CHASE SECURITIES

Sri Lanka and Ghana

Debt, Default and Reforms

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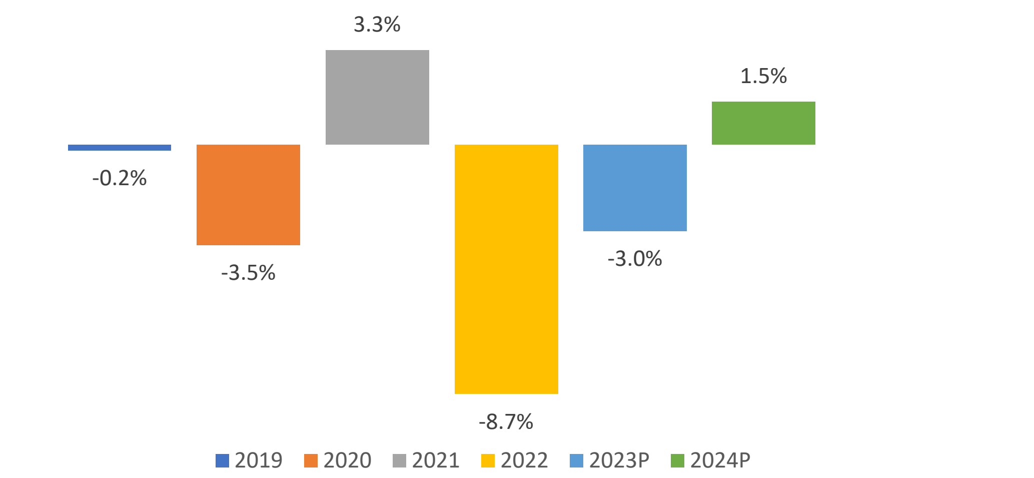
Sri Lanka- A Full Blown Crisis

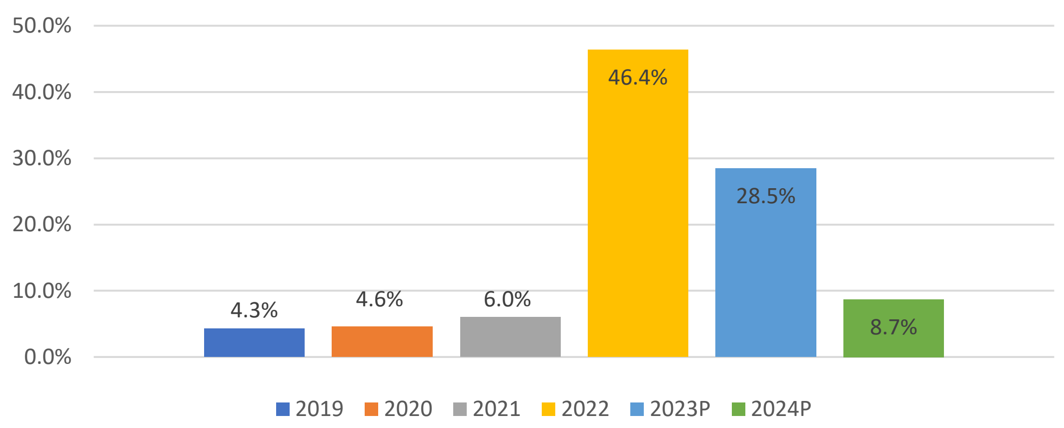
- Sri Lanka was in IMF Program from 2016-2019 and faced droughts in 2017, political crisis in 2018 and terrorist attacks in 2019.
- Following change in government in late 2019, unsustainable policies were implemented to spur growth. The political narrative was built by pledging to develop a people centric economy through significant tax cuts and delay in reforms to increase productivity and reduce cost of living.
- Income Tax and Value Added Tax (VAT) were drastically cut, automatic fuel pricing mechanism was discontinued and legislative reforms to enhance Central Bank autonomy and fiscal rules were suspended.
- Resultantly, Sri Lanka entered pandemic with low FX reserves and high debt levels. FX reserves were used to repay debt obligations which further depleted the reserves and on top of it, exchange rate was effectively fixed in April 2021.
- As a result, usable FX reserves declined from USD 7.6 bn at end of 2019 to USD 1.6 bn at end of 2021 which are less than one month import cover.
- Post Ukraine war in early 2022 resulting in higher commodity prices and high energy import bill, Sri Lanka fell into deep crisis and therefore, it suspended external debt servicing on April 12, 2022.
- Rupee depreciated by about 40% in 3 months and Inflation soared.
- Severe shortages of food, fuel, cooking gas and daily power cuts fueled nationwide anti-government protests leading to the resignations of leaders and top government officials.

