Looking Up

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NDB Shares Sale-Opposition Reaction

The selling of NDB shares to foreign buyers came under criticism from the UNP. The financial watch dog of the party Mahinda Samarasinge, MP for Kalutara made some mumblings and grumblings in parliament saying that…at least 65% of the NDB will be owned by foreigners. In a nut shell we will be selling our future development prospects to some institutional foreign investors, who will be more short-term profit oriented than long-term development-oriented.'

Samarasinghe pointed out that this sale of shares. would achieve only one purpose that of revenue generation for the government. He also says that there are other implications, 'first and foremost the NDB has invested in equity of many industrial concerns. A detailed list of investments made can be seen in the 1996/ 97 annual report of the company. This quoted portfolio of shares represents a tremendous hidden value that the financial statements do not reflect, because of the depressed stock market condition and because the unquoted portfolio is valued in a conservative manner. Therefore, the proposed issue price of Rs 230 per NDB share does not reflect the true value of the shares held by the government."

The MP for Kalutara also cautioned the government on another issue saying it was not prudent for Sri Lanka to divest its majority share holding (in NDB) to foreigners, because NDB also had a tremendous re- source base of information on local industries; the implications and concerns of local industrialists need to be studied, he said, before divesting it to foreigners.

Foreign Interest

On the other hand, foreign interest in these shares were certainly high, investors were very enthusiastic about this buy and the share issue was subscribed twice over. The foreign offering which amounted to Rs 4290 million is now considered to be the single largest of fering for the sale of a listed company in Sri Lanka. NDB sources said that this offer for sale attracted over fifty of the largest institutional investors in the world, many of whom were coming to Sri Lanka for the first time, thus making NDB one of the highest market capitalisations among the companies trading in the stock market.

The share capital of NDB was raised from 17.5 million shares to 35.8 million shares following the conversion of debentures owned by the Government creating 18.33 million shares. 16.5 million of these shares were sold by the Government through this successful international offering. This has been followed by a local offering of 0.9 million shares and the purchase of a further 0.9 million shares by NDB to create an Employee Share Option Scheme.

NDB’S Services

NDB is the single largest source of medium and long term financing for development projects in Sri Lanka and provides funding via direct lending, refinancing and equity investments. It also provides trade finance related services and short term working capital.

NDB’s direct lending portfolio which consists of term loans and working capital finance accounts for over 80% of total advances (excluding leases) and is the 90% of the total income in the financial year ’96. bank’s primary source of income, which accounted for Refinancing, which accounts for the remainder, is a lend- in scheme where ADB/WB loans and funds are channeled through to other lending agencies (L.e., commercial banks and DFCC) for development purposes in government targeted sectors (SMI-Small and Medium Scale Industries). NDB only receives a fixed 1% per annum fee on these disbursements, but in the case of funds refinanced for shorter maturities the bank is entitled to use repayments through the balance term therefore provided the bank with one of the resources for its general banking purposes. These funds have with which to offer short term loans.

The strategic review conducted by the Industrial Credit & Investment Cooperation of India (ICICI) in 1997 highlighted the bank’s need to venture into commercial/retail banking activities to provide a wider range of products and services to customers and access a wider array of funding. The bank has already incorporated these findings into its future strategy and will concentrate on direct lending operations (ie., working capital finance, trade finance, leasing etc.) to small and medium sized industries. NDB is also gearing to access the housing and auto finance market. which will be facilitated by the expansion of its branch network, scheduled to grow to 30 by 1999. Though this strategic change will take a year or two to realize its full potential, implementation is already underway via branch expansion and additional recruitment. As such, rapid growth in shorter term assets will be experienced by 1998 and 1999 with overall loan growth set to increase by 23.1% and 20.9% respectively.

Sector Exposure

The bank's total exposure is well diversified with its direct credit facilities and equity investments (89% of total assets) spread across sectors such as services, hotels, metal & chemicals, rubber/leather products, wood/paper products, textiles & wearing apparels, agriculture, agro & fisheries, food, beverage, tobacco and miscellaneous.

