



The Lankan Economic Dilemma

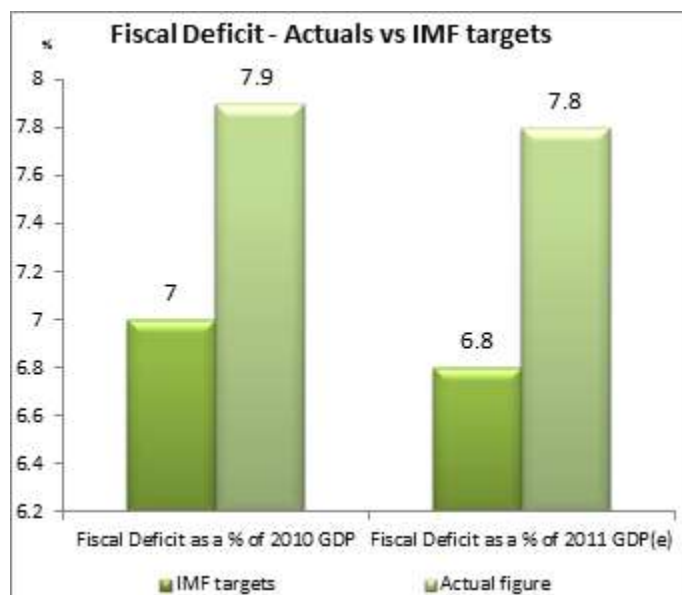
Asia Wealth Management Research

Oil price hike – IMF backed austerity measures takes its toll

Despite the weak global outlook, the volatile situation that is currently prevailing in the region surrounding the Strait of Hormuz through which almost 20% of the world's oil requirements pass through has triggered a flurry of precautionary demand which has pushed a barrel of crude oil above USD110.

However, the rise in domestic prices was not merely due to general increase in world crude oil prices. Government measure to raise petrol, diesel and kerosene prices by 8.7, 36.9 and 49.3 percent respectively, is in our view a step taken to streamline government finance according to conditions pertaining to the IMF's stand-by facility. The price hike was a result of the government withdrawing from subsidizing the domestic fuel prices and less as an outcome of escalating world prices. This is reflected by the fact that world crude oil prices increased marginally to 4.7 percent from October 28, 2011 to February 10, 2012; and despite this small increase Sri Lankan government raised oil prices by a margin much higher as noted above during the corresponding period.

Hence, these moves can be interpreted as new austerity measures demanded by the IMF to curb the fiscal deficit hovering well over 6.8 percent target which the government failed to achieve in 2011. It is clear that the hike in oil prices and electricity tariffs are steps taken to convert loss making Ceylon Electricity Board and Ceylon Petroleum Corporation into non-loss making entities in pursuit of obtaining the final installment of USD 800 million from the USD 2.6 billion bailout package approved in 2009.



Senior Minister of International Monetary Co-operation Dr. Sarath Amunugama briefed the parliament on last Friday of government expectations to enter new agreement with IMF in a quest for obtaining final installments of USD 2.6 billion bailout package. IMF withheld these installments last July criticizing the government for not implementing all the stipulated austerity measures. Dr. Amunugama did not explain what conditions were attached to the new agreement, however, it is learnt that the government agreed to reach a balance of payments surplus of over USD 800 million for 2012 as a part of the new agreement. IMF had been continuously stressing the need to adhere government's spending targets, the devaluation of the rupee and cuts to subsidies including fuel and electricity. The recently adopted fiscal and monetary measures demonstrate government's compliance to these conditions:

- ✓ From February 3, the monetary authority allowed the LKR to devalue and by 14th February currency depreciated nearly 6 percent from LKR113.00 a USD to LKR120.00 and is expected to depreciate further. Devaluation will trigger price increases for all imports, and flow through to other goods and services. This is to say that liquidity level of the financial system would erode and thereby, demand for CB interventions in financial markets as a lender of the last resort will escalate to stabilize market rates.
- ✓ On February 13, the government permitted private and state transport services to increase fares by between 20 and 28 percent.
- ✓ On February 14, the Electricity Board announced a 20 to 40 percent increase.
- ✓ The CB also imposed 18 percent credit growth limit on commercial banks for 2012 and increased repurchase and reverse repurchase rates by 50 basis points each, to 7.5 percent and 9 percent respectively.

Theory

Oil price shocks are most commonly cited as a supply side shock in most standard economic models. According to the standard models, an oil shock for a small open economy that is a net oil importer would face rising domestic price levels, declining output, investment and a loss of welfare. Taking each of these effects in turn, rising oil prices would directly impact import costs of raw materials, energy costs, transportation costs and other costs involved in the production process. At a more technical level, given that capital and oil are complimentary goods a decline in the marginal product of capital would deter investments. With respect to consumption, the price elasticity of oil is approx. (0.3) – (0.9) and would result in a rise in cost of living and decline in consumption and hence output.