Sri Lanka- Economic Indicators

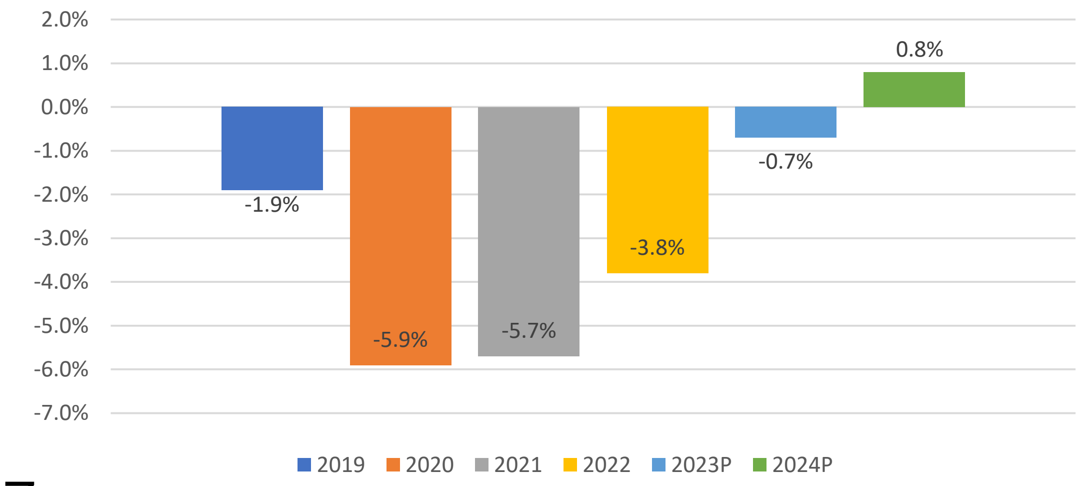
Real GDP Growth



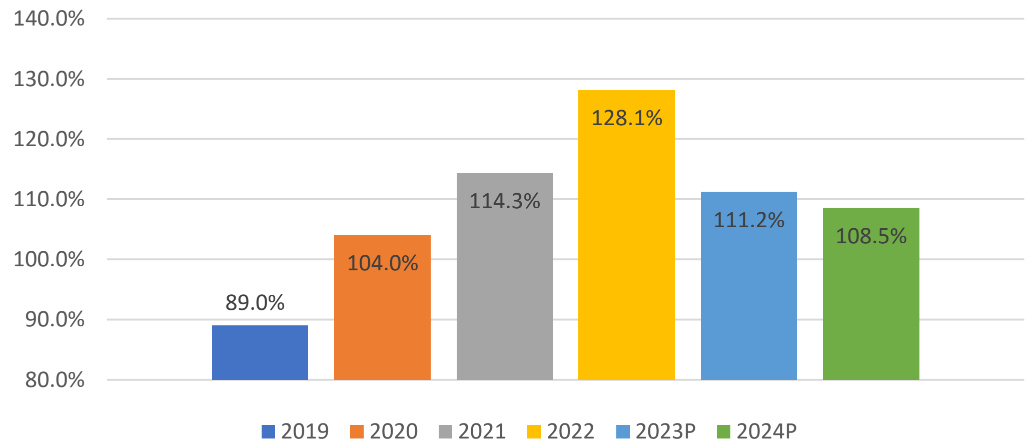
Inflation



Primary Balance as % of GDP



