High Hopes

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Financial analysts predict good results in the second quarter of the corporate sector. Most of the companies are reducing their financial charges with access to low-cost funds, and plans are afoot to increase investments.

In the stock market the All Share Price Index crossed the 800 point mark recording a 150- point jump from March. The upturn was due to a combination of factors, one of them being a spate of good results for most corporates, especially the four largest conglomerates Hayleys, John Keells, Aitken Spence and Richard Peiris whose earnings growth averaged 32% for the year. Although the market had expected good performances for the four, the sheer size of the growth took it by surprise.

MARKET OUTLOOK

Richard Peiris & Co Ltd, has recorded good results in the year ending March 31, 1997, with substantial increases in turnover and profitability. The group turnover is reported to have topped the two billion rupee mark, growing by 11% i.e., Rs 2.1 billion from Rs 1.89 billion in the previous year. Provisional unaudited results circularized among shareholders indicated profit before extraordinary items as Rs 161 million, up from Rs 94 million last year.

The overall operating profits of Hayleys Ltd., have risen to Rs 623 million for the year ended March 31, 1997 a 58% increase over the preceding year. The pretax profits also rose to Rs 695 million during the period under review – a 43% rise from that of the previous year. The post tax profits of Rs 530 million was also a 65% increase from the previous year.

The Aitken Spence Group has performed strongly in the last quarter of 1996/97 to dramatically change what appeared to be a dismal performance earlier in the year. In an interim statement covering the year ending March 31, 1997, Aitken Spence announced

that turnover was up from Rs 2.7 billion of the earlier year to Rs 2.8 billion, while the net profit attributable to the company at Rs 81.4 million had grown from Rs

54.9 million the previous year.

Almost all research arms of stock broking companies predict GDP growth rate for 1997 to be above 5.5%. UBS Global Research say their forecast for 1997 will be 5.8%. However they say that the Central Bank is expecting real GDP growth to rise at an even faster rate of 6% in 1997. The reasons for the likely economic rebound in 1997 and 1998 are a recovery in agricultural and industrial production and the relative reduction in the country's war effort.

Agricultural production had declined 4.6% in 1996 due to the prolonged drought, which also severely affected Sri Lanka's (largely hydro-based) electricity production. However, with the weather conditions remaining stable, the 1997 rice harvest is expected to come in at around the 1995 record level of 1,750 metric tons. Aided by normaley in power supply and an easing of credit, the manufacturing sector, which accounts for almost 20% of overall GDP, is likely to show vastly improved results in 1997.

However, analysts say, many constraints on growth still exist. UBS forecasts a 14.8% rise in consumer price inflation in 1997, against 15.9% in 1996, and consequently a high cost of production. The import bill in 1997 is likely to be over 40% of GDP due to the 9% rupee depreciation over the past 12 months. The diversion of scarce development resources to defense over the past decade peaked in 1996, when defense spending alone comprised over a third of government revenues. This could impair future.

growth prospects unless defense spending is sharply reduced. Sri Lanka also needs to revive tourist inflow (an inevitable fallout of the war), which is a primary contribution to foreign exchange earnings.

BUDGET DEFICIT

UBS Global analysts also say that the budget deficit remains the key area of concern at the macro- economic level. It is a lasting legacy of the war and is unlikely to decline substantially over the next 2-3 years. 1997 budgeted defense spending is Rs 44 billion, or almost 5% of GDP. However, as in 1996, the 1997 defense spending target could be easily exceeded, particularly given the likely depreciation of the currency and the need for continuing defense imports.

According to their report, longer term deficit control will depend on whether the government can simultaneously raise and cut expenditure. Higher revenues depend on a significant industrial growth recovery over the next two years. The government anticipates 12% industrial growth in 1997, which is possible if there are no unexpected economic hiccups. On the expenditure side, the government needs to sharply reduce administrative and defense expenditure. Although the government continues to stress on the need for fiscal discipline and has removed many subsidies (e.g., the wheat subsidy), it is unlikely to meet the budget deficit target.

Government expenditure in 1997 is budgeted at Rs 281 billion and revenues at Rs 195 billion, leaving the total budget deficit at Rs 86 billion.

IMMEDIATE CONCERNS

The immediate worries for the Government would be the high trade deficit and the very high levels of monetary expansions in the recent past. Financial analysts say a little bit of monetary tightening might have helped to somewhat contain the inflation. In the past years the Government has relied a great deal on local borrowings to fund the war effort. This tightened the liquidity situation and pushed the prime lending rate levels to as much as 20%. This pressure however, has been lessened in the last few months due to the reduction of the statutory reserve ratio.

Another worrying factor is the rising internal debt of the Government which has increased from 286 billion at the end of 1995 to Rs 349 billion at the end of 1996-almost 46% of GDP. This, analysts say may force the Government to borrow more, simply to repay past borrowings. UBS Global Research has pin- pointed this saying ‘the basic culprit remains the ethnic conflict’ which they say could lead the Government into a ‘debt trap.’

The most important thing to watch out for in the coming months is the Government’s borrowing, as there is a consistent pattern of it entering the market in the second half of the year. If this happens like in the past years, it would again lead to a vicious cycle, i.e., the Government mopping up the liquidity in the market, leading to higher interest rates and so on.

