



Fitch Affirms Sri Lanka at 'B+'; Outlook Revised to Stable

Fitch Ratings-Hong Kong-09 February 2017: Fitch Ratings has affirmed Sri Lanka's Long-Term Foreign- and Local Currency Issuer Default Ratings (IDR) at 'B+' and revised the Outlook to Stable from Negative. The Country Ceiling and issue ratings on Sri Lanka's senior unsecured foreign- and local-currency bonds are also affirmed at 'B+'. The Short-Term Foreign- and Local-Currency IDRs are affirmed at 'B'.

KEY RATING DRIVERS

Sri Lanka's 'B+' rating balances its weak public finances and strained external liquidity position compared with peers against the steady progress made on the country's ongoing International Monetary Fund (IMF) supported programme, which commenced in June 2016. The IMF programme has eased near-term pressure on the balance of payments. The rating is supported by Sri Lanka's favourable growth performance as well as its basic human development indicators and governance standards, which are more favourable as compared with some peers.

The Outlook revision reflects the following key rating drivers:

Improving Fiscal Finances: Fitch estimates that Sri Lanka's 2016 fiscal performance was better than in 2015, following strong revenue growth that was supported by a value-added tax (VAT) hike. This, along with lower government spending, should narrow the deficit in 2016 to around -5.6% of GDP, from -7.4% in 2015. Fitch believes the 2016 VAT hike to 15% from 11% and other revenue reforms announced in the 2017 budget are likely to support further fiscal deficit reductions in 2017, with the agency revising down its 2017 deficit forecast to -4.7% of GDP against its earlier estimate of close to -7%. The authorities' 2017 deficit estimate of -4.6% is below the agency's estimate, as the authorities have higher growth assumptions. However, Fitch expects authorities to lower spending if there is a large revenue shortfall to keep the fiscal deficit under control.

Improved Policy Coherence and Credibility: Sri Lanka's three-year extended fund facility with the IMF has improved policy coherence and credibility and has eased some near-term balance of payments pressure. Fitch expects the country's external funding profile to benefit from support by multilateral agencies, although its external liquidity position remains weak compared with peers. The IMF-supported programme sets ambitious fiscal targets and the authorities have made steady progress, meeting their quantitative performance targets for the first review in November 2016. Progress on some structural benchmarks has also been made, including passage of the 2017 budget in line with programme targets.

Stable Growth Trends: Sri Lanka's growth performance remains favourable. Fitch estimates the country's five-year (2012-2016) average real GDP growth at 5.3%, which is stronger than some of its 'B' category peers. However, Fitch has revised its 2016 growth estimate to around 4.5%, from 5.3% (forecast at the time of the last review) due to weaker-than-expected 1H16 growth caused by the May 2016 floods. Furthermore, the Central Bank of Sri Lanka hiked-up interest rates twice in 2016 by a cumulative 100bp, slowing credit growth and private consumption, although this has also improved macro stability.

Sri Lanka's 'B+' IDRs reflect the following key rating drivers:

Relatively High Government Debt: Fitch estimates overall gross general government debt to have reached close to 77% of GDP by end-2016, although it should gradually decline over 2017-2018 due to improving government revenues. At this level, government debt remains above the 56% 'B' median and 51% 'BB' median. Further, foreign-currency debt - which is close to 40% of GDP - weakens Sri Lanka's fiscal finances, as it increases the risk of higher debt in local currency terms if the rupee depreciates sharply.

Weak External Liquidity Position: Sri Lanka's external liquidity position is weakened by low foreign-exchange reserves and high external debt service payments. Measured by Fitch's external liquidity metric, this ratio is far below the 'B' and 'BB' median. As per the agency's estimate, the external liquidity ratio was close to 58% at end-2016, against around 163% for the 'B' median and 155% for the 'BB' median. Furthermore, Sri Lanka's external finances are vulnerable to a sell-off in treasury bills and bonds by foreign investors, which currently account for nearly 30% of foreign-exchange reserves. Outflows from treasury bills and bonds in October and November 2016 led to a fall in foreign-exchange reserves, although the reserves improved by around USD419m from end-November 2016 to around USD6bn by end-2016.

Strong Human Development Indicators: Sri Lanka's basic human development, including education, health and literacy standards, is high compared with the 'B' and 'BB' median, as indicated by a favourable United Nations Human Development Index score. The country also ranks better than the 'B' median on the World Bank's composite governance indicator score - falling in the 48th percentile against the 31st percentile of the 'B' median.

SOVEREIGN RATING MODEL and QUALITATIVE OVERLAY

Fitch's proprietary sovereign rating model (SRM) assigns Sri Lanka a score equivalent to a rating of 'BB-' on the Long-term Foreign-Currency IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR by applying its qualitative overlay (QO), relative to rated peers, as follows:

- Public Finances: -1 notch to reflect Sri Lanka's weak fiscal position on account of high government debt and interest payments as a share of government revenue.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign-Currency IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The Stable Outlook reflects Fitch's assessment that upside and downside risks to the rating are balanced.

The main factors that, individually or collectively, could trigger positive rating action are:

- Continued improvement in public finances underpinned by a credible medium-term fiscal strategy, including a broadening of the government revenue base.
- Increase in foreign-exchange reserves supported by smaller current-account deficits and higher non-debt capital inflows.

The main factors that, individually or collectively, could trigger negative rating action are:

- Deterioration in policy coherence and credibility, leading to a loss of investor confidence, or a derailment of the International Monetary Fund supported programme that leads to external funding stress.
- Reversal of fiscal improvements that leads to a failure to stabilise government debt ratios.

KEY ASSUMPTIONS

Global economic assumptions are consistent with Fitch's latest global economic outlook.

Contact:

Primary Analyst
Sagarika Chandra
Associate Director
+852 2263 9921

Fitch (Hong Kong) Limited
19/F Man Yee Building
68 Des Voeux Road Central
Hong Kong

Secondary Analyst
Thomas Rookmaaker
Director
+852 2263 9891

Committee Chairperson
James McCormack
Managing Director
+44 20 3530 1286

Media Relations: Wai-Lun Wan, Hong Kong, Tel: +852 2263 9935, Email:
wailun.wan@fitchratings.com.

Central Bank of Sri Lanka has a 10% equity stake in Fitch Ratings Lanka Ltd. No shareholder other than Fitch, Inc. is involved in the day-to-day rating operations of, or credit reviews undertaken by, Fitch Ratings Lanka Ltd.

Additional information is available on www.fitchratings.com

Applicable Criteria
Country Ceilings (pub. 16 Aug 2016)
Sovereign Rating Criteria (pub. 18 Jul 2016)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer

and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001