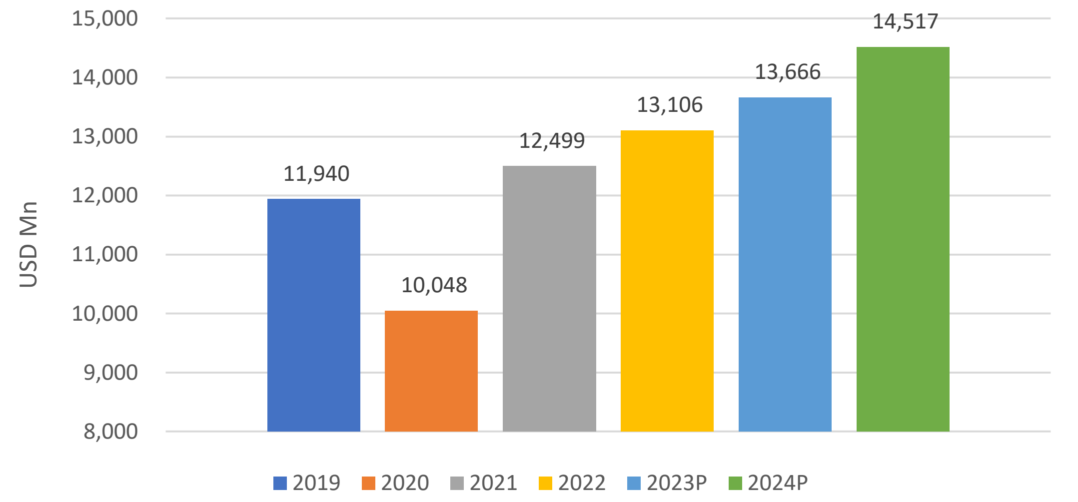
Public Debt as % of GDP



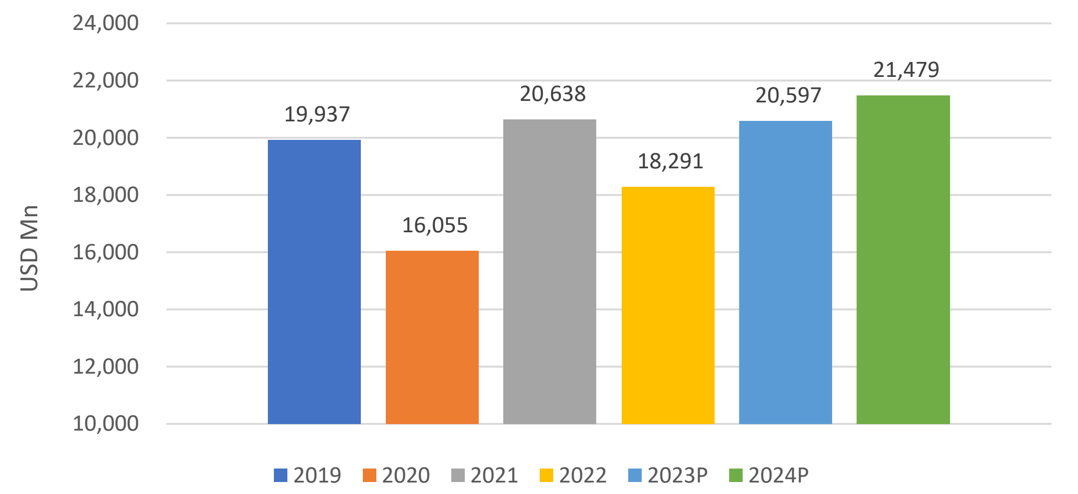
Source: IMF Program document, Chase Securities

