Government Debt to GDP



Source: Central Bank of Sri Lanka

Although from figure 4 we can see Sri Lanka’s external debt portion has reduced from 58% of its GDP in 1991 to 43% as of 2019, the composition of external debt has now come entirely from International Sovereign Bonds and loans which unlike Sri Lankan Treasury Bills and Treasury Bonds are denominated in foreign currencies. Furthermore, looking at table 2, the weighting of concessional loans and multi-lateral loans (loans from agencies such as the Asian Development Bank, World Bank) has fallen from 31% and 25% of external debt in 2011 to 13% and 14% respectively as of 2019. This has been a result of Sri Lanka’s access to concessionary loans reducing as well as Government policy shift towards bilateral loans and away from multilateral loans, given the somewhat strict, albeit arguably necessary condition imposed by these agencies to disburse loans.

Table 2. Key External Debt Ratios

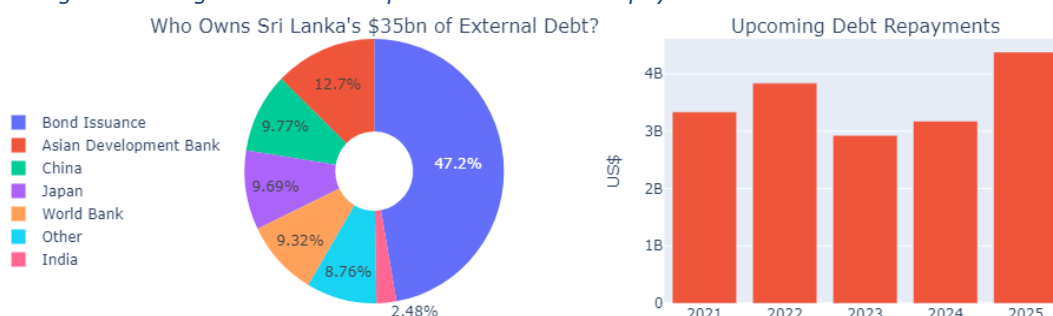
Key External Debt Ratios	2011	2012	2013	2014	2015	2016	2017	2018	2019	Trend
External debt stock to GNI (%)	39.9	53.2	54.2	54.5	55.9	58.2	59.6	61.5	68.8	
Debt service to exports (%)	9.3	15.5	14.1	38.2	20.8	18.9	21.9	36.1	31.7	
Interest payments to GNI (%)	0.8	1	1.1	1.1	1.2	1.5	1.5	2.2	2.2	
Concessional to external debt stocks (%)	31	22.8	20.3	17.9	16.8	15.7	15	14	13	
Multilateral to external debt stocks (%)	24.6	18.6	17.6	16.3	15.7	15.4	15.5	15.2	14.7	
Reserves to external debt stocks (%)	24.2	17.8	16.8	17.3	14.9	11.1	13.8	11.5	11.9	

Source: World Bank, International Debt Statistics

Debt Ownership & Repayments

Common misconception by foreign investors is that Sri Lanka remains indebted to China given the issues surrounding Hambantota port⁶. However, Figure 5 illustrates Sri Lanka’s indebtedness to China is only 9.8% of total foreign debt, with in fact is as much debt owed to Japan as it is to China. Furthermore, the largest foreign debt remains the capital market issuance of ISB’s and SLDB’s.

