Sri Lanka - A Safe Harbour?

We visited Sri Lanka during September and left the island with a largely upbeat mood. The country has a long established stock market, is peaceful after a protracted civil war and enjoys a new government that is keen to mend the mistakes of the previous one.

One year ago, the political outlook was much much worse. Mahinda Rajapaksa was displaying every hallmark of a strongman there to stay. Term limits abolished – Tick. Muzzling of free press – Tick. Installation of close family across the levers of power – Tick. Independence of judiciary hindered – Tick. Promulgation of chauvinistic nationalist identity at expense of minorities - Tick. This man was on the same well-trodden path that Erdogan and Putin are on elsewhere in the EM universe. But a seemingly routine snap Presidential election in January caused the wheels of his regime to fall off.

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Maithripala Sirisena, a recent defector from Rajapaksa's party, won it in a massive upset by uniting the vote of beleaguered Tamils in the North, intimidated Muslims and generally sensible people from the Sinhalese majority who were worried about where the family were taking the country. This result was as unlikely as Putin losing an election in Russia. That it could stand is testament to the strength of institutions in Sri Lanka.

Promptly announcing a retrospective tax of 25% on last year's profits for the country's largest companies wasn't exactly what investors were hoping for from the new president but wrestling power away from the previous cabal was a job only half done until parliamentary elections in August. Some populism was to be expected.

Rajapaska's alliance still won 95 of parliament's 225 seats but it wasn't enough to prevent the United National Front for Good Governance to prevail with 106 seats. The Prime Minister Ranil Wickremesinghe leads the largest party in the government – The UNP. Happily for business this a centre-right group so will be able to keep the (socialist) President on the straight and narrow. This is lucky because there is much to be done.

On the foreign policy front, bridges are being mended with India after a generally icy relationship when the Rajapaskas were exclusively courting China for investment. Allowing Chinese submarines and warships to dock didn't go down well in Delhi. Though by no means a pariah, alleged war crimes towards the end of the civil war by both sides and a reluctance to investigate them properly did not help the country's international standing. A truth and reconciliation commission in the style of South Africa's will help the country come to terms with its violent near history. A cycle of score settling such as we have seen in Thailand and Bangladesh should be avoided. To his credit, Mr Wickremesinghe has stated he wants an end to 'divisive politics'. Plans to devolve more power to the regions away from the centre will help empower the impoverished Tamil North of the Island.

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The country's finances need urgent reform. Tax as a percentage of GDP has declined from a historical average of 20% to 12%. A hugely complicated tax code riddled with exemptions has not helped. An unhealthy side effect of this can be seen in the stock market where conglomerates have been encouraged to list many of their subsidiaries. The result is a lot of zombie listings with zero liquidity. Though regressive, VAT is likely to be introduced in the upcoming budget as one of the simplest ways to gather more revenue. As a country with little mineral or energy wealth, the drop in commodity prices has helped. Extra revenue is important for the country –

education spending accounts for just 6% of the budget whilst wages, benefits and interest payments stand at 60% US$5-7b of assorted FDI announcements from a number of governments, international development institutions and corporates including Volkswagen will help the country in the short to medium term.

This aside, the country is still expected to enjoy 6.4% GDP growth in 2015. The peace dividend probably has further to go with an underdeveloped North East. The tourism industry has huge potential (Sri Lanka regularly features in top destination lists post war) from East and West alike and can benefit from some easy improvements like visa on arrival. The textiles and garmenting business will continue to grow as the industry continues to decamp from China and supply chain clustering occurs. The country benefits from an English speaking heritage which makes the development of a BPO business possible. Though dominated by two large state owned banks, the private banking sector is sensibly run and has a bright future financing the infrastructure demands of the country.

The stock market is very reasonably priced and many stocks offer growth and respectable dividends. The main problem with investing in the market is the lack of liquidity. Unappealingly diversified conglomerates own big chunks of the market and promoter groups own large chunks of the conglomerates. Investors are unwilling to sell shares at low valuations and yet valuations will remain low until foreign investors can see enough liquidity to invest in the market. Progress is beginning to be made. Fund investment Hemas Holdings has benefitted from a dramatic rerating as it has slimmed down its operations to concentrate on the FMCG and healthcare, brought on professional management and improved liquidity by diluting the founding family's stake. An early expansion into Bangladesh is reaping dividends. Indeed, we think many more Sri Lankan companies might enjoy considerable success in their massive neighbour which has been strangely overlooked by many Indian companies.

Residents of Colombo, the capital of Sri Lanka, are some of the most prosperous in South East Asia. However, plans to devolve more power to other regions will help empower the impoverished Tamil North of the Island.