Present scenario

Since the two oil crises of the 1970's, almost all of the oil price shocks have been due to demand driven shocks and precede recessions. The current crisis is no exception with commodity markets on the rise as emerging markets compensate for weaknesses in developed markets. Although the oil price shock is expected to be temporary, given the import-driven nature of the Sri Lankan economy, the oil price rise could result in a decrease in competitiveness and worsening of the already fragile BOP deficit.

Implications for equity markets

In general almost all companies at different points in the value chain would be faced with increasing transportation and utility costs. Specifically, the manufacturing sector would feel the brunt of this shock given that the majority of factory output is dependent on non-renewable energy sources such as heating oil; diesel for their energy needs which accounts for a sizeable proportion of production costs.

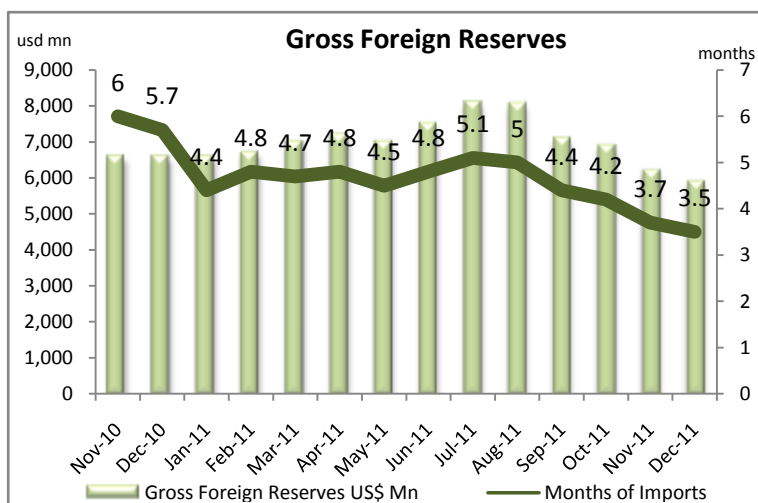
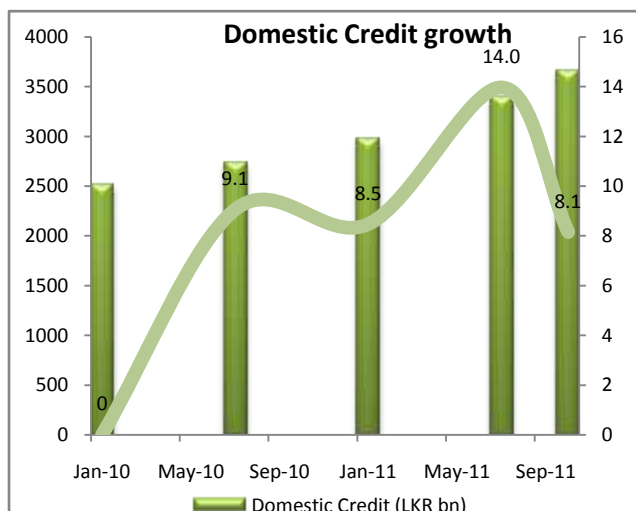
Exchange rate & interest rate risk – Central Bank credibility in question

The Crisis

The Central bank which had attempted to maintain both a pegged exchange rate and a stable interest rate in defiance of the impossible trinity, surrendered to the inevitable and relaxed the Peg on the exchange rate and allowed interest rates to rise. Since the beginning of this week, the rupee has been in free-fall with the rate at one point reaching USD/LKR 122.35. Despite the Central banks attempts to reassure the markets, the Rupee is expected to depreciate even further. In an attempt to curb the unsustainable explosion in demand for credit which rose in excess of 34% in 2010, the Central bank had taken steps to curtail this by raising policy rates by 50 basis points and placing a quantitative limit on the growth in lending.

The Theory

As discussed in a number of previous articles, this crisis has arisen due to an unprecedented rise in private sector credit for consumption purposes coupled with an unsustainable current account deficit. Due to the downward pressure resulting from the unfavorable terms of trade, the Central Bank is forced to intervene in the FOREX market by selling down foreign reserves and attempt to prop up the currency by creating artificial demand for the Rupee. At the same time the Central Bank must intervene in the domestic money market through open market operations in order to keep interest rates stable. This scenario leads to a worsening current account deficit as imports become artificially cheaper and places pressure on the country's foreign reserves.