Figure 5. Foreign Debt Ownership and Next 5 Years’ Repayment Schedule



Source: Department of External Resources & Refinitiv

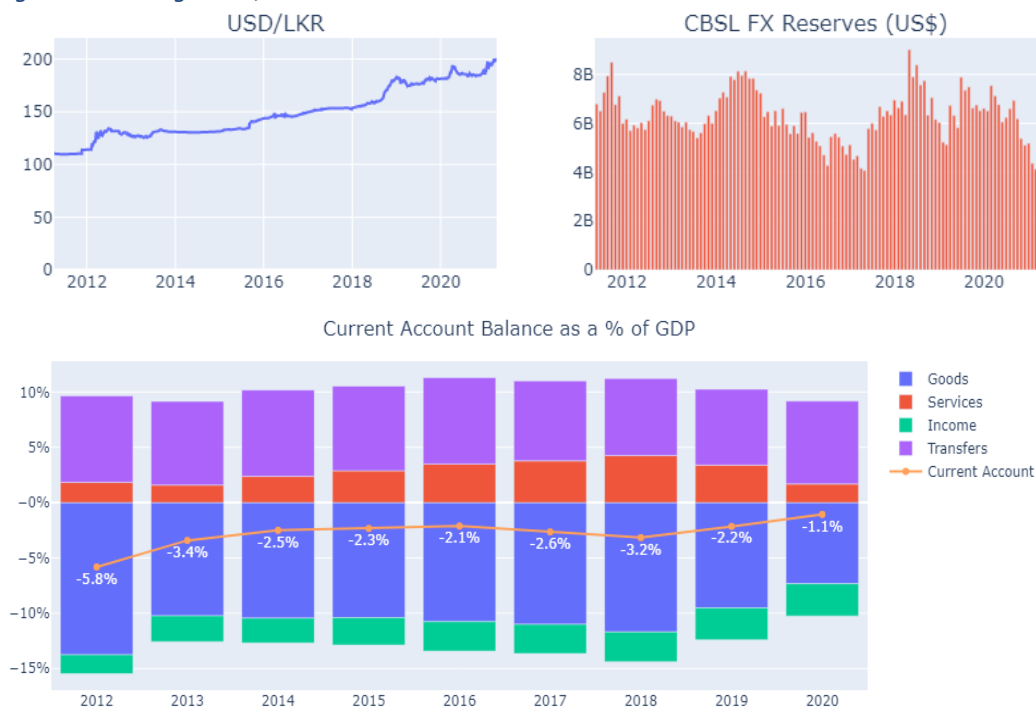
The key concern amongst investors in ISB’s is the Government’s upcoming debt repayments of principal and interest over the next 4-5 years which can be seen in figure 5. Furthermore, with a reduction (down by 75% to \$1bn in 2020)⁷ in revenue from tourism, this will also reduce foreign currency inflows and the CBSL’s FX reserves stockpile. This can be seen in the falling FX reserves and weakening exchange rate in figure 6. There is mounting pressure on Sri Lanka’s ability to settle foreign debt payments as subsequent higher funding costs makes rolling over the debt more expensive, effectively “pricing them out” of International Sovereign bond markets. Having said that, the Government of Sri Lanka has been historically innovative in the way that it manages its liability book, also using bilateral financing arrangements. For example, these include currency swaps from India and China as well as syndicated loans from China to bridge its foreign financing gap and manage foreign reserves.

⁶ The Hambantota Port Deal: Myths and Realities, <https://thediplomat.com/2020/01/the-hambantota-port-deal-myths-and-realities/>

⁷ Tourism in Sri Lanka, <https://www.worlddata.info/asia/sri-lanka/tourism.php>

FX & External Position

Figure 6. Exchange Rate, Central Bank FX Reserves & Current Account Balance



Source: Central Bank of Sri Lanka & Refinitiv

Although inflation has been relatively controlled, ranging between 2% and 8% over the last 6 years (see figure 3), the Sri Lankan Rupee (LKR) has depreciated by 6.6% p.a. over this period. This has primarily been the result of the previously mentioned political instability, historical BoP crises from large trade deficits and funding imbalances as well as low levels of FX reserves. Sri Lanka’s current account (see figure 6) has persistently been in deficit, despite running a service and transfer surplus.

