JK Capital Management Ltd.

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Sri Lanka: Who shall come and saveth?

Months following the political and economic fallout in May, the people of Sri Lanka still struggle with the daily challenges of inflation on a day-by-day basis. With recent official data showing food prices rising by 84.6% YoY, the South Asian nation of 22 million continues to be unable to afford key imports – including fuel, fertilizer and medicine. Recall that Sri Lanka became the first Asia-Pacific nation in more than two decades to default on its public bonds, totaling around USD 80.6 billion. Although the political instability has somewhat been alleviated with the appointment of the new President Ranil Wickremesinghe, the government now needs to make progress in debt relief talks with its creditors which include private bondholders as well as countries such as China, Japan and India.

These proceedings finally kicked off last week as the government conducted debt negotiations with its bilateral and private creditors, saying it aims to make enough progress in the talks to unlock a $2.9 billion IMF loan ideally by the end of this year. During the presentation to creditors, the nation's finance ministry and central bank hoped to receive final approval by the IMF in mid-December, and subsequently aim to complete a restructuring agreement with its other creditors by the second quarter of next year.

However, investors' reaction to the call were largely skeptical as they believed the plan had an ambitious timeline. One hurdle the finance ministry will need to overcome is litigation-related risks which could delay the restructuring process for the USD bonds and create uncertainty should a material number of bondholders push back. Sri Lankan authorities have urged creditors to form an ad hoc group in order to streamline the negotiations. They argued that this would "increase trust and build and environment for constructive discussions."

Another question that has yet to be addressed is the stance of its bilateral creditors which hold about USD 13.8bn in debt, including major sovereign funds such as those of China, Japan and India. Negotiations with the sovereign investors are expected to require a degree of co-operation between China and India, both of which compete fiercely for geopolitical influence over the island. One thing to monitor closely are the actions to be taken by China, as the country has been a significant lender to developing nations in recent years. For instance, in July, Beijing agreed to provide debt relief to Zambia while Chinese lenders also signed a $1.4 billion restructuring deal with Ecuador last week. These could potentially be an important case studies for Sri Lanka, although the presence of many other parties including the IMF, India and Japan will no doubt complicate the negotiations.

Sri Lankan USD bonds which were at one point one of the largest Asian high yield index constituents were removed from indices last June. We maintain a small exposure at the short end of the curve on the view that current valuations are already pricing a highly anticipated haircut and debt rescheduling. We see limited downside from these levels.