Present scenario

As outlined by the Economist Harris Dellas, one of the primary reasons for a collapse of a pegged exchange rate regime is a loss of credibility. The arbitrary depreciation of the currency through the government budget places the independence of the central bank in question. This was despite the central banks rhetoric that it would not devalue its currency when other South Asian currencies such as Vietnam were doing so citing the risk of rising inflation (Discipline hypothesis). Although inflation has been brought to heel, the cost in terms of depleting foreign reserves has been considerable. In a classic example of doublespeak the Central Bank has started to relax the peg on the exchange rate claiming that it would be beneficial to exports. However, one must remain vigilant that given the state of the credibility of the Central Bank's policy announcements, there is a real danger that the central bank might lose its nerve and resort to sterilization measures. This being only a temporary measure would prevent the structural changes necessary for the economy to emerge from this quagmire from materializing. This would also adversely impact the fiscal position of the economy as the debt obligations of the government rise in dollar terms for its dollar denominated bond issues. This would also imply that for future dollar bond issues, the government would have to borrow at a higher rate once existing borrowings reach maturity.

Although analysts applaud this move as although this shock therapy approach recommended by the IMF would be painful in the short-run as the trade account deficit would worsen, it would lay the groundwork for a structural shift in the economic structure to take place.

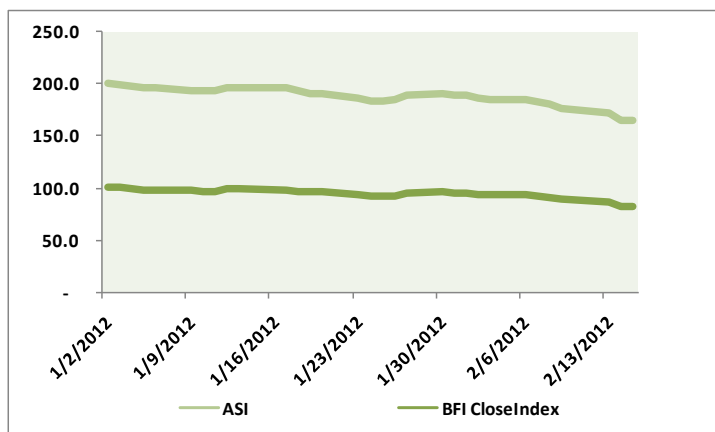
In response to this, the Central bank in its monetary policy review for February cited reducing current account deficit and restricting inflation to single digit levels in defense of its action to raise the policy rates. This would be expected to trickle down through the financial system and raise the cost of borrowing. However this attempt at contractionary monetary policy is thwarted by the monetary board's action which continues to intervene in the domestic market through its open market operations. Hence there is a mismatch between the current monetary policy requirements and the monetary board's actions. In the words of the Nobel Prize winning economist Robert Mundell, a pegged exchange rate arrangement requires a consensus among the participants about its stance on monetary policy. Therefore unless a fully-fledged currency board is established whose sole motive is maintain a pegged rate, it would be prudent for the government to abandon its attempts to prop up the exchange rate.

Implications for Equity Markets

The immediate effect of a hike in interest rates would be to lower firm values across the board as both equity and debt holders demand a higher return as both risk premiums and company default spreads adjust to reflect the heightened macroeconomic risks. This could also lead to changes in a firm's capital structure who would weigh the benefit of borrowing abroad at a lower rate against the possibility of a currency loss. The exchange rate would as expected, heavily influence counters engaged in external trade as well as company's dependent on raw material costs.

Ensuing sections of this report would elaborate on the key sectors that would be mostly affected by the exchange rate, interest rate and crude oil price movements.

Impact on the Banking and Finance sector



The recent economic changes would hold a direct impact towards the banking and finance sector which would later trickle in to the other sectors directly or indirectly. Banking and finance sector, the back bone of the economy would undergo changes in the wake of consequences stemming from policy rate changes, rupee devaluation and massive hike in oil prices.

The Central Bank of Sri Lanka raised the reverse repurchase rate to 9% from 8.5% and the repurchase rate to 7.5% from 7%, being the first increase since 2007. During 2007, the policy interest rates had been increased as to dampen rising prices as inflation rose to a record 20.5 percent in January 2007. Earlier to this, during 2011, the interest rates were in the lower regime as to induce credit demand in achieving post war economic developments. In terms of growth, low interest rates were beneficial but stability point of view a very high credit growth is of concern. Yet, the credit growth expanded above expectations creating a liquidity gap and various other economic consequences, including current account deficit due to unprecedented growth in imports etc...

According to CBSL, continued substantial increase in import expenditure resultant from increased domestic economic activity, low interest rates, as well as the high energy prices in the international market and this has led to widen the trade deficit. The total expenditure on imports increased substantially to US dollars 18.4 billion during the first 11 months of 2011.