Trade

Table 3. Sri Lanka’s Top 5 Merchandise Trade by Category and Country

Export Goods	% of Exports	Import Goods	% of Imports
Garments	43.6%	Fuel	19.5%
Tea	11.3%	Textiles	14.6%
Rubber Products	7.3%	Machinery & Equipment	12.5%
Petroleum Products	4.4%	Building Materials	7.6%
Jewellery	2.6%	Chemical Products	4.2%

Export Countries	% of Exports	Import Countries	% of Imports
US	24.3%	India	23.9%
India	8.4%	China	23.1%
UK	7.3%	Singapore	6.6%
Germany	7.2%	UAE	6.0%
Italy	4.1%	Malaysia	4.8%

Source: Central Bank of Sri Lanka

In terms of key trading partners and goods, almost 50% of imports are sourced from China and India and 55% of exports are from lowly valued and less sophisticated products such as Garments and Tea. Given Sri Lanka’s educated workforce, policies and reforms should focus on better utilisation of these skills to produce higher valued goods. A weakening currency should help to create greater competitiveness for Sri Lankan exports.

CAPITAL MARKETS

Fixed Income Overview

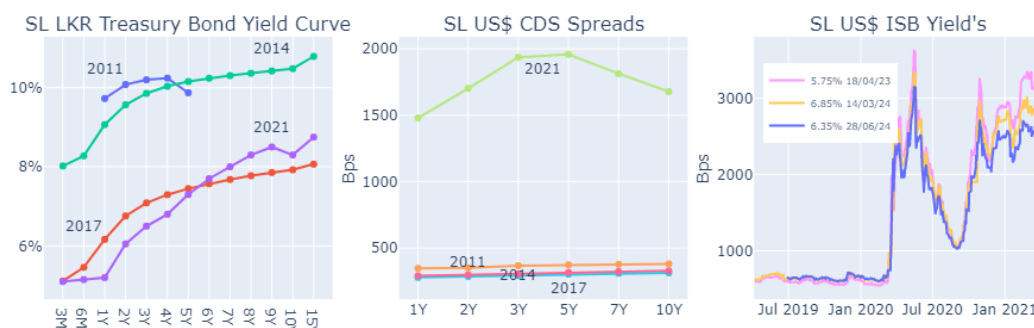
The Sri Lankan fixed income market predominantly consists of Government securities. The money market, is the market for short-term interest-bearing assets with maturities of less than one year. The main issuer in the Money Market is the Government issued by the Public Debt Department of the CBSL, known as Treasury bills (T-bills). Usually, Treasury bills are issued in maturities of 91 days, 182 days and 364 days. Most of the time Treasury bills are zero coupon securities and are sold at a discount to face value, which is paid at maturity. Banks and private companies also issue money market instruments but the number of issuances are relatively low compared to Treasury bills. The main investors in these instruments are banks, insurance companies and pension funds. T-bill have the most liquidity on the secondary market.

The Bond Market is the market for trading in debt instruments for maturities of greater than one year. The Government is also the main issuer and issues Treasury bBonds (T bonds). These medium and long-term government securities are issued in maturities ranging from 2 years to 30 years. Typically, interest is paid bi-annually for T Bonds. Both T-bills and T-bonds are sold by auction to Primary Dealers (quoted on yield), who then sell these in the secondary market. The yields on T-bills and T-bonds are determined by the secondary market. Both T-Bills and T-Bonds currently have 10% ownership limits by foreign investors.

Foreign Currency Debt

In addition to T-bills and T-bonds, the Government of Sri Lanka also issues foreign currency bonds such as Sri Lankan Development Bonds (SLDB) and International Sovereign Bonds (ISB). The largest of these are the ISB's which began in 2007 and are USD issued denominated debt either on a floating or a fixed rate basis. Maturities of ISB's range from 2 to 10 years. Like T-Bonds and T-Bills, the yields of the ISB's are determined by competitive bidding in terms of rates or spreads over the London Interbank Offered Rate (LIBOR) and are traded on the Berlin and Singapore exchanges.