Sector exposure is limited to under 20% of the total exposure with the exception of the service category which covers several large sub-sectors such as public utilities and transport and accounted for the largest growth in '96. The bank's growing exposure to the Hotel/Tourist sector has been cause for some concern with the downturn in arrivals and a number of outstanding loans have been rescheduled or provided for. The recent turnaround in the industry augurs well for the bank and even though we believe the recovery will be gradual, given the country's potential in this very lucrative industry and the bank's strong balance sheet and holding power, a 12% exposure is not of significant concern. In contrast, the bank has, over the years, gradually reduced its exposure to the Textiles and Garment Industry. NDB has been compelled to make fairly large capital and interest provisions in this sector though recent recoveries will help negate some of the losses and write-backs should help bolster the bot- tom line in the financial year '97.

Shares Oversubscribed

Meanwhile, the 5% slice of the government-held debentures in the NDB, which were converted into shares numbering a total of 916,700 shares constituting 2.6% of the Bank, which came up for sale in the domestic market on 28th August at a price of Rs 250 per ten-rupee share (ten rupees less than the price at which the government sold 16.5 million of these shares to foreign institutional investors), was oversubscribed 7 1/2 times over (the foreign issue being oversubscribed twice over) resulting in the issue being closed the self- same day with a total of

4093 applications being received.

The run on the issue was predicted by both ana- lysts and brokers prior to the issue opening and in fact the share was traded last week at Rs 280 and Rs 275 (a price above Rs 260 at which the foreign component was sold).

Mano Tittawella, director general, PERC, in a release immediately after the first day of the issue stated ‘the government is pleased with the eager response of the investor community to the domestic offer of the shares of the NDB, resulting in the offer being oversubscribed 7 1/2 times over. The government had three objectives in conducting the offer for sale of shares of the NDB. Bringing in revenue to the government, promoting capital markets and strengthening the NDB. I am happy to say that these objectives have been achieved in full measure both in Sri Lanka and abroad. The government has raised Rs 4.5 billion in revenue, the overseas issue has attracted over 54 foreign institutional investors into Sri Lanka and the removal of the debentures from the balance sheet of the NDB now allows the company to have a stronger financial structure. We expect to see the company going from strength to strength contributing in a great measure towards the development of Sri Lanka.’

According to a bank spokesman the subsequent Issued Share Capital of the Bank stands at Rs 385.3 million, consisting of 35.83 million shares.

In terms of holdings he said that the breakdown is as follows:- Government – 7.4%, Central Bank – 4.9%, Peoples Bank – 2.9%, Bank of Ceylon – 2.8%, Common- wealth Development Corporation – 5%, Citibank – 3%, ADB-2.4%, Overseas Institutional Investors close to 60% and bank employees – 2.5%.

SLT Privatization

Earlier, in the month of August, the government approved the divestiture of 35% of Sri Lanka Telecom (SLT) to Nippon Telegraph & Telephone Corporation of Japan (NTT) for a price of US$225 million. It was reported that this was the single largest investment in Sri Lanka and is seen as a major confidence boost to the government’s economic policy. The deal with NTT was that they would have the opportunity to appoint the chief executive officer and several senior executives who would join the government appointed board members to manage SLT.

To reassure the employees of SLT, the organization for the protection of Sri

Lanka Telecom in a press release said that the restructuring of SLT with the divestiture of 35% of its shares should not create any fears in the minds of the employees as regards the future of their job security.

In the wake of this it was reported that the president had directed the Treasury to retire Rs 10 billion treasury bills.

Inflation

The Department of Census and Statistics announced a decline in the annual average inflation rate from 14.7% in June to 13.9% in July. It was reported that this declining trend has been prevalent since February when it reached a peak of 16.7%.

The Department of Census and Statistics further reports that the annual average rate of inflation would be at a single digit level for 1997, perhaps below 9%, as indicated by the Colombo Consumers' Price Index, well below last year's rate of 15.9%.

The Colombo Consumers' Price Index recorded a figure of 2102.2 in July showing an increase of 2.1% over the month of June. This increase is attributed to the rise in the prices of dried chillies, fish, coconut and coconut oil, vegetables, eggs, potatoes and some varieties of dried fish. Price declines were recorded for red onions, lime, cowpea and sprats.

