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Sri Lanka Steps into International Capital Markets

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Since independence, the Sri Lankan government has invested heavily to develop the socio-economic infrastructure in the country. Being a developing country with its savings not sufficient to meet the development aspirations of the country, the government had to seek foreign financial assistance to finance such investments. During the first four decades, foreign financial assistance was in fact available in the form of multilateral and bilateral concessional loans. However, with the development of the country towards middle income emerging market status, the availability of such concessional financing has been shrinking gradually requiring the country to look for alternate sources of external financing to finance the public investment programme.

Accordingly, while implementing measures to attract foreign direct investment, a source of non-debt creating finance, the government decided to reap the benefits of the international capital market. Unlike the funds received through multilateral and bilateral sources, the receipts and use of which are subject to certain conditionalities, the government has the complete freedom in the use of funds raised in the international capital market. However, the government is disciplined by the dictates of the market forces and the terms of the funds raised in the capital market reflect the perception of the investors on the strength of the economy, particularly in honouring its obligations.

The Sri Lankan government's first step into the international capital market was in 1997 by issuing a Floating Rate Note of US dollars 50 million. Although it had a good response from the international investors, for nearly a decade the country could not raise funds through a similar issue in the international capital market at a reasonable price due to the aggravation of the internal conflict and weak macroeconomic environment that prevailed in the country. In this backdrop several attempts were made to mobilise funds from international market through loan arrangements. These include three "Syndicate Loans" during 2000-2005 and a "Club Loan" in 2008. Since the funds mobilised through the international loan market are relatively short term and the investors' appetite for the size of the issue is also small for a country like Sri Lanka, such funding arrangements would not match with the long term funding requirement of the capital investment as well as key objectives of the prudent public debt management, i.e., extending maturity structure and yield curve, improving liquidity and broadening the investor base.

In this context, the government of Sri Lanka decided to enter into the international capital market by issuing sovereign bonds and commenced preparatory work for the issue in early 2000's. Accordingly, two international rating agencies, namely, Fitch Rating and Standard and Poors' (S & P) were appointed in 2005 to obtain sovereign ratings for the country by each of them. In addition, a sovereign rating advisor was also appointed to advice on sovereign rating upgrades and to develop a strategy to enter into the international capital market. In line with these arrangements, necessary steps were taken to improve the macroeconomic environment of the country. With the completion of the preparatory work, the government was ready to issue its debut international sovereign bond in 2007.

First Sovereign Bond Issue - 2007

The Central Bank, which has been entrusted with the responsibility of managing the public debt as an agent of the government, played a major role with the concurrence of the government Treasury in issuing the sovereign bond into the international market. The process involved from selecting international Lead Managers and working with them to fulfill the legal requirements, including keeping the documents ready to the listing of issued bonds at an international exchange for the secondary market operations. The work involved in the issue was handled by a Steering Committee comprising senior officials of the Central Bank and the government Treasury. On completion of an evaluation of proposals made by the selected leading international banks and investment houses, three international banks/investment houses; JP Morgan, Hong Kong and Shanghai Banking Corporation Limited (HSBC) and Barclays Capital were selected to act as Joint lead managers, Book Runners and Underwriters of the bond issue while Bank of Ceylon was appointed as a Co-manager. The bond was issued in October 2007, just after the Road Shows held in Singapore, Hong Kong, London, New York, Boston and Los Angeles.

The bond issue was of the benchmark size of US dollars 500 million with a maturity period of five years and a fixed coupon rate of 8.25 per cent per annum. The issue was oversubscribed with total subscriptions amounting to 3.2 times the offer, attracting US dollars 1.6 billion from 136 investors across Asia, Europe and U.S. comprising asset managers, banks, insurance and pension funds, retail and private banks and other funds.

The bond issue was a success, especially as it was floated amidst multiple challenges both in the external and internal market. At the time the bond was to be launched, the international markets were affected by the emerging sub-prime crisis, which had not been envisaged initially, forcing investors eventually away from the market, posing a great challenge for emerging market debut sovereign bond issuers. Internally, the country was fighting a war against a terrorist group and at the same time, the main opposition political party opposed the sovereign bond issue strongly with a threat that they would not honour under their government, obligations arising from the bond issue.

Despite all these issues, investors placed their confidence on the Sri Lankan bond taking into account macroeconomic fundamentals, future growth potentials and especially the unblemished record of debt service payments by the country in the past. Finally, the Sri Lankan bond issue was adjudged the Best Sovereign Bond Issue of the year by three international financial magazines, namely, Asia Money, Finance Asia and The Asset.

Sri Lanka Entering a New Era

With the end of the civil war in May 2009, Sri Lanka has entered to a new era with more prospects for accelerating growth and development with the liberation of the Northern and Eastern provinces, integrating them with the rest of the country. It opened up resources in a vast area of the North and the East for development activities which are fully integrated with the mainstream economic activities in the country. It also removed the fear of any interruptions destructive to the economy and boost the investor confidence on the country. There was a further boost to the investor confidence with the approval of the Stand-By Arrangement (SBA) facility by the IMF and official recognition by them of Sri Lanka as a country which has graduated to the status of a middle income country of the emerging world.

The international investor confidence is reflected in investment in the capital market and the real sector including investments of US dollars 1.5 billion in government rupee securities by USA funds, the highest investment by a single country and heavy investments made by some Asian countries such as India, China and Malaysia in Sri Lanka. This behaviour of foreign investors showed their confidence on the future growth prospects of the economy. In order to gauge the appetite of global investors in Sri Lankan sovereign