Figure 7. Local Yield Curve and Hard Currency Bond Yields & Spreads

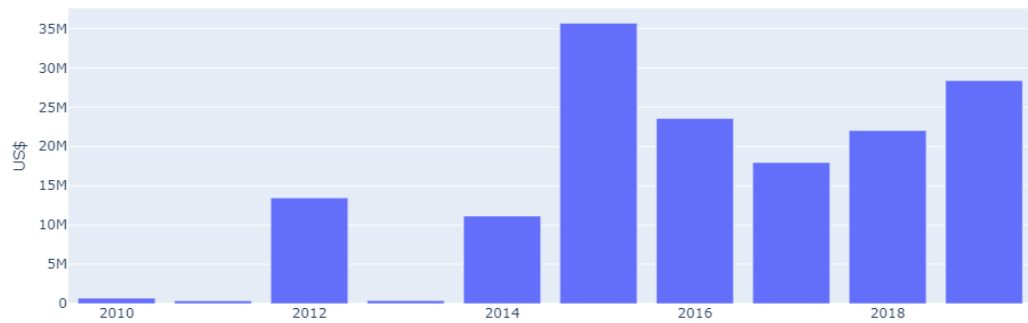


Source: Refinitiv Eikon

Corporate Debt

The corporate debt market, although growing rapidly from a very small base, is still very much in its nascency, and largely a capital raising vehicle for Banks and Insurance firms. Over the last few years, Sri Lanka has witnessed a sharp increase in corporate debt issuance as can be seen in figure 8. This growth has been primarily driven by tax incentives and new listing rules to encourage issuance and investor appetite. The CSE is in the process of extending the multi-currency board to locally incorporated entities to facilitate listing also in foreign currency debt. This will enable local companies to raise debt in other currencies and encourage foreign investors participation in the sector.

Figure 8. Corporate Debt Market Turnover



Source: Colombo Stock Exchange

Equity Market Overview

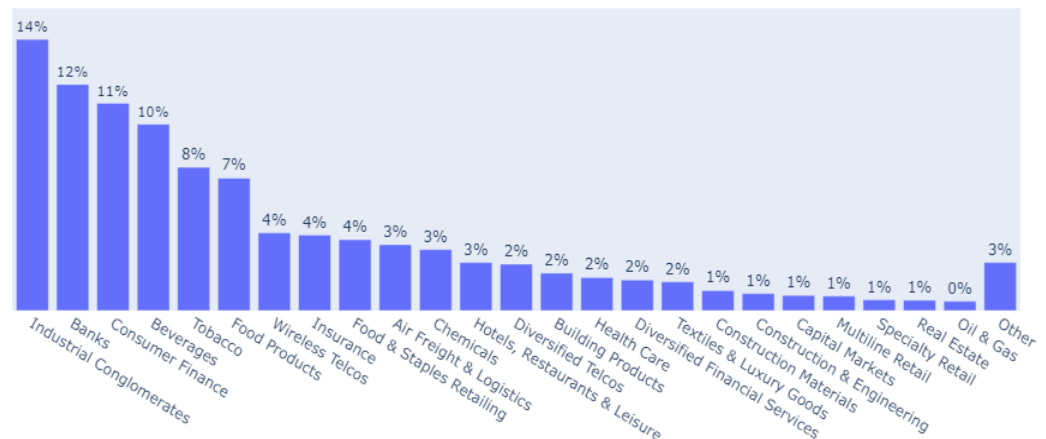
Sri Lanka has one stock exchange called the Colombo Stock Exchange (CSE) which was formally incorporated in 1985. There are currently 15 institutions which are licensed to operate as stockbrokers. The Central Depository Systems Limited (CDS) was incorporated in 1991 and is a wholly owned subsidiary of the CSE and is licensed as a clearing house and custodian by the Securities and Exchange Commission of Sri Lanka. Trading has been fully automated since 1997 and operates on a single tier settlement cycle of T+3 to settle transactions.

The CSE has 283 listed companies with a total market capitalization of US\$16bn⁸. With a market cap to GDP of only 18.7% it is significantly smaller compared to other lower middle-income countries of 61.1%⁹. Furthermore, trading volumes remain low, at around 1.1% of GDP compared to 26.9%¹⁰ for other lower middle-income countries. Whilst cheap stock valuations are a large part of this, there is also a large number of private and state-owned enterprises that remain unlisted. Ultimately more listings and greater relinquishing of share ownership by major shareholders is required to increase liquidity.

