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Sri Lanka Market Strategy

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Executive Summary

>> The war is over. The immediate expressed priority of the GoSL now is the resettlement of the IDP's & re-integration of the North and East with the mainstream economy and laying the foundation for sustained economic growth through island wide upgrading of infrastructure. Whilst there seems to be delays in the resettlement drive over the initial ambitious plans due to de-mining and weeding out the remnants of the LTTE, the infrastructure drive is stepping up momentum with the government embarking on a wide ranging program including power generation, roadways, ports and airports, most with foreign funding commitments in place.

>> As outlined in our August 2009 Strategy, the base case requirements for the rebuilding of the two affected provinces equates to almost 4.4% GDP over the medium term. The reconstruction of the provinces and their integration with the mainstream economy has significant upside potential not only to the North and East but to the entire breadth of the country's economy. Whilst we prune down our CY09 GDP estimates to 3.8% from 4.3% due to the initial resettlement delays, this is seen as a temporary step down, and we maintain our medium term outlook at 8-10% GDP expansion.

>> Inflation and interest rates continue to fall. The CCPI on a point to point basis have come down to a record 0.7% in September. Interest rates to date have shed over 880 and 550 bps on the 364 day T-bill and the AWPLR respectively. There is further room for downward movement with the government banks reducing their lending rates to a band of 8-12%. Ex government banks, we see the sustainable level of 13-14% on the AWPLR in the medium term.

>> Currency has stabilized with the significant inflows to the system. Despite a projected widening of the trade deficit in CY10 on expanding import requirements, the BOP is likely to remain positive creating marginal pressure on the exchange rates, with competitiveness helped by falling inflation and borrowing costs.

>> The budget deficit is likely to expand given the reconstruction drive on hand. The government has launched a two pronged attack on the deficit with drive towards widening the tax net as well as waste expenditure management. For once, we do not mind a rising deficit, given that it's predominantly capex driven.

>> The All Share has seen a 102% increase over the year to date and a 62% rise from 18th May since the final battles with the LTTE. The rally accelerated in the month of September with the index surging by 17% but has essentially flatlined with the market reacting to fears of Raj Rajaratnam's positions being hastily wound down.

>> However the fundamentals over the medium to long term remain solid. We conservatively expect the benefits of peace and reconstruction to kick in from FY11 leading to an earnings growth of 12% for FY10 followed by 39% in FY11. Given expectations of sustained long term growth, the market trades at multiples of 14x FY10E and 10x FY11E earnings which we feel is well below fair value and presents a compelling case for the Colombo Bourse.

>> Despite outperforming the market by 128% we still believe our core portfolio holds value. We add NDB to our recommended holdings on account of its strong fundamentals.



Political Overview

>> The political developments are now centred around the legislative and presidential elections that are expected by the first quarter of 2010. Parliamentary elections will have to take place before April 2010 when the current term expires but expectations are that the Presidential elections will also be held during this period.

>> A new mandate for Mahinda Rajapakse as well as a new legislature will be important in fostering a sense of national renewal after the game changing defeat of the LTTE in May. The political capital gained by what are expected to be victories in both these elections will help to push a new agenda of regaining lost momentum for the country.

>> The recent round of Provincial Council elections provide an interesting foretaste in what we can expect in the next polling cycle. The extremist fringe parties of the JVP and JHU appear to have completely lost their electoral share with their message completely undermined and upstaged thanks to the end of the civil war. The minority Tamil and Muslim parties are bound to retain their share of the vote. Also despite the opposition UNP having suffered an overwhelming defeat much of the voting in the provincial election was off a low turnover of less than 50%. The reduction in the ruling party's share of the vote from 72% in the Uva Provincial Council in early August to a 68% share of the vote in the Southern Provincial Council in October would appear to indicate that a the necessary two thirds of votes cast in a national election to effect constitutional change is still a daunting task for any one party or coalition. Not achieving this mark would necessitate compromise between the two major parties in making constitutional changes which can only be to the long term benefit in revamping the current system.