Sri Lanka- Economic Indicators

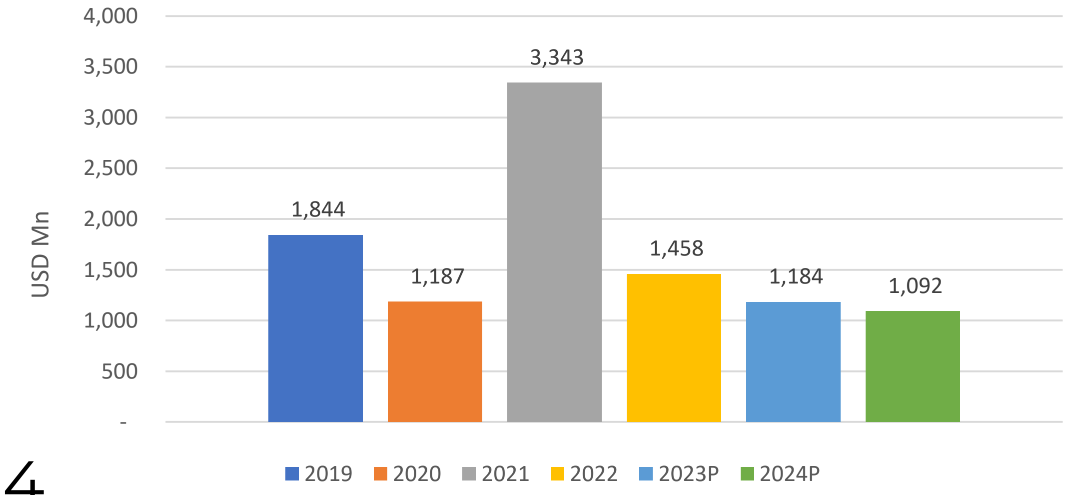
Imports



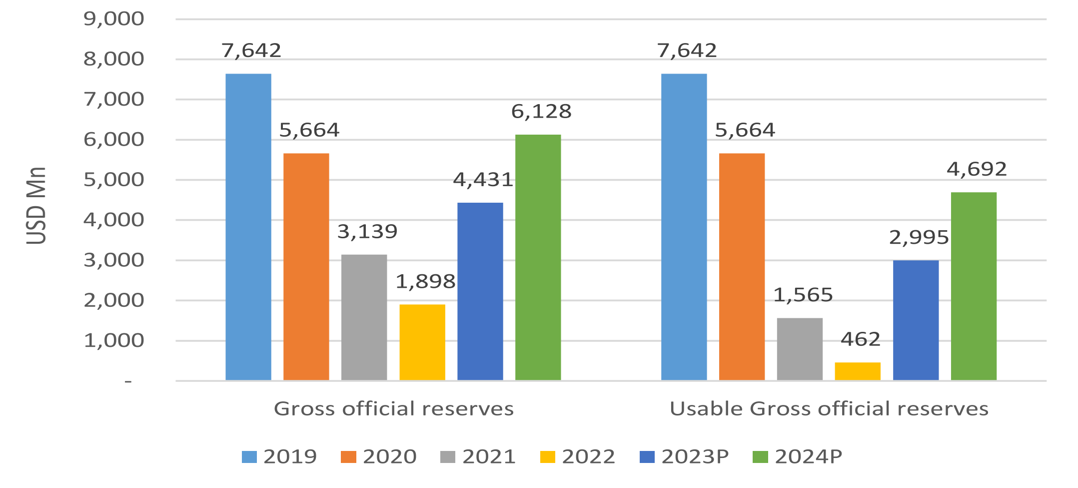
Exports



Current Account Deficit



Reserves



Source: IMF Program document, Chase Securities

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IMF Policy Recommendations to Sri Lanka

- Revenue Based Fiscal Consolidation
- Restoring Public Debt Sustainability
- Rebuilding External Buffers
- Ensuring Financial Stability
- Reducing Corruption Vulnerabilities