Equity Indices

Sri Lanka has 2 major stock indices that investors follow. The All-Share Price Index (ASPI) and the S&P SL20 index. The ASPI is a market cap weighted measure of all listed companies. The index is weighted after adjusting for free float and has a base value of 100, starting in 1985. It is the broadest measure of the Sri Lankan stock market. Standard & Poor's Sri Lanka 20 (S&P SL20) is a market capitalization free float weighted index that tracks the largest 20 companies and was officially launched in 2012. The industry composition by weight is shown in figure 9.

Figure 9. Industry Weights of all stocks listed on CSE



Source: Refinitiv Eikon

⁸ March 4th, 2021 as per cse.lk website

⁹ World Federation of Exchanges database as of 2019, <https://www.world-exchanges.org/our-work/statistics>

¹⁰ World Bank Open Data, 2019, <https://data.worldbank.org/>, Stocks Traded, total value (% of GDP)

Top 10 Listed Companies

Sri Lanka’s top 10 companies make up around 36% of the total market capitalization and cover a variety of industries. Table 4 illustrates the size and industry types they belong to. By global standards, these companies are very small by market cap. John Keells Holdings is Sri Lanka’s largest company that manages a portfolio of holdings in business segments such as Transportation, Leisure, Property, Consumer Foods and Retail, Financial Services and Information Technology. There are several multinational corporations (MNC) listed in Sri Lanka. For example, British American Tobacco, Chevron Lubricants and Nestle Lanka.

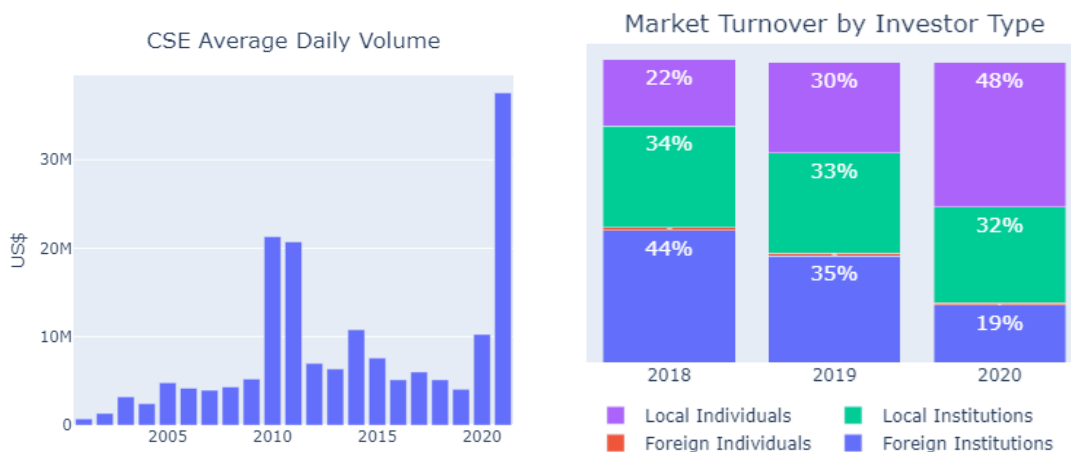
Table 4. Top 10 Listed Companies

Company Name	GICS Industry Name	Company Market Cap (USD)
John Keells Holding PLC	Industrial Conglomerates	\$1,026,868,903
Ceylon Tobacco Company PLC	Tobacco	\$988,493,025
Lanka ORIX Leasing Company PLC	Consumer Finance	\$810,276,923
Dialog Axiata PLC	Wireless Telecommunication Services	\$536,537,213
Commercial Bank of Ceylon PLC	Banks	\$512,099,798
Distilleries Company of Sri Lanka PLC	Beverages	\$469,435,897
Expolanka Holdings PLC	Air Freight & Logistics	\$455,144,313
Browns Investments PLC	Food Products	\$405,299,723
Nestle Lanka PLC	Food Products	\$327,587,567