Political Package to the Minorities

>> Devolution of power to the provinces will be key to reconciliation between the Tamil and Sinhala communities. Currently the only available constitutional instrument for this is the 13th Amendment which established the Provincial Councils. While this amendment has been in place for over 20 years, the civil war meant that it has hitherto never been implemented to its fullest extent.

>> President Rajapakse has indicated a firm willingness to implement a home grown political solution to the minorities and is likely to attempt to amend the current Constitution in his second term. Amending the Constitution requires an overwhelming two thirds majority in the Parliament and this means that any changes would need to be discussed after the current composition of Parliament has changed after a General Election.

>> Historically the political newsflow has been paramount in deciding the timing of entry and exit into the Sri Lankan market. We believe that going forward these considerations will matter less. Both the major parties essentially reached consensus on an essentially free market economic model for Sri Lanka in the early 1990s and the Rajapakse administration have already demonstrated that they are prioritizing the key requirements of security and provision of infrastructure.



Economic Overview

GDP Growth

>> The war is over. The expressed priority of the GoSL now is the resettlement of the IDP's & re-integration of the North and East with the mainstream economy and laying the foundation for sustained economic growth through island wide upgrading of infrastructure.

>> The population in the two provinces is estimated at 2.7m or 13.5% of the country's total population. Keeping in mind that a significant portion has family members overseas, the speed of personal recovery and rebuilding will be fast. The key will be the speed of the resettlement process. 5 months after the end of the war, it seems that the resettlement of the IDP's will take longer than the originally promised 6 months due to the extensive de-mining requirements and the necessity to ensure that remnants of the LTTE are weeded out from the IDP camps. However, the infrastructure drive is picking up steam with the government embarking on a wide ranging program including power generation, roadways, ports and airports, most with foreign funding commitments in place.

>> As outlined in our August 2009 Strategy, the base case requirements for the rebuilding of the two affected provinces equates to almost 4.4% GDP over the medium term. The reconstruction of the provinces and their integration with the mainstream economy has significant upside potential not only to the North and East but to the entire breadth of the country's economy.

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>> Both the Eastern and the Northern provinces are home to some of the country's most fertile agricultural and fishing grounds in addition to a bulk of the country's mineral deposits. The benefits of the clearing of the East is already in evidence, with the Sri Lankan economy growing 2.1% during 2nd quarter of CY09 during arguably one of the worst periods for the country, both internally and externally.

>> Intra province trade is likely to spike from the relatively low base, once the main A9 highway is fully open. Retail trade is already picking up with most consumer durable retailers moving into the two provinces.

>> Similarly, fixed line penetration in the North is estimated at just 1% with Mobile in the East at 20% as opposed to the ex-north-east penetration of 17% for fixed line and 58% for mobile, signifying strong upside potential for the telecommunications sector.

>> Banking penetration in the North and East of the country has significantly increased with most banks setting up new branches or adding to their existing branch networks in these areas within a few months of the end of the war. Potential for aggressive loan disbursement and sound deposit growth in these areas is already evident. Credit growth which was flat for much of the last 18 months have started to turn positive over the last month while NPL ratios in some banks that peaked in July have begun to decline on increased recoveries. We expect the sector to record asset growth of 3% for FY09 with a strong 4Q, accelerating to 12% - 15% in FY10.



>> Tourist arrivals have picked up by 25% from June 09 and current bookings point to an excellent winter 09/10 season. Given the wide array of attractions that the country offers, the potential to outshine the Cambodian tourism revival is very much on the cards especially given the close proximity to the vast Indian market.

>> We scale down our CY09 GDP estimates from 4.3% to 3.8% as the resettlement process now seems to be taking longer than anticipated. However, this will be temporary as the benefit of the resettlement will only be pushed into the following year with a resultant higher GDP expansion in CY10. We maintain our medium term outlook at 8-10% GDP growth, externalities notwithstanding.