Credit extended to the private sector by commercial banks, trade related credit and credit driven by import related items such as motor vehicles and consumer durables increased significantly. Import related credit increased by over 34% during 2011, while the increase in credit for export activity was only around 8%.

At the same time, excess liquidity in the domestic money market has declined from LKR124 billion as at end 2010 to the current level of around LKR15 to 20 billion, and such decline in liquidity in the domestic money market led to market interest rates recording an upward movement in recent months. Therefore, excess

liquidity declining has led commercial banks to competitively engage in accumulating deposits to satisfy the credit demand where these attempts has pushed up the interest rates paid on deposits.

Stemming out from the policy rate hike, the CBSL initiated in limiting the credit expansion through increasing the policy rates and directing the commercial banks to moderate their credit disbursements. Policy rates were revised with the aims of curtailing import related credit to reduce trade and current account deficit, reducing inflation expectations through cooling demand and ease pressure on the exchange rate.

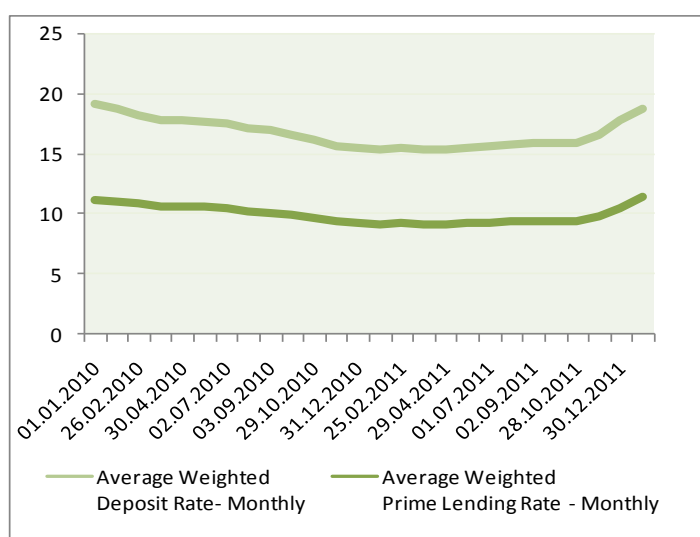
According to the new directive- the Monetary board also decided to direct commercial banks to moderate their credit disbursements so that the overall credit growth in 2012 will not exceed 18% of their respective loan book outstanding at the end of 2011, while credit growth of up to 23% will be allowed for those banks, which finance excess up to 5% of the credit growth from funds mobilized from overseas.

Followed by the policy rate changes and the limit on credit expansion, the performance of banking sector counters would get adjusted accordingly.

The impact to the sector counters would be an amalgamation of all three aforesaid economic changes (interest rate hike, oil price hike and rupee devaluation). Followed by the interest rate hike and limitation on credit, the growth in top line of banks would slow down due to higher reduction in volume of credit than the rate increase. But at the same time banks would immediately benefit from the interest rate hike on their existing loan portfolios.

A revisit in to the recent growth rates in bank loan books we see the growths had been significantly above 18%. Adding further, the significance of net interest income in operating income is high (on average net interest income/operating income is 70%) in the Sri Lankan banks, which can give a substantial impact to the bottom line.

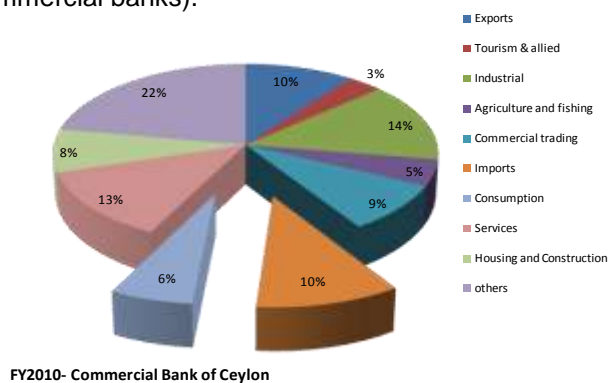
Total Gross Loans and Advances (mn)	31st Dec 2010	30th Sept 2011	9 months growth
COMB	228,149	267,955	17%
HNB	207,612	257,330	24%
SAMP	129,321	163,751	27%
NDB	72,323	94,722	31%



The demand for credit would come down due to increasing cost of borrowing with Interest payments on credit cards and loans are being more expensive. This would discourage people from borrowing, and people who already have loans will have less disposable income because they spend more on interest payments hurting the ability to save. On the other hand there would be increased incentive to save rather than spend. Higher

interest rates make it more attractive to save in a deposit account because of the interest gained. However, on overall the increased living expenses would dampen amount of savings flowing to the banking sector. This would result in banks to resort to borrowings as a source of funding, irrespective of borrowings being relatively expensive in a high interest rate regime. Driven by the above factors, interest margins are expected to decrease owing to both reduced interest income and increased funding expenses.