INFLATION TRENDS

Sri Lanka continues to remain prone to high inflation. This has resulted from a domestic shortage of essential commodities (caused by the war) and the sharply rising cost of food and defense imports, a fallout of the large currency depreciation. On an annual average basis, the Colombo Consumer Price Index rose 15.9% in 1996 and as yet shows no signs of abating, rising over 15% in April 1997. Though the government is trying to keep inflation within single digits (through monetary tightening), this will be difficult given the current and expected levels of government spending and monetary expansion. For example, the original defense budget for 1996 (of Rs 36 billion) is estimated to have been overshot by almost 40%. Due to continuing inflationary pressures generated by the war, on an annual average basis, the Colombo Consumer Price Index is expected to rise by 14.8% in 1997, UBS analysts say.

Meanwhile, the latest Colombo Consumer Price Index published by the Government's Department of Census & Statistics for the month of May 1997 is 2047.4. This figure is on a base of 1952= 100. When the May 1997 Index is compared with the Index of May last year, the indicated annual inflation is 7.8%.

It is noteworthy that this annual point-for-point increase in the Index has steadily declined from 16.8% in December last year to 14.3% in March and now to 7.8%. The annual average inflation derived by taking a moving average from April 1996 to May 1997 indi- cates an increase of 15.8%. This figure also shows a steady decline since February 1997 when it peaked at 16.7%. When the effect of administered price changes which account for about 5 percentage points in the Index are excluded, the underlying average inflation could be deemed to be about 10.8%.

These trends confirm the expectations that inflation is on a downward trend in the country. The Government expects the annual average inflation this year to be about 9%. This would mean that the average annual inflation which stood at around 16% at the beginning of 1997 is expected to decline well below 9% towards the end of 1997, possibly around 6 to 7%

MARKET NEWS

The economy is beginning to show signs of resilience. Two more plantations were privatized in the month of June. 51% of Maturata Plantations Ltd, was sold to the Employees Trust Fund at a price of Rs 466.6 million (at Rs 45.75 per share), whilst 51% of Namunugala Plantations was sold to Keells Plantation Services Ltd, for a price of Rs 408 million (at Rs 40.0 per share).

This is the third plantation company in which the Keells Group has a controlling stake. The other two are Kegalle Plantation and Maskeliya. The controlling shares of 4 more plantations i.e., Malwatte, Elkaduwa, Elpitiya and Kahawatte will be sold this month. The same method of sale will be used where the controlling shares of these plantation companies will be open for bidding to a short list approved by PERC (Public Enterprises Reform Commission). The bidding will have to be done through the Colombo Stock Exchange.

In the meantime, funds to the amount of Rs 45 million have been approved by the cabinet to be invested in Bogalla Graphite. These are for several projects earmarked for the coming years. Bogalla Graphite intends starting operations on two graphite mines in Pussahena and Rangala.

Royal Palms Beach Hotels Ltd, a hotel under the Mercantile Investments Group, has successfully raised Rs 75 million by way of two rights issues to existing shareholders within six weeks of each other. Both issues were reported to be oversubscribed. The project was promoted by the Mercantile Investments Group which together with Tangerine Beach Hotels Ltd, a quoted public company are the majority shareholders. Royal Palms also made a bonus issue of one new share for every seven held by their original shareholders who had invested in the early stages of construction of the hotel.

Meanwhile, there has been some very positive statistics coming from the Colombo Port which is said to have set a record by handling 660,927 TEUS from January to May 1997. Forecast for the year exceeds the 1.5 million mark according to Ports & Shipping Ministry sources. The port development project with John Keells Holdings (JKH) has got some positive response from the market.

Jardine Flemming analyzing the JKH bottom line in the event of the project going through, says ‘the signing of the Letter of Comfort (LoC) by the government and the consortium led by JKH prompted us to take the project into account in our profit estimates.’ Jardine Flemming Financial Analyst, Azra Jafferjee, taking a closer look at the country’s fi- nances, points out that M2 growth remained stack in April, rising 8.1% YoY, while M1 growth registered a

marginal 1.4% growth. The subdued money supply picture continues on the back of falling net external asset growth (down 11.3% in April) and stagnant domestic asset growth (up 15.6%). Private sector credit expanded 9.7% in April up slightly from 8.7% in March. Government borrowing, however, continued to be strong, rising 23% YoY. Total loans and advances came in flat, rising 9.1% YoY to Rs 212.6 billion, while deposit growth slowed to its lowest levels in over 5 years, at 10.9 % YoY.

Jafferjee says Jardine Flemming are not overly concerned by the slow growth of private sector credit as they expect the impact of lower rates to only make itself felt in the second half of 1997. Commercial banks have only just begun to drop lending rates on the back of the statutory reserve ratio reduction in the first quarter. With the loan/de- posit ration rising to 79% as at April, from an all time low of 77.3% as at YE96, interest rates are expected to edge upwards in the second half.

But not all news was good in the financial market. Vanik Incorporation, has reported that it has lost its momentum of growth in assets for the year ending March 31, 1997 and the company's profits have nosedived to Rs 20.3 million during the period under review from the Rs 81.6 million a year ago.

Vanik's president/CEO Justin Meegoda has told shareholders that the principal reason for this was that the investment banking sector, which derives most of its margin income from capital market activities, was inhibited by loss of profit making opportunities largely due to the adverse performances of the stock market.

In the meantime, Vanik has announced a debenture issue and intends raising Rs 150 million from the market. The unsecured redeemable debenture will carry an interest rate of 18% per annum payable half- yearly.

Hopes are still high among market watchers for the economy's turnaround. With the Sri Lankan tea fetching high prices in the world market, the inbound tourist figures coming out of the dumps, the apparel industry having one of it's best years, interest rates stabilizing at lower levels and foreign investors (such as Koreans and Malaysians) showing an active interest in the country, the only other aspect required to complete the picture is political stability. If the PA Government can ensure this, 1998 could turn out to be a very good year indeed.