INFRASTRUCTURE PROJECTS

Ongoing

Proposed

ROADS

Colombo - Matara Expressway - 128 km

Estimated cost US\$585m, funded 70% by the ADB & JBIC and 30% by the GoSL

Approx 50% completed. Scheduled for completion by 2011.

FLYOVERS

Target of 17 flyovers in Colombo & Suburbs

3 already completed.

Colombo - Kandy Expressway

Colombo - Katunayake Expressway - 25km

Estimated cost US\$235m, funded by the EXIM Bank of China and the GoSL

Expected to be completed in 2012.

Katunayake - Anuradhapura Highway

Estimated cost US\$40m, funded 80% by the Government of Korea and 20% by the GoSL

POWER PROJECTS

Kerawalapitiya Power Plant - 300MW Combined Cycle

Estimated cost US\$300m, funded 97% by West Coast Power Ltd and 3% by the GoSL

Part Commissioned

Upper Kotmale Hydro Power Plant - 150 MW Hydro

Estimated cost US\$332m, funded by JBIC

Expected to be completed in 2011

Norochcholai Coal Power Plant - First Stage 300MW

Estimated cost US\$450m, funded 97% by EXIM Bank of China and 3% by the GoSL

Expected to be completed in 2011

Coal Power Plant - Trincomalee - 500MW

Estimated cost US\$520m, funded jointly by the GoSL and India

Expected to be completed in 2012

SEA PORTS

Hambantota Port Development

Estimated cost US\$370m, funded 80% by EXIM Bank of China and 20% by the GoSL

Expected to be completed in 2011

Galle Port Development

Estimated cost US\$146m, funded 80% by JBIC and 20% by the GoSL

Oluveli Port Development

Estimated cost US\$53m, funded 80% by Denmark and 20% by the GoSL

Colombo Port Expansion

Estimated cost US\$750m, to be funded 38.5% each by ADB and selected Private Investors and by the GoSL

Construction of breakwater has commenced

OTHER

Moragahakande & Kalu Ganga Development

Estimated cost US\$425m, funded by the GoSL, JBIC and the Government of Kuwait

Jaffna Water Supply Scheme

Estimated cost US\$100m, funded by ADB (80%) and the GoSL

Expected to be completed in 2012



GDP Growth (%)										
Sector	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
Agriculture	-3.0	2.5	1.6	-0.9	1.9	4.7	3.3	7.5	7.7	8.9
Mining & Quarrying	0.7	3.0	5.6	7.9	14.1	8.0	19.2	12.8	5.0	6.0
Manufacturing	-4.0	1.1	4.2	5.1	6.0	5.3	2.4	4.9	3.3	4.6
Construction	2.5	1.0	5.5	6.6	8.9	8.0	9.0	7.8	8.5	15.0
Services	-0.6	6.0	7.9	7.6	6.8	8.7	7.6	5.3	2.0	8.8
GDP Growth	-1.4	4.0	6.0	5.3	6.0	7.4	6.8	6.0	3.8	8.6

Fiscal Deficit

>> The approved estimates for CY09 points to a revenue base of 16.4% GDP and a deficit of 6.5% with current expenditure budgeted at 15.8% GDP and capital investment at 7.1% GDP. The slowdown in the economy in the first half makes a targeted nominal revenue growth of 30% a stiff target. Revenue collections for the first seven months of the year in fact trail the previous year by approximately 3.3%, whilst current expenditure has grown 25%. In the past, shortfalls in revenue have been shored up at the expense of capital spending, which, the looming large scale reconstruction effort make difficult to prune down. Our revenue estimates stand at 14.9% GDP with the increased capital spending requirements pushing the deficit to 9.5% GDP in CY09.

>> The government's target of pruning down the deficit to 5% GDP by 2011 as spelt out in the MEFP attached to the LOI signed for the IMF Stand-by facility though admittedly steep, is nothing new, as the government has, repeatedly in the past attempted to stem the declining revenue trend. Practical implementation however is, and will be, a difficult proposition especially under current circumstances.