Rising interest rates would discourage consumption loans even though the need arises for consumption loans due to cost of living increases, instead they would forego current consumption to a certain level, which include purchasing consumer durable goods and automobile for domestic consumption. A situation like this would negatively impact banks with high concentrations of consumption loans. (Given commercial bank loan categorization below is one such example of weight given on Import and consumption loans by leading commercial banks).



Apart from the above the loans granted for importation would get massively curtailed due to both the hike in interest rates and devaluation of rupee, where the devaluation of rupee would increase the rupee expenditure. In bank loan books, importation loans are ranked at 3rd-4th largest category.

In terms of the leasing segment, we can expect a massive plunge. Firstly, the price escalation of automobiles after the rupee devaluation would lessen the demand for vehicles and the problem would further aggravate with high interest rates on lease/loans and the hike in fuel prices.

Interest rates have an effect on consumer and business confidence. A hike in interest rates discourages investments and this makes firms and consumers less willing to take out risky investments and purchases. For an instance borrowers at floating interest rates are currently at a massive disadvantage.

Operating expense base of banks would not experience a significant deviation, but the cost to income ratio would become unfavorable due to declining operating income. On a separate note it is important to emphasize that the administrative expenses are relatively high compared with the amount of business generated while operating in a restricted environment, where the credit expansion is limited to 18% to 23%. In the booming economy during 2011, banks were aggressively expanding their branch net work and its operational capacity, but going with the current limitation of credit, the capacity would be underutilized.

From government's point of view, the Government debt interest payments increases consequent to the interest rate hike. The government of Sri Lanka, based on 2010 figures pays over LKR352.6 bn a year on its own national debt. Higher interest rates increase the cost of government interest payments. This can lead to a possible hike in taxes in the future, where currently the banks are enjoying lower rates of 28% (previously 35%) benefiting the bottom line.

During FY 2011 number of leading commercial banks raised capital via rights issues and other means of funding as pre measures to reap benefits of possible future unprecedented demand. However with the unanticipated limit on credit, banks are left with high capital adequacy levels. For instance, *HNB* concluded its rights issue of LKR6 bn giving rise to a Core Capital Adequacy Ratio of 11.82% as at end September 2011, where the pre rights issue ratio was 10.99%.

Rising interest rates can also lead to increased default rates, as holders of adjustable rate debt find themselves faced with higher payments. So the quality of the loan book would come down whilst at the same time banks would be required to make high provisions to cover up possible loan losses.

Apart from the above, there can be a slight revival on financial institutions due to the fact that commercial banks are posed with a limit on credit expansion, and the excess demand would find its way in to the financial institutions, including *LB Finance*, *Central Finance* etc...

In conclusion the outlook of banks has not largely shaken by the recent economic changes, yet the phase of growth would curtail.

Impact on the Manufacturing Sector

The manufacturing sector mainly comprises of firms which mainly import raw materials for the production processes. Hence the devaluation of the Sri Lankan rupee will adversely affect these companies and the importers will now have to pay more rupees to obtain dollar quoted raw materials. Thus counters such as *Piramal Glass* (imports raw material soda ash to produce flaconnage glass), *Royal Ceramics*, *Lanka Walltile*, *Lanka Floortile* (these manufacturers import ball clay to produce bathware and tiles) and **Tokyo Cement** (imports raw material clinker to manufacture cement) will be negatively affected with the adverse exchange rate movement.

Since *Tokyo Cement* produces cement to meet the needs of the local market, exposure to exchange rate would limit the ability of the firm to pass on the risk to the consumer due to the fact that cement is a price regulated product. Nevertheless counters such as *Royal Ceramics* and *Chevron Lubricants* Lanka mainly focus on the domestic market with premium products hence have the ability to pass on the risk to the consumer via price hikes. Supporting this is the local glass monopoly *Piramal Glass* whom too can flip the burden to the consumer due to its high bargaining power.

Moving forward, the rupee devaluation and escalating crude oil prices compelled the government to raise the energy costs. As a result, the price of kerosene was raised by LKR35.00 to LKR111.00 per litre whilst the price of furnace oil (800 & 1500) was raised by LKR40.00 each to LKR92.20 and LKR90.00 per litre respectively. Also, a 15% fuel surcharge on electricity was placed for industrial customers.

The rise in oil prices will impact *Tokyo Cement* directly as oil price movements are treated as a good proxy for clinker prices, which is the primary raw material found in the production for cement. However historically, *Tokyo Cement* has been a solid example of cost management as its GP margins have been significantly less volatile than oil price movements. Further they're exposure to the oil shock is greatly reduced by the fact that they generate their own power to meet the entirety of their manufacturing requirements using renewable resources.