Energy News

On another front, the threat of power cuts are gradually diminishing under the government's accelerated plan of replacing the country's reliance on hydro power with thermal power. The month of August saw the commissioning of a 115 mega watt gas turbine plant costing Rs 2.1 billion, at the Kelanitissa Power Station in Colombo.

The plant being the largest of its kind in the country is capable of meeting 20% of the country's electricity demand. The turbine whose output equals the peak load in the Colombo city was installed and commissioned within a period as short as nine months in order to avoid a possible power crisis which might loom in the future. Funding of the project was by the Ceylon Electricity Board.

The Ceylon Electricity Board, on a directive issued by the Power Minister and acting defense minister Anuruddha Ratwatte, will under the rural electrification program, supply electricity to 1000 villages covering 100,000 households prior to year 2000.

According to CEB sources, the project which will cost Rs 3,500 million, would be funded by the Asian Development Bank (ADB). The bank has already advanced a sum of US$60 million for the cause. It was reported that General Ratwatte has also made plans to provide at least 80% of rural households with electricity by the year 2005. Under this several phased project, 200 villages are to be provided electricity within this year, while 400 villages will receive electricity in 1998 and another 400 by 1999.

Foreign Investment

The month of August also had good news for the country where foreign direct investment was concerned. An agreement was signed with the Common wealth Development Corporation(CDC). This agreement would facilitate an additional US$86.4 million into Sri Lanka's private sector expansion.

CDC which concentrates on emerging economies especially those carrying economic reform such as Sri Lanka, say that they are bullish about the potential for development with the fully automated Stock Exchange and Central Depository System. It is on record that the CDC has not suffered any defaults on its loans to projects in Sri Lanka and plans for the current portfolio to continue to grow into the foreseeable future. A spokesperson for the company has said 'the emphasis however is likely to be more on the infrastructure and industrial projects – all of which have a high value addition and are in keeping with the development needs of Sri Lanka.'

petitiveness in relation to trading partners (US, Japan,

Vanik Debenture

The economic good cheer was spreading as Vanik which had bad luck in their previous debenture issue was oversubscribed this time round. This issue of 1.5 million unsecured redeemable debentures with an interest bearing of 18% per annum was sold at a par value of Rs 100. Vanik sources say that this issue was mainly to enhance Vanik's fund-based activities such as leasing and bills discounting.

Rupee Overvaluation

Economic analysts such as Econsult were skeptical on other issues such as the over-valued Sri Lankan rupee. They say that to get 'to end-1994 competitive levels in relation to trading partners, one would be looking to a depreciation of the Sri Lankan rupee to around Rs 80: 1 USS.' Tracing back the problem they say that Econsult first raised the problem of an increasingly overvalued rupee exchange rate in late 1994, during the tail-end of the previous UNP government, when it was becoming clear that the government was deliberately allowing the exchange rate to become overvalued and that the latter, in combination with high real interest rates, was beginning to have an impact on the industrial export growth. 'Our view then, as now, was that a competitive exchange rate is a sine qua non for sustained industrial export expansion. We noted that the overvaluation of the exchange rate was beginning to impact Sri Lanka's industrial export growth performance. Growth in US dollar earnings from non-garments and textile exports had slipped from over 50% in the 3rd quarter of 1994,' says the Econsult monthly update for July '97.

Econsult, in their 1995 Annual Report have gone on to quantify, in some detail, the extent of the overvaluation of the currency. They have pointed out that whichever way one looked at the real value of the rupee, and assessed its competitiveness vis-à-vis both Sri Lanka's trading partners and competitors, the cur- rency was significantly overvalued. Specifically, be- tween end-1989 and end-1994, Sri Lanka's loss of com-

Germany, UK and France) was 16%, while in relation to competitor countries (India, Pakistan, Bangladesh, Thailand, Malaysia, the Philippines and Indonesia) it was 35%. As a result of this overvaluation, Econsult argued, Sri Lanka was losing ground to her competitors in the East and in South Asia. It was noted that Sri Lanka's trade imbalance with Asian countries as a group had risen sharply from a deficit equivalent to 8% of GDP in 1983 to one of 16% in 1994. Over the same period the trade deficit with other South Asian countries had risen threefold from 1% of GDP to 3% of GDP. One inevitable consequence of such a loss of competitiveness, they say, would be a protracted decline in foreign exchange reserves.