Revenue Based Fiscal Consolidation

- Reduce Primary Deficit from 3.8% of GDP in 2022 to 0.7% of GDP in 2023 and post Primary Surplus of 0.8% of GDP in 2024.
- Target of Tax Revenue to reach 10% of GDP and to at least 14% by 2024. Raise Personal Income Tax and Corporate Tax from 24% to 30% and remove **all** sector specific tax exemptions. Raise VAT rate from 8% to 15%. Raise Fuel taxes to 0.3% of GDP.
- Revamp VAT system before 2024, remove **all** product specific VAT exemptions and **introduce property tax, gift and inheritance tax before 2025.**
- Government was asked to develop strategies to **limit growth in the public sector wage bill and public pension spending**.
- Set a floor on Social Safety Net spending at 0.6% of GDP. These programs aims to cushion the impact of the economic crisis on the poor and vulnerable.
- **Depoliticize energy pricing** with Retail fuel prices to be set at their cost recovery levels with monthly formula based adjustments implemented through **automatic fuel pricing mechanism**.
- End user electricity tariff schedule to be set at their cost recovery level with semi annual formula based adjustments implemented through **automatic electricity pricing mechanism.**
- Any shortfall in revenues arising from fuel and electricity pricing will be recorded as government expenditure to avoid off-budget subsidies and therefore, **no piling of debt on State Owned Entities.**

Restoring Public Debt Sustainability

- Comprehensive strategy to restructure balance sheets of State Owned Entities and prompt publications of audited financial statements for All State Owned Entities.
- Debt to GDP ratio projected to have reached 128% of GDP due to exchange rate depreciation, fiscal deficit and negative real GDP growth. Therefore in order for debt to be at sustainable levels, Debt to GDP ratio to be brought down to 95% by 2032.
- Tax and Fiscal measures alone cannot reduce the debt to sustainable levels and therefore, **debt restructuring is required**.
- Debt to official bilateral and commercial creditors is expected to be restructured through extension of grace period and maturity, interest rate reduction, nominal haircut or a combination of these.
- **Domestic Commercial Banks FX loans to the Government and State Owned Entities will also be restructured.** An option to convert FX debt to local currency debt instruments has also been offered by the Government and taken by some Banks.
- **Maturity Shortening and Interest Rate increase of Local currency debt in the recent periods contributed to a sharp increase in Government Financing Needs. Government and Restructuring advisors are studying different options to optimize the design of local debt while preserving financial stability.**
- Establish operationally independent debt management agency and publish quarterly debt bulletin.
- Central Bank will refrain from direct financing of budget deficit and will unwind its large holdings of treasury securities.
- Government to restore market determined and more flexible exchange rate.

Rebuilding External Buffers

- Central Bank will rebuild gross international reserves through outright FX purchases, **non-interest current account surplus**, new external financing, non-debt creating inflows and sovereign debt relief.

- During program period, Government will not introduce or intensify exchange rate restrictions, **impose or intensify import restrictions for balance of payment purposes** or conclude any bilateral payments.

- Central Bank autonomy will be strengthened by **preventing from any form of Government representation or participation on the Governing Board or Monetary Policy Board** and prohibiting from providing monetary financing and from primary market purchases of treasury securities.

- Central Bank has hired two internationally reputable independent specialist firms to conduct a diagnostic exercise for nine major banks including comprehensive asset quality review.

- Central Bank will develop a roadmap for financial sector restructuring and recapitalization to address capital and FX liquidity shortfalls identified through the diagnostic exercise, and to intervene in Banks assessed to be non-viable.

- By October 2023, the Government will determine conditions for any potential use of public funds to support the roadmap and to close capital shortfalls at viable banks.