In addition *Chevron Lubricants* Lanka due to its dominant market position (65% market share) in the domestic lubricants will be maintaining its margins by transferring the cost increment via price hikes.

On the other hand, counters such as local glass giant *Piramal Glass* and companies in the tile sector *Royal Ceramics*, *Lanka Walltile* and *Lanka Floortile* will be badly hit, as 30% - 40% of their production costs comprise of energy related costs. Hence as highlighted above, accelerated fuel and electricity prices will negatively affect the gross profit margins, thus crippling the future bottom lines.

With regard to the interest rate risk, due to the fact that *Tokyo Cement* is currently deleveraging with a preference for funding new investments with retained earnings and equity issues which resulted in a decrease in interest expense by more than 50% in FY11. We expect this trend to continue as the company moves towards its optimal capital structure and hence its exposure to interest rate risk would be limited.

On the other hand we expect the impact on future finance cost for *Piramal Glass* to curb as its healthy operating cash flows have paid off most of its dollar loans. Nonetheless, short term debt to service working capital requirements may adversely be affected.

Over the past, tile sector counters *Royal Ceramics, Lanka Walltile and Lanka Floortile*, mainly financed their capacity expansions through debt finance. Hence escalating interest rates will certainly increase the finance cost, thereby pulling down the forward PBT and earnings.

On the contrary, *Chevron Lubricants Lanka* is virtually an ungeared company hence no adversities expect to be confronted, instead rise in finance income as most of the company's investments are in the form of fixed income securities.

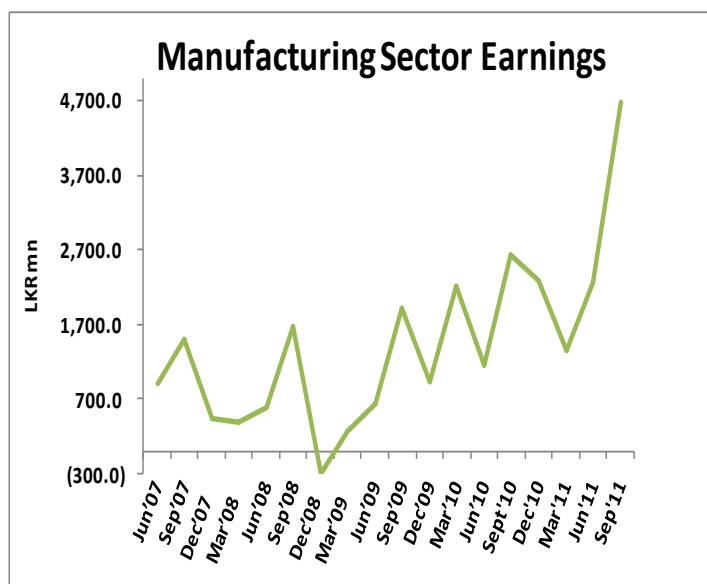
The following are the key ratios which will be affected negative affected via the macro-economic risks discussed earlier.

Counter (as at 31-12-2011)	Energy cost as a percentage on Production cost	Interest Cover (PBIT/ Fin. Exp)	Debt/ Equity Ratio	Debt Service Coverage Ratio (CFO/Total Debt+Fin Exp.)
<i>Royal Ceramics Lanka</i>	35%-40%	7.8	56.9%	35.5%
<i>Lanka Walltile</i>	35%-40%	5.6	77.2%	8.7%
<i>Lanka Floortile</i>	35%-40%	23.5	25.3%	31.6%
<i>Piramal Glass</i>	30%-35%	4.5	87.6%	26.4%
<i>Tokyo Cement</i>	30%-40%	3.4	53.9%	52.7%

All figure are in LKR 'mn

*Chevron is an ungeared company with nil interest bearing debt

*The above graph depicts the susceptibility for the adverse interest rate and energy cost movements for some of the core counters covered by Asia Wealth.



Overall as discussed earlier, rupee devaluation, increase in oil prices and rise in exchange rate expect to create a negative impact on the manufacturing counters which mainly import raw materials and which highly depend upon fuel and energy. Hence these adversities will trickle down towards low earnings in the manufacturing sector.

Impact on the Food & Beverages Sector

Food and beverages sector is one of the key sectors listed in the Colombo stock exchange. Thereby any negative movement in the said sector would invariably negatively impact on other related sectors such as manufacturing, banking & Finance, Hotels, Plantations etc.

Sri Lanka witnessed an upward move in its benchmark interest rates which was followed by increase in policy rates by the central bank. In the mean time Central Bank of Sri Lanka stopped intervening in the exchange rate, resulting in depreciating rupee value from its previous levels of LKR114.00 to current level of LKR119.00 as at 18.03.2012.