In response to these arguments government economists and their advisors contended that the rupee was not significantly overvalued. One line of argument held that the exchange rate was not overvalued because the forces of supply and demand freely determined it. Another line of argument was that if one used 1991 as the base year in real exchange rate calculations instead of 1989, as favored by Econsult, the rupee would not be shown to be overvalued. Most participants in the debate and outside observers agreed that the ultimate test of the veracity of the arguments put forward would be future trends in industrial export earnings, particularly non-textile and garments, and the overall balance of payments situation. “

As is now well-known, industrial export earnings growth has declined systematically since 1994 as has the country’s external reserve position. Since indus trial export growth had been responsible for pushing real GDP growth to nearly 7% in 1993, the decline in the former has, naturally enough, led to a decline in the latter. By end-1996, US dollar industrial export earnings growth had slumped to around 6%, while non- textile and garments export earnings had fallen to around 9%. This resulted in a fall in the growth rate of the industrial sector and with it changed the trend in the GDP growth.

Exchange Rate

At the same time, the rupees exchange rate overvaluation worsened. The PA government that assumed office in August 1994, encouraged by the World Bank and IMF, simply continued with the (populist) overvaluation policy of the outgoing UNP administration, Econsult says. The justification was that growth would take care of itself once inflation was brought under control and that currency depreciation, apart from being unnecessary, was harmful to inflation.

The table below shows the extent to which this strategy worsened the overvaluation of the Sri Lankan rupee. Specifically, in relation to trading partners, the overvaluation of the rupee has moved from 16% at the end of 1994 to 68% at the end of 1996. In relation to competitor countries, the overvaluation has moved from 35% to 78% over the same period.

Accompanying the decline in export earnings growth has been a worrying loss of competitiveness to other South Asian countries, particularly India. Between 1989 and 1996, the overvaluation of the Sri Lankan rupee against the currencies of the South Asian region has been 98%. Against India it has been 111%. This loss of competitiveness is starkly reflected in Sri Lanka’s trade balances with the region.

With South Asia as a whole, Sri Lanka's trade deficit jumped to 4% of GDP at the end of 1996 from 3% of GDP at the end of 1994 and 1% at the end of 1989. India is responsible for most of this imbalance, some Rs 27.5 bn, and now accounts for more Sri Lankan import expenditure than any other country.

It is not that the exchange rate alone is responsible for the decline in export earnings and competitiveness. High real interest rates have also played a part, as has the (World Bank's) level playing field' philosophy which one heard about so much in the early days of the present government. As industrial export growth and economic activity as a whole have faltered, the government too appeared to have abandoned many of the economic dogmas it once cherished so dearly. In fact, the first to go was the 'level playing field' philosophy. Except for depreciating the currency, the government appears to be giving every incentive possible to exporters and other sectors it deems to be strategic. More recently, the long-held belief of the importance of high real interest rates have given way to its opposite the importance of low (even negative) real interest rates. Hopefully, the next dogma to go will be the alleged importance of a "market-determined" exchange rate."

Econsult analysts say, allowing the market to determine the exchange rate tends to result in the overvaluation of the currency in the presence of capital controls. The problem facing the monetary authorities once the currency becomes seriously overvalued, is how to restore the competitiveness of the rupee without destabilizing the economy. As has been seen in Mexico and, more recently, in several East Asian countries (Thailand, the Philippines, Malaysia, and Indonesia), any corrective action undertaken by the authorities in such a situation is extremely painful. Of course, unlike the aforementioned countries, Sri Lanka does not have a liberalized capital account. This will certainly make the economy less susceptible to wild gyrations in the process of correction. However, given the extent of the rupee's overvaluation, a fair amount of economic pain is unavoidable. The temptation for the government is to duck currency depreciation until the very last. The worry is that by doing so the economic problems besetting the country may become truly intractable, these analysts say.