>> The current income tax regime is not benign by any stretch of the imagination. The challenge to the authorities will be in broadening its collection base so that the tax revenues mirror the economic growth of the country. The immediate growth is likely to come from the Construction, Tourism, Agricultural, Retail and Banking Sectors. Whilst the formal sectors will anyway contribute to revenue along existing tax collection routes, roping in the predominantly rural informal agricultural sector and the retail sectors will be a practical and political problem.

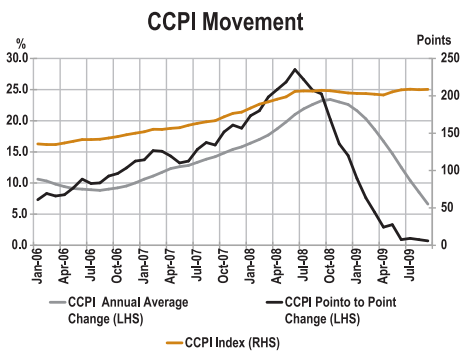
The running of a high deficit over the medium term however for once does not cause for alarm as a bulk will be through increased capital spending and the rebuilding of the war torn provinces, all of which will have significant economic paybacks in the medium term.

Government Finance										
(% of GDP)	2001	2002	2003	2004	2005	2006	2007	2008	2009E	
Revenue	16.7%	16.5%	15.2%	14.9%	15.5%	16.3%	15.8%	14.9%	14.9%	
Tax revenue	14.8%	14.0%	12.7%	13.5%	13.9%	14.6%	14.2%	13.3%	13.1%	
Non tax revenue	1.9%	2.5%	2.5%	1.4%	1.6%	1.7%	1.7%	1.6%	1.8%	
Total expenditure	27.5%	25.4%	22.9%	22.8%	23.8%	24.3%	23.5%	22.7%	24.4%	
Current expenditure	21.6%	20.9%	18.4%	18.6%	18.1%	18.6%	17.4%	17.0%	17.3%	
Current account deficit	-4.9%	-4.4%	-3.2%	-3.7%	-2.6%	-2.4%	-1.6%	-2.2%	-2.4%	
Budget deficit	-10.8%	-8.9%	-7.7%	-7.9%	-8.4%	-8.0%	-7.8%	-7.7%	-9.5%	



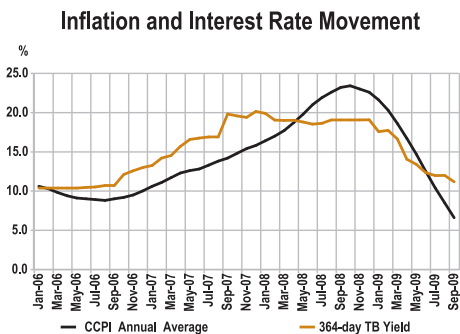
>> However, it should be appreciated that despite the conflict, the government has been successful in curtailing recurrent expenditure. With the end of the conflict, current expenditure curtailment should be a much more feasible way of attempting the 5% deficit hurdle. The government is likely to defer the 2010 budget scheduled for November this year, having instead a Vote on Accounts, which is valid for a period of 4 months. With either presidential or general elections likely early next year, this may be a political gambit before putting in tough and perhaps unpopular measures in place post elections.

>> The running of a high deficit over the medium term however for once does not cause for alarm as a bulk will be through increased capital spending and the rebuilding of the war torn provinces, all which will have significant economic paybacks in the medium term. The postponing of the budget does seem to suggest that the government cognizant of the necessity of capex, may be looking towards current expenditure management.



Inflation

>> Whilst the CCPI has picked up marginally in September the high base of 2008 and the flat movement thereon continue to keep inflation at low levels, with a 0.7% point to point movement in September, despite a hike in administered prices of petrol along with LPG in the 3Q of the year.