Crude oil contributes circa 22% to the country's import bill, thereby any change in crude oil prices in the world market have a major impact on country's trade balance and invariably on the BOP. Therefore it's very important to review the impact on Corporates by the rise in interest rates, devaluation of Rupee and increase in Fuel prices.

Devaluation of Rupee would directly impact on import dependent companies owing to inflating raw material prices. Companies such as *Bairaha Farms*, *Lion Brewery*, *Lanka Milk Foods*, *Nestle*, would be negatively affected, because those companies primarily source raw materials by importing from various countries. Although, the devaluation of rupee would make imports costlier, albeit we do not anticipate a sudden drop in consumption levels in the country.

Nevertheless the devaluation of currency would positively affect on the export oriented counters in the food and beverages sector such as *Ceylon tea Services*, *Convenience foods*, *Renuka Agri Foods*, *HVA Foods* etc. Since those companies generate earnings in dollar terms, those would benefit with improved rupee earnings.

Increase in interest rates would negatively affect on the food and beverages sector across the board. Since increase in rates would increase the cost of capital of the market, it would result to reduce the overall valuation of the sector. Nevertheless counters such as *Ceylon Tobacco Company* and *Nestle Lanka* would marginally be affected owing to minor level of borrowings in these companies. (CTC and NEST, both operate with zero long term interest bearing liabilities; however they possess some short term borrowings in order to finance their working capital requirements).

Substantial increase in fuel prices would impact on the cost structure of the Corporates across the board. Especially counters such as *Cargills*, *Ceylon cold Stores*, *Convenience Foods*, *Distilleries*, *Keells Food Products*, *Lion Brewery*, *Lanka Milk Foods* and *Nestle*, since distribution cost adds a substantial component in their cost structure. Thereby any increase in fuel prices would have more impact especially on those counters.

	Gearing	Interest Cover	Debt Service Coverage Ratio
Bairaha Farms	5.2%	44.5	160%
Cargills	3.8%	4.0	5%
Distilleries	2.1%	17.6	33%
Lion Brewery	31.3%	13.3	27%
Ceylon Cold Stores	3.8%	13.6	326%
Ceylon Tea Services	0.0%	11.3	741%

Impact on Hotels and Leisure Sector

Hotel and Tourism sector in Sri Lanka plays a pivotal role in the post war economic growth of the country. With tourist arrivals recording a high over 855,000, the hotel sector recorded an average occupancy rate of nearly 80% during the calendar year 2011, while contributing a circa of 2% to 3% for the country's gross domestic product. The recent macroeconomic changes such as rising policy rates, depreciation in rupee and hike in fuel prices will have both negative and positive implications for the sector.

Exchange rate depreciation

Foreigners make up the majority of patrons at Sri Lankan tourist hotels contributing nearly 70% of their room nights. Sri Lanka's dependence on this segment makes tourism sector highly vulnerable to changes in global as well as local macroeconomic conditions and events. However the devaluation of rupee will create a favorable impact towards the lodging revenue of the hotels since room rates will become cheaper in dollar terms. Nevertheless the rise in cost of imports will have a negative effect on the margins from food and beverage. Sri Lankan hotels which have invested in overseas such as Aitken Spence Hotels Holdings and John Keells Hotels which have hotels in Maldives will benefit since the dollar income when converted to rupee will generate higher revenue. However international tour operators such as Shangri La and Six Senses which are expecting to start operations in Sri Lanka will witness a reduction in their expatriated profits in dollar terms if the exchange rate depreciation continues.

Interest Rates

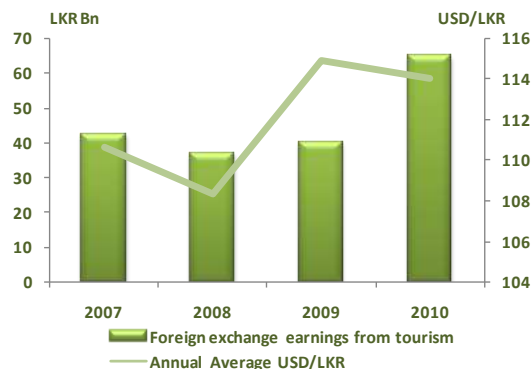
Rising interest rates and lending curtail of 18% by commercial banks will negatively affect future hotel construction projects. Counters which are planning to construct new hotels will incur a higher construction cost in future, given the projects are financed through debt. Further any refurbishment plans of hotels will also notice a setback.

Loans granted to tourism sector by licensed commercial banks have increased by 7% from 2010 to 2011. However their aggregate contribution to the tourism sector out of the entire loan portfolio is less than 3%. We could also witness a low gearing ratio of the Sri Lankan hotel operators (refer Chart). In the light of these circumstances there won't be a huge impact on the tourism sector from rising interest rates.

