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NOTES FROM THE ROAD—
TRAVELING THE FRONTIER MARKETS
Sri Lanka

SRI LANKA—ON A STRUCTURAL PATH TO GROWTH

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While it is easy for investors to overlook Sri Lanka due its close proximity to its larger and highly populated neighbor India, there is significant untapped potential in this frontier economy. We found plenty of promise during a recent research trip to this diverse Asian country—in particular in its strategic Indian Ocean location.

KEY TAKEAWAYS

- Sri Lanka's reform agenda remains well on track. GDP growth is expected to come in at around 4.5% to 5% this year, a slightly softer number, but reforms, an IMF programme, and infrastructure spending should see economic growth accelerate thereafter.
- Monetary policy should now start to become more accommodative. Inflation is back within the central bank's target ranges again, so interest rates are expected to stabilize, subject to credit growth remaining under control. We could even see a loosening of policy over the next 18 months.
- The banking sector remains an area of focus, and we had good meetings with some of the banks. Loan growth is in double-digit territory and is expected to remain there in the medium term.
- Sri Lanka is one of our largest active positions in the Institutional Frontier Markets Equity Fund, and we remain comfortable with this, predicated on continued positive government reforms and accelerating economic growth.

A CLOSER LOOK

Situated in the more stable center of the often volatile Indo-Australian tectonic plate, Sri Lanka's shoreline, unlike India's, is fortunate to be largely surrounded by deep water—the ingredient needed to house large-scale port developments. The country has three main ports—on its east, west, and south coasts—which are perfectly situated along the main shipping route between Asia and Europe.

Colombo, the Sri Lankan commercial capital, is home to the country's largest port, which currently has three major associated quays. These quays are each owned by the Sri Lankan government, the Chinese, and John Keells Holdings—Sri Lanka's largest listed conglomerate.

China is well aware of Sri Lanka's strategic location and has invested heavily in the country over recent years and only recently signed a US$1.1 billion deal for development and control of the southern port of Hambantota. This project forms part of China's giant trillion-dollar "One Belt, One Road" initiative.

POSITIVE PATH OF REFORMS

After almost three years of government inactivity, we are finally witnessing positive momentum in reform agenda. These reforms have the ability to further accelerate economic growth in Sri Lanka, a country already fortunate to boast a highly educated workforce and a growing number of international tourists.

Recent market-friendly government action includes the naming of a new finance minister—among other top-level ministerial changes—as well a new central bank governor. We were fortunate to have dinner with the new governor, who articulated to us the substantial reforms in the pipeline.

Another positive development has been the establishment of a new five-person working group—including the aforementioned minister of finance and central bank governor, as well as two other economic ministers, one of whom we also met on this trip—that sits with President Maithripala Sirisena each week to push forward the reform agenda. Key recent initiatives include plans to broaden the tax take—which currently sits at a low 15% of GDP—as well as the implementation of a fairer tax structure and the ending of subsidies.

ACCELERATION OF GROWTH

Sri Lankan GDP growth is expected to come in at about 4.5% to 5% this year, a slightly softer number than previously expected due to a spate of recent natural disasters—namely floods and drought. However, the aforementioned economic reforms—as well as the current IMF loan program, renewed infrastructure investment, and the recent resumption of European Union GSP+ duty-free concessions—are expected to drive GDP growth upward in 2018 and 2019.

As for monetary policy, the Central Bank of Sri Lanka is now close to the end of what has been a rather benign hiking cycle, with interest rates tightened to control credit expansion, which hit 28% at its peak. The tightening has successfully brought inflation down to around 5% which is within the 4% to 6% target range. Rates are expected to stabilize at this level and, subject to credit growth remaining under control, a loosening of policy could be on the cards over the next 18 months. In terms of currency, while central bank intervention has been substantially reduced, a fully floating currency is unlikely to be in place until 2019. The Sri Lankan rupee is currently deemed to be only about 6% overvalued, but the authorities plan to allow it to continue adjusting on a gradual basis and only intervening to smooth the volatility.

THE BANKING SECTOR PROVIDES OPPORTUNITIES

There is strong growth within the banking sector, and valuations are cheap relative to historic price-to-book levels. Hatton National Bank expects to deliver loan growth of 15% in 2017, rising to 20% over the next two to three years on stronger economic growth in the country. In addition, its nonperforming asset levels have fallen from 4% in 2013 to just 1.8% last year. We also met with Commercial Bank of Ceylon, which expects loan growth of about 17% this year, a level it sees as sustainable over the next three years.

COMFORTABLE BEING EARLY

We remain convinced that Sri Lanka, one of the largest active positions in the T. Rowe Price Institutional Frontier Markets Equity Fund, is an attractive multiyear investment opportunity. While there is always danger that we might be too early, our thesis is predicated on continued positive government reforms and accelerating economic growth. This last visit impressed us, and we believe that the authorities are finally on the front foot.

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Hatton National Bank represented 1.46% and Commercial Bank Ceylon represented 0.71% of the Institutional Frontier Markets Equity Fund as of June 30, 2017.

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