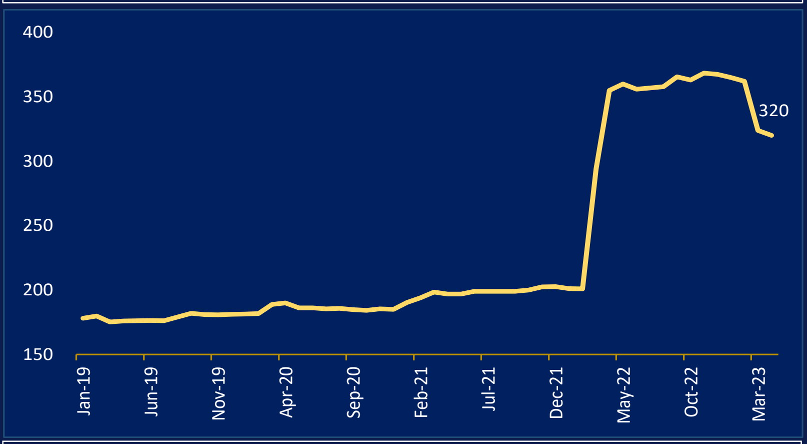
- IMF governance diagnostic mission has started to **assess Sri Lanka's Governance and Anti corruption framework.** The report finding will help identify specific priority and time bound reforms to be implemented under the program.

- Anti corruption legislation is being upgraded which aims to strengthen **asset declaration system. It also creates a new anti-corruption independent commission with strengthened investigative power.**

One Year After Default

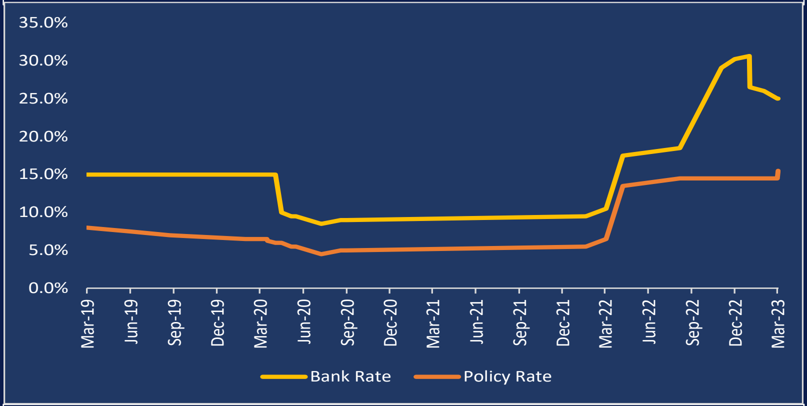
- One year has passed since the country defaulted on its debt on April 12, 2022
- During 2022, exports expanded by 5% YoY helped by better export prices and improved competitiveness, while imports contracted 11% YoY due to lower demand after depreciation and import restrictions.
- Remittances and tourist arrivals are slowly picking up. March records 125,495 tourists arrivals, highest figure in 15 months.
- Worker remittances for March 2023 were recorded at USD 568.3mn, a 79% increase over March 2022 and 39% increase over February 2023.
- Exchange rate stabilized at about 360 LKR/USD under FX market guidance from Central Bank of Sri Lanka and have now improved to around 320 LKR/USD post talks of debt relief and IMF program negotiations.
- World Bank and Asian Development Bank continued to disburse by repurposing the existing project loans for emergency assistance. India extended emergency loans and provided currency swaps.
- Secondary market yields plunge below 25% after reaching as high as 30%. Foreign investors bought ~USD 230mn of treasury papers till April 04, 2023.
- CPI Inflation YoY in March 2023 dropped to 50.3% after posting a high of 69.8% in Sep 2022.