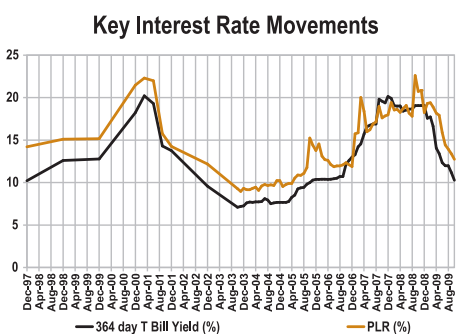


>> The opening up of the eastern province has increased crop, suppressing food prices and this should extend further with the additional output of the Northern province along with the revival of the fisheries industry through CY10. Price levels are likely to remain soft in CY09 with a possibility of a moderate climb off the low base in CY10 when economic activity steps up. The unknown which can alter the soft trend will be global commodity prices, including crude oil.

>> We further reduce our inflation target for CY09 from 6% to 5%.

Interest Rates

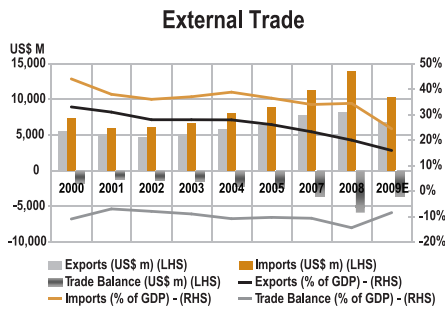
>> Despite an emerging high deficit outlook, rates have maintained their descent with the government capitalizing on the post war improved sovereign ratings and soft global rates to raise foreign debt. The 364 day T Bill and the PLR have shed over 880bps and 550 bps respectively YTD.



>> With the government continuing to harness foreign capital we see a further 100-150 bps reduction in rates in CY09 before a pick up in corporate borrowings and price levels kick in. Given the emerging rebuilding requirements, the high deficit outlook will also require sustained public borrowing which is likely to see rates reverse the trend in CY10 to a more sustainable level of approximately 13% on the 364 day T-bill and 14% on the PLR.

Exports

>> Exports continue to feel the global pinch, contracting by 18.3% for the first 7 months of CY09, with proportionate declines in both Agricultural and Industrial



export revenues. Textile exports have slid by a smaller 6.8% for the period with price advantages diverting volumes to Sri Lanka, despite the global slow down. Tea output is expected to recover towards the final quarter of the year. We downgrade our estimates marginally for CY09 to a decline of 17.5%, from our earlier estimates of a 16% yoy drop.

>> Tea should fully recover in CY10 from the weather and trade union issues of CY09. In addition, initial indications point to a marginal recovery in Industrial export demand through 4QCY09. Off the depressed base of CY09, we expect exports to recover by 17.5% in CY10, but yet remain under CY08 on absolute booked revenues.

Imports

>> Imports have fallen 35.3% for the first seven months of the year, led by a 49% drop in petroleum imports. Similarly, restrictions and higher duties on selected categories of consumer goods including motor vehicles and electrical goods have resulted in a 32% drop in Consumer good imports for the period. The significant easing of inflationary pressure coming on top of the envisaged demand for capital goods created by the pipeline of infrastructure projects and post war rebuilding efforts point to a sharper rise in imports in CY10. We up our estimate for the import bill for CY10 from US \$12,102b to \$12,172m.

Summary of External Trade

In US\$ Mn.

	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
Agricultural Exports	932	939	965	1,065	1,153	1,299	1,507	1,854	1,520	1,860
Industrial Exports	3,710	3,630	3,977	4,506	4,948	5,381	5,966	6,159	5,134	5,803
Mineral Exports	90	90	84	120	144	137	128	122	60	85
Other	88	41	108	66	102	70	38	-	-	-
Total Exports	4,820	4,700	5,134	5,757	6,347	6,887	7,639	8,135	6,714	7,748
Consumer Good Imports	1,236	1,318	1,480	1,623	1,644	1,981	2,002	2,549	1,742	2,020
Intermediate Good Imports	3,321	3,492	3,812	4,645	5,317	5,965	6,515	8,338	5,744	6,562
Investment Good Imports	1,081	1,164	1,320	1,670	1,869	2,246	2,684	2,976	2,725	3,500
Other	337	125	60	61	3	3	65	100	80	90
Total Imports	5,975	6,099	6,672	7,999	8,863	10,257	11,301	14,002	10,291	12,172
Trade Balance	(1,155)	(1,399)	(1,538)	(2,242)	(2,516)	(3,370)	(3,662)	(5,867)	(3,577)	(4,425)