Trading Volumes

The trading volumes of Sri Lanka’s market increased significantly in 2009 as both local and foreign investors returned to the market in hope of a major catalyst for change and reform in a country that had been held back from reaching its full potential for so long. To put this into perspective, the average daily volume (ADV) in FY2010 and FY2011 jumped 4-fold to US\$21mn/day. Unfortunately, this newfound optimism did not last long as volumes fell back to historical averages in 2012 onwards. However, since the COVID pandemic, much like the rest of the world, we have seen an explosion of participation, particularly from retail investors, with ADV in 2021 nearly double the volume we saw in 2010-11 period.

Figure 10. Trading Volumes and Investor Types



Source: Refinitiv Eikon, Colombo Stock Exchange Quarterly Reports

Types of Investors

There are 2 broad categories that the CSE keeps track of. Foreign and local investors, and within each category, they are divided into either individual investors or institutional investors. Given the size of foreign investors, it is unsurprising that they are the largest player in the local market. However, whilst foreign investment is critical, particularly for capital deficient countries, the market can be at the whims of foreign sentiment creating undue pressure not just on market returns and volatility, but also on the current account and the currency. This has been a problem in the past but with the recent increase in local investor participation, it has come at a welcome time as foreign investors in 2019 and 2020 have been net sellers, (to the tune of ~\$US330mn). Whilst one could argue that this may not be structural due to COVID work from home culture, we have seen greater resources contributed by Government agencies such as the CBSL and the

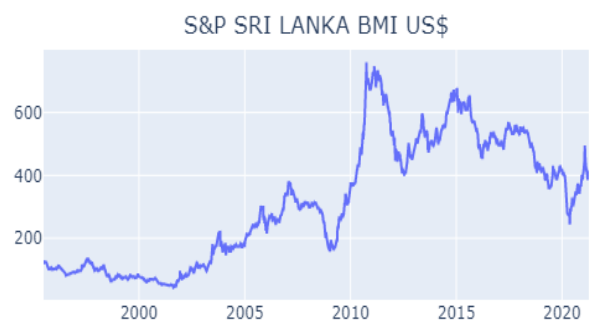
International Finance Corporation¹¹ to increase financial inclusion and education and believe that some of the new flows to be structural. Figure 10 depicts the make up by investor type and how it has changed over the last 3 years.

Equity Market Performance

Sri Lankan equity markets performed well between 2000 and 2010 but has subsequently provided poor equity market performance, particularly for foreign investors, given the LKR's depreciation against the USD of around 5.8% p.a. over the last 10 years. Stock valuations for the S&P SL 20 Index are compellingly attractive with the market trading at 8.2x trailing 12 months P/E, a P/B less than book at 0.75x and a dividend yield of 2.2%¹². Government incentives, Rupee, macro and political stability and greater liquidity is needed to encourage foreign institutional investors which can help the market re-rate higher.

Figure 9. Sri Lanka Equity Market Returns

Period to 31/03/21	S&P SRI LANKA BMI US\$ Total Return
1 Month	-4.5%
3 Months	-1.3%
6 Months	8.6%
1 Year	43.1%
3 Years (p.a.)	-9.5%
5 Years (p.a.)	-2.9%
10 Years (p.a.)	-5.6%
20 Years (p.a.)	10.8%
25 Years (p.a.)	5.4%



Source: Refinitiv Datastream

Challenges

Sri Lanka has several challenges that it needs to overcome in the short to medium term, to sustain the next leg of economic growth. Below we highlight 3 of these challenges that warrant attention.