LKR/USD Performance



Source: Bloomberg, Chase Securities

Sri Lanka Policy Rate and Bank Rate

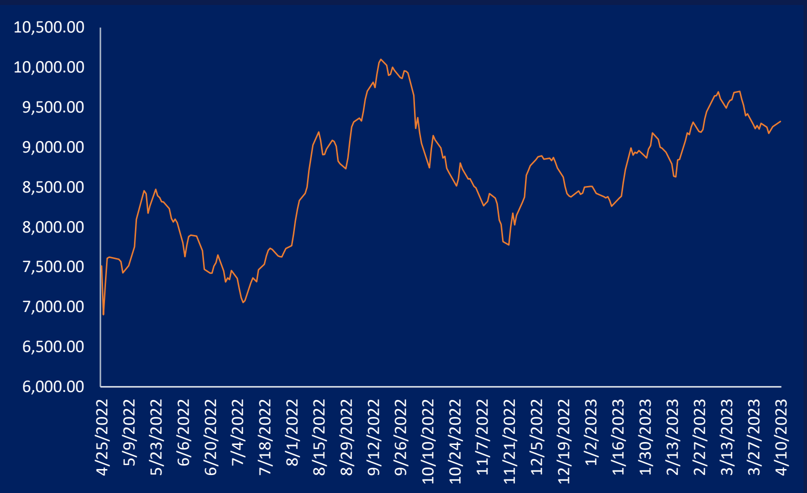


Source: Bloomberg, Chase Securities

Sri Lanka Equity Market Performance

- Colombo All Share Index is up more than 20% post default and market trades at P/E of ~5x and P/B of ~0.9x.
- Colombo All Share Index traded at 7,624 points on April 29, 2022 and closed at 9,301 points on March 31, 2023.
- YTD, Sri Lanka market return is 30% in dollar terms USD and ~13% in local currency LKR.
- Revenues for Sri Lanka listed companies have grown 28% per year for last 3 years reflecting more sales being generated by the companies overall.
- Market performance is driven by Energy, Telecom, Materials and Tech sector while General Industries and Financial sector remain laggards due to import restrictions and debt restructuring.
- Despite strong rally in Energy and Materials sector, they still trade at P/E in the range of 3x-4x.
- Foreign investors remain buyers with inflow of USD 2.4mn year to date.

CSE All Share Index Performance



Source: Bloomberg, Chase Securities

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IMF-Ghana Staff Level Agreement

Ghana- IMF Staff Level Agreement

- During Covid-19 pandemic, Ghana's public debt increased significantly leading to credit rating downgrades, exit of non-resident investors from the domestic bond market and Ghana's loss of access to international capital markets.

- Price and Supply chain shocks from the war in Ukraine, have led to large exchange rate depreciation. Ghanaian cedi has depreciated ~55% in 2022 amid pressure on exchange rate and monthly inflation surged over 40%.

- Resultantly, Ghana suspended payments on most of their external debts on December 19th,2022, **a week after reaching an agreement with the IMF** for a USD 3bn loan.

- The staff level agreement is subject to IMF Management and Executive Board approval and receipt of **necessary financing assurances by Ghana's partners and creditors.**

- The program include developing a medium term plan to **generate additional revenue** and advancing reforms to bolster tax compliance.

- The program also includes strengthening public expenditure commitment controls, **improve the management of public enterprises and tackle structural challenges in energy** and cocoa sectors.

- To restore public debt sustainability, Ghana Government has announced comprehensive debt restructuring, both foreign and local. Sufficient assurances and progress from creditors will be needed before program approval from IMF Executive Board.

- Bank of Ghana (Central Bank) is required to strengthen monetary policy framework and promote exchange rate flexibility to rebuild external buffers.

Ghana- Progress on Debt Restructuring

- Ghana has secured registration of around 85% eligible bond holders for its Domestic Debt Exchange Program, bringing it one step closer to secure program approval from IMF Executive Board.

- Government has initially earmarked USD 10.6 bn of domestic bonds for restructuring, but after negotiations with labor unions, agreed to exempt pension funds from debt exchange program.

- Government focus is now on restructuring foreign debt which is still in its initial stages.

- Two third of Ghana's debt was domestic about USD 48bn while external debt was USD 29 bn as at end of 2022.