Rising Fuel Prices

Rising fuel prices affect both consumer and individual hotel operators. For the consumer the rising fuel prices will reduce disposable income and the ability to purchase travel products. As a transport intensive business, tourism is highly sensitive to changes in fuel prices. Due to hike in oil price Hotel operators will witness high operating and overhead costs which will affect the bottom line negatively. Furthermore long haul travelling can be abridged due to high cost of air travelling.

Comparison of Foreign exchange earnings from tourism and Exchange rate



Source - Tourist Development Authority

Gearing of Selected Hotel Sector Counters

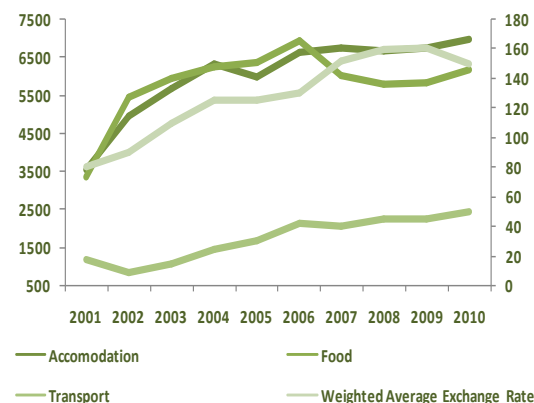


Source - Asia Wealth Management

	Gearing	Interest Cover	Debt Service Coverage Ratio
Asian Hotels and Properties	0.0%	114.7	2659%
Aitken Spence Hotels Holdings	27%	8.9	55%
John Keells Hotels	39%	3.2	10%
Hotel Sigiriya	0.4%	69.4	378%
TAJ Samudra	28.2%	5.3	15%
Eden	1%	22.6	136%

Source - Asia Wealth Management

Indexed tourist prices compared with weighted average exchange rate



Source - Tourist Development Authority

Impact on the Motor Sector

In addition, the devaluation of currency would more adversely impact on sectors like Motor Sector. Since their business model is highly dependent on imports, the sector is highly prone to adverse consequences arising with the devaluation of the rupee. Nevertheless the risk would be less for counters such as DIMO and United Motors, since those counters have diversified into other business segments. DIMO has business interests in other areas such as vehicle Parts & Services, Lighting & Power Tools, Electro Mechanical & Bio Medical Engineering etc. Meanwhile United Motors has diversified into other areas such as Repairs & Services, Leasing Activities and Lubricant etc. Nevertheless the industry operates with 3 to 6 months forward contracts; hence we do not expect an immediate rise in automobile prices in the short term basis.

Increase in interest rates would make borrowing more expensive for importing vehicles, especially on the backdrop of Central bank's directions to the banking system to limit the credit growth of the country to 18% for 2012. Automobile imports adds to circa 6% to the total imports bill of the country, thus any control for imports would negatively affect on growth prospects of the sector.

Rise in fuel prices in the country have adverse concern on the demand for automobile and that might have negative impact on the sector across the board. Especially the demand for passenger vehicles which are being catered for low end market would have major hit on the increase in fuel prices as well as increasing interest rates. Nevertheless we do not anticipate a major impact on up market brands such as Mercedes Benz, Chrysler, Jeep, and Mitsubishi Montero due to inelastic demand persist for luxury vehicles.

The said sector witnessed exponential growth in earnings after the slash in import taxes and duties.



Nevertheless with the current backdrop we do not anticipate the same upside growth going forward since, the devaluation of currency could adversely affect on cost structure of the companies in motor sector which would result in dipped earnings.

	Gearing	Interest Cover	Debt Service Coverage Ratio
DIMO	7.9%	41.6	-15%
United Motors	1.2%	156.1	237%
Colonial Motors	1.4%	32.7	30%

Research

Saminda Weerasinghe	(94-11)5320250 saminda@asiacapital.lk
Amali Perera	(94-11)5320256 amali@asiacapital.lk
Minoli Mallawaarachchi	(94-11)5320259
Nirmala Samarawickrama	(94-11)5320253
Dilan Wijekoon	(94-11)5320253
Thilina Ukwatta	(94-11)5320000
Shan Silva	(94-11)5320251
Yogini Yogarasa	(94-11)5320361
Dhanusha Pathirana	(94-11)5320254
Travis Gomez	(94-11)5320000
Nuwan Pradeep	(94-11)5320257



Asia Wealth Management Co.(Pvt) LTD.

**Level 21, West Tower,
World Trade Centre, Colombo – 1**

Tel Hotline : 94 11 5320000

**Email : research@asiacapital.lk
info@asiacapital.lk**

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