Build-up of external debt and rising cost of funding

All 3 global rating agencies downgraded Sri Lanka's sovereign credit rating to substantial risk /extremely speculative category (S&P/Moody's/Fitch of CCC+, Caa1 and CCC respectively) in late 2020. Whilst previous issuance of ISB's were done at the single B or highly speculative category at anywhere between 5-6.5%, it is extremely unlikely in the short term that they will be able to raise debt at rates near that given the downgrade, the ongoing pandemic and yields rising again globally. Furthermore, in November 2020, Sri Lanka attempted to issue around US\$75million development bond at an auction, but only drew only US\$25 million of bids¹³, leaving it sharply undersubscribed. Hence it is almost inevitable, Sri Lanka will continue to shift towards China, largely through Foreign Currency Term Facility loans as the lending typically doesn't follow the same sort of restrictions or targets as set out by multi-lateral agencies like the World Banks' IMF. (e.g. commitment to fiscal or foreign exchange reserve targets) For any short term funding requirements, it is likely that this will continue to be done via currency swap facilities, through countries such as India and China.

Falling FDI

FDI in Sri Lanka has remained benign over the last 40 years and has remained persistently below the lower middle-income category over the last 20 years. This has constrained the country's

¹¹ Central Bank of Sri Lanka and IFC Launch the Country's First National Financial Inclusion Strategy, March 4, 2021, <https://pressroom.ifc.org>

¹² S&P Dow Jones Indices, S&P Sri Lanka 20, <https://www.spglobal.com/spdji/en/indices/equity/sp-sri-lanka-20/#overview>

¹³ \$75m SLDB issue goes undersubscribed by over 60%, LK FT, <http://www.ft.lk/front-page/75-SLDB-issue-goes-undersubscribed-by-over-60/44-708967>

growth. Furthermore, the composition of foreign investment lately has mainly been in the form of portfolio investment, which is a much less sticky form of investment and subject to repatriation risk in the case of global shocks or Sri Lanka specific risks. Whilst the Government has been actively promoting foreign investment, a lack of political certainty and direction, frequent changes of key staff (e.g., central bank governors) and unorthodox policy measures) has led to foreign investment uncertainty.

Growing reliance on Tourism and falling complexity of trade.

Approximately 24%¹⁴ of Sri Lanka's export income is generated by tourism and is Sri Lanka's largest exporter. Although Sri Lanka has run a good and services trade deficit as seen in figure 6, there were promising signs of the trade deficit narrowing as Tourism revenue has grown 11x since the end of the civil war. However, the adverse impact of the pandemic on the tourism industry, and the uncertainty around how long this will last will impact Sri Lanka's Balance of Payments and foreign reserve position. In terms of imports, fuel is Sri Lanka's largest import making up around 20% of total imports as per table 3 and also a commodity that warrants attention when understanding Sri Lanka's terms of trade. This has been due the country's low level of economic complexity¹⁵ which measures the diversity of a country's export and their sophistication. Sri Lanka ranks 101st out of 157 countries in 2019 as per the Economic Complexity Index.

Summary

Despite Sri Lanka's important geographical location and success across human development scores, they have unfortunately not been able to translate this into sustained economic growth. This has kept the country well entrenched in the middle-income category for the last 20 years. Politics has been a large driver of this underperformance through a lack of growth friendly reforms and macroeconomic mismanagement. Furthermore, whilst Sri Lanka has had their fair share of Balance of Payments issues in the past, they have managed to avoid any ongoing or severe economic crises.

The current government now commands a two-thirds majority and has a more informed understanding of the need to drive long term growth. Reforms that attract foreign investment and establish a robust export base will not only help manage balance of payments and create greater demand for the currency, but also create more sustainable economic growth.

Finally, notwithstanding the challenges and risks faced above, we feel that contrary to consensus, Sri Lanka's capital market securities such as ISB's and the equity market appear to have priced much of the current concerns into valuations. We believe Sri Lanka warrants further attention for those investors seeking contrarian mispriced assets in today's expensively priced global financial markets.

¹⁴ World Bank Open Data, International Tourism, Receipts (% of Total Exports), 2019, <https://data.worldbank.org/>

¹⁵ The Observatory of Economic Complexity, 2019, <https://oec.world/en/rankings/eci/hs6/hs96>