- Under the final terms of domestic debt exchange program, banks exchanged existing local currency government bonds for new bonds with lower coupons and longer tenors.

- To ensure Banks participation in Domestic Debt Exchange Program, risk weighting of old bonds was increased from 0% to 100% and non-participating Banks were not eligible for liquidity support from newly created Ghana Financial Stability Fund.

- Banks holding eligible bonds maturing in 2023 will receive seven new bonds with near-equal weights, with one maturing each year from 2027 to 2033.

- Banks holding eligible bonds maturing after 2023 will receive 12 new bonds with near-equal weights, with one maturing each year from 2027 to 2038.

- MoF will pay accrued interest on old bonds in the form of capitalized interest added to the principal of the new bonds.

Ghana- Progress on Debt Restructuring

- Local Currency Debt Exchange will significantly weaken banking system capitalization, leading to material capital shortfalls at some banks.
- Regulators and External auditors are working on a standardized accounting model to capture losses from debt restructuring. Banks are likely to apply flexible accounting to reduce reported losses.
- Bank of Ghana is expected to ease regulatory requirements to enable banks to remain compliant with minimum capital ratios.

Pakistan- Similar Recipe for Reforms

- IMF Program notes of Sri Lanka and Ghana clearly outlines the reforms necessary to bring economy into recovery and ensure debt sustainability.

- During the IMF program negotiations, there were concerns about the extraordinary demands being made by the IMF, such as drafting legislation to combat corruption and securing financial commitments from friendly countries.

- The program notes for Sri Lanka and Ghana confirm that the requirements of the IMF program were consistent with what was presented to other countries.

- Although the necessary reforms to secure the IMF program until June 2023 have largely been completed, the requirements for obtaining another IMF program after June are expected to be broader in line with those of Sri Lanka and Ghana.

- Increase in Tax revenues, Taxes from untaxed sectors, limiting public expenditure, no fuel or energy subsidies, restructuring state owned entities, flexible exchange rate, current account in control, strengthening legislation on corruption are some of the broader reforms that IMF will emphasize on.

- Debt repayments of next few years are of significant amounts and it is about time to get the house in order failing which, there will be a complex and painful path towards debt restructurings.

Pakistan Economy Projections

		2023F	2024F	2025F	2026F	2027F	2028F
GDP	**PKR Bn**	85,448	108,449	125,150	139,605	156,143	174,590
GDP Growth	**%**	0.5	3.5	4.4	4.8	5.0	5.0
Inflation	**%**	27.1	21.9	10.5	6.5	6.5	6.5
Unemployment rate	**%**	7.0	6.8	6.6	6.0	5.5	5.0
Revenue	**PKR Bn**	10,465	13,588	15,675	17,494	19,540	21,851
Expenditure	**PKR Bn**	16,308	22,579	24,521	26,198	28,562	31,308
Fiscal Deficit	**PKR Bn**	(5,843)	(8,991)	(8,846)	(8,704)	(9,022)	(9,457)
Primary Balance	**PKR Bn**	(436)	(434)	(516)	(578)	(647)	(721)
Debt Servicing	**PKR Tn**	5.4	8.6	8.3	8.1	8.4	8.7
Net debt	**PKR Bn**	58,677	70,532	80,692	90,196	100,575	111,230
Current Account Deficit	**% of GDP**	(2.33)	(2.39)	(2.45)	(2.47)	(2.46)	(2.52)
Debt/GDP	**% of GDP**	73.60	68.90	67.80	67.60	67.10	66.10

*Source: IMF Projections

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Rating Definition	
BUY	Total stock return > 15%
NEUTRAL	Total stock return between 0% -15%
SELL	Total Stock return < 0%

* Total stock return = capital gains + dividend yield

Valuation Methodology:

- Period end target prices, Chase Securities Pakistan Private Limited uses different valuation methodologies including but not limited to:
- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return o arrive at our based methodologies (EVA, Residual Income etc.)

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