Trade Deficit

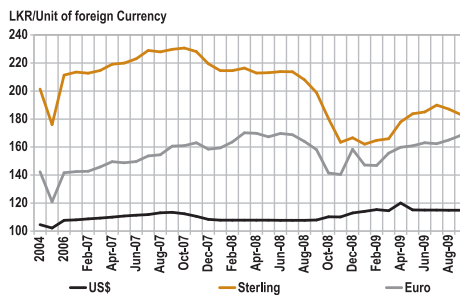
>> The trade deficit has contracted by 57% to July CY09. With imports likely to be under our original estimates for CY09, we revise our estimates for CY09 to a deficit of 3,557m or 9% GDP from our earlier estimate of 3,772m. With imports likely to pick up on the reconstruction and infrastructure drive, the deficit is likely to expand by 18% in CY10.



External Reserves

>> Despite the external turmoil, net remittances have grown 6.5% during the first seven months of the year to US\$ 1,884m, approximately 21% over the trade deficit for the same period. Aid and inflows to government securities have spiked and along with the initial disbursements of the IMF standby facility, are estimated to have raised official reserves to over US\$ 4b by September 09. Excluding the IMF drawdown, reserves are likely to come in at approximately 4.1 months of imports for CY09. With the upgrading of the country rating to B+ by Fitch, the access to foreign capital is likely to be easier and cheaper in the medium term.

Exchange Rate Movement



Exchange Rate

>> With the influx of foreign capital, the Central Bank has been absorbing excess foreign exchange, preventing a sharp appreciation of the currency. The LKR has depreciated by a marginal 1.5% YTD against the greenback whilst depreciating by a faster 6% and 12.6% against the Euro and Sterling respectively.

>> The IMF posture favours reserve build up as opposed to currency devaluation. With the potential for increased inflows over the short and medium term, the outlook for the currency now looks stable.

ECONOMIC INDICATORS

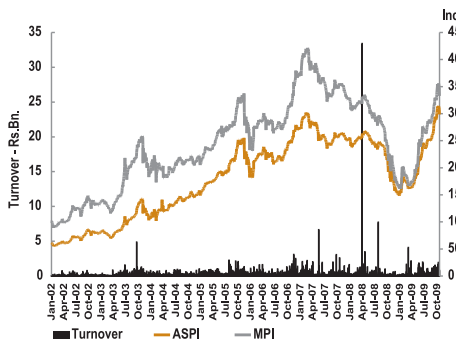
	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
GDP										
GDP at current market prices	1,410	1,582	1,822	2,091	2,453	2,938	3,579	4,411	4,825	5,713
Per Capita GDP at current prices (US\$)	841	870	983	1,062	1,241	1,421	1,663	2,014	2,066	2,346
GDP Growth (%)	(1.4)	4.0	6.0	5.4	6.0	7.4	6.8	6.0	3.8	8.6
Population										
Mid year Population (m)	18.7	19.0	19.2	19.4	19.6	19.8	20.0	20.2	20.4	20.6
Government Finance (% of GDP)										
Revenue	16.7	16.5	15.2	14.9	15.5	16.3	15.8	14.9	14.9	-
Expenditure	27.5	25.4	22.9	22.8	23.8	24.3	23.5	22.7	24.4	-
Current Account Deficit	(4.9)	(4.4)	(3.2)	(3.7)	(2.6)	(2.4)	(1.6)	(2.2)	(2.4)	-
Budget Deficit	(10.8)	(8.9)	(7.7)	(7.9)	(8.4)	(8.0)	(7.7)	(7.7)	(9.5)	-
Interest Rates & Inflation (%)										
AWDR (Year end)	10.8	8.0	5.3	5.3	6.2	7.6	10.3	11.6	7.0	8.0
AWPR	14.3	12.2	9.3	10.2	12.2	15.2	18.0	18.5	12.7	14.0
CCPI (Annual average)	14.2	9.5	6.3	7.6	11.6	13.7	17.5	22.6	5.0	8.0
External Trade (US \$ m)										
Exports	4,820	4,699	5,133	5,757	6,347	6,887	7,740	8,135	6,714	7,748
Imports	5,980	6,106	6,672	7,999	8,863	10,257	1,300	14,002	10,291	12,172
Trade Balance	(1,160)	1,407	1,539	2,242	2,515	3,370	(3,560)	(5,867)	(3,577)	(4,425)
External Reserves										
(months of imports)	2.7	3.3	4.2	3.3	3.7	3.3	3.7	2.2	4.3*	5*
Year-end Exchange Rate (LKR/\$)	93.2	96.7	96.7	104.6	102.1	107.7	108.7	113.1	115.5	118.3

* Excluding IMF Stand-By Facility Draw down

Market Overview and Strategy

>> The All Share has seen a dramatic 102% increase over the year to date and 62% rise from the 18th of May since the final battles with the LTTE. The rally accelerated in the month of September with the index surging by about 17%, partly thanks to a reduction in interest rates. The month of October has seen the indices essentially flatline with the market reacting to news of Sri Lankan hedge fund manager Raj Rajaratnam's arrest with fears of his large positions in Sri Lanka being wound down in haste.

ASPI / MPI vs. Turnover



>> The improved turnovers have also continued with the daily average for the month of September coming to Rs.952m as compared to the postwar (after May 17th) average of Rs.748m which in turn is considerably higher than the January to May average of Rs.355m showing the potential of domestic participation has to boost activity.

Corporate Earnings

>> The political and consequent economic uncertainty meant that historically equity valuations have consistently lagged earnings growth. Earnings multiples over most of this period rarely went above the 11-14x range. Over the last decade non-telco corporate earnings as measured in our JKSB coverage have grown at 16% while the All Share has grown at a CAGR of no more 12% over the same period.

>> Sri Lanka's stock market capitalization accounts only for roughly around 25% of GDP and while important sectors of the economy remain unrepresented (most notably the garments sector) we feel that this signifies ample potential for long term expansion.

>> Potential IPO activity is likely to pick up in the next 12 to 18 months with the mandatory requirement for insurance and finance companies to list. Higher market valuations could also tempt further listings from corporates who have been holding back for the last five years.

>> The market is still trading at 14x FY10E and 10x FY11E earnings which we feel is well below fair value for this market considering future economic prospects.



Sectoral earnings prospects

Sector	Price/Book Value (x)	ROE (%)	PER (x)				EPS Growth (%)			
			FY08	FY09	FY10E	FY11E	FY08	FY09	FY10E	FY11E
Banking & Finance	1.31	12.49	9.5	10.5	9.1	7.9	30.08	-9.46	15.17	15.42
Food & Beverage	2.84	26.39	11.8	10.8	9.0	7.7	22.90	9.84	19.38	17.14
Engineering	2.69	32.21	12.8	8.3	7.1	6.3	239.29	53.00	17.65	13.45
Conglomerates	1.65	9.59	16.2	17.2	15.9	11.5	27.83	-5.65	8.25	38.29
Leisure	1.55	6.11	21.6	25.3	24.5	11.4	45.71	-14.46	3.04	114.63
Manufacturing	1.62	12.47	9.9	13.0	8.5	6.4	-7.96	-23.40	53.14	32.75
Telecommunications	1.55	4.23	9.5	36.7	162.9	17.9	-6.10	-74.15	-77.49	808.71
Energy	1.16	-15.67	3.9	-7.4	23.0	20.4	441.30	-152.89	-132.32	12.50
Plantations	1.08	8.90	3.4	7.6	10.1	7.6	76.86	-54.72	-25.38	33.11
Trading	1.47	5.60	11.7	26.2	17.7	14.9	-24.49	-55.31	48.07	18.37
Market	1.60	10.41	10.81	15.34	13.67	9.83	22.66	(29.51)	12.19	39.13

>> The JKSB coverage universe comes to 67% of the total market capitalization of the Colombo Stock Exchange. The largest weighting comes from Banking and Telecom sectors. The Banking and Finance sector which comes to 25.3% of our coverage universe is expected to essentially show a rebound in FY10E from an expected hit in FY09. FY09 profitability was hit mainly due to marginally negative asset growth as well as rising provision expense in a volatile year. FY10E earnings for this sector will only be 4.3% higher in FY10E than they were in FY08 levels.

>> The Telcos come to 15% of the total market cap and have been the millstone around earnings performance over the last few years essentially due to the losses made by Dialog. Lower tariffs in FY09 did not result in the expected pickup in demand. We expect Dialog to return to profitability in FY11E but the sector's earnings will only be a little more than half what they were in FY08.

>> We expect the Diversified sector to have a three year earnings CAGR of 12.2% upto FY11. FY10 earnings are expected to be 2% higher than level attained in FY08. The FY11 outlook however is strong for players with exposure to the Leisure sector, including JKH and Aitken Spence.

>> We expect the best three year earnings CAGR of 23.6% for the hotels sector. Correspondingly we also expect the highest valuations in our coverage for this sector as well.



Comparison to regional valuations

Country	PER (x)				EPS Growth (%)		
	FY09	FY10E	FY11E	FY09-FY11E CAGR	FY10E	FY11E	PBV (x)
China	34.5	22.8	18.6	9.3	51.6	22.2	3.9
Hong Kong	22.7	17.1	14.6	6.9	32.8	17.1	2.0
India	19.5	19.1	15.7	6.3	1.9	21.6	3.4
Indonesia	30.9	15.4	13.2	31.4	100.6	16.7	2.6
South Korea	32.4	14.9	10.9	46.8	117.7	36.9	1.2
Malaysia	23.3	16.9	14.8	10.8	37.7	14.3	2.0
Phillipines	15.1	13.7	12.1	10.3	10.7	12.7	2.0
Singapore	20.8	17.3	14.9	1.1	20.1	16.3	1.6
Taiwan	122.9	24.1	16.2	77.1	409.3	49.3	1.7
Sri Lanka	15.3	13.7	9.8	15.4	12.2	39.1	1.5
Australia	83.4	17.1	14.7	37.7	388.0	16.4	1.8
New Zealand	42.1	14.9	12.8	48.7	182.6	16.4	1.3

Source : Bloomberg & JKSB Research

Colombo trades at 13.7 FY10E earnings, which by itself is substantially attractive when compared to the regional Asian markets. The FY11E multiple is the cheapest of the markets surveyed.

Model portfolio

Companies	Recommended Price	Current Price	Performance	PER (x)			EPS Growth		
				FY09	FY10E	FY11E	FY09	FY10E	FY11E
Aitken Spence Hotel Holdings PLC	160	235	46.9%	15.63	13.41	9.71	16.06	16.55	38.16
Asian Hotels & Properties PLC	56.75	75	32.2%	31.27	22.29	9.33	(37.33)	40.29	138.85
Commercial Bank of Ceylon PLC	145	180	24.1%	10.11	8.52	6.82	7.73	18.60	24.97
Sampath Bank PLC	125	185	48.0%	8.53	7.46	6.35	30.56	14.35	17.44
Tokyo Cement Company PLC	154.75	220	42.2%	17.12	10.13	5.39	(37.36)	69.04	87.88
Cumulative performance			38.7%						
NDB Bank PLC	-	184	-	9.39	7.81	6.78	26.17	20.18	15.13

Despite picking up by 38.7% from our last update in August as against an index growth of 17%, we maintain our key portfolio composition, with its focus on the key growth sectors including Construction, Tourism and Banking. We add NDB to the portfolio on account of superior asset quality, strong inherent competency in project finance, a low cost to income ratio and high capital adequacy making it more likely to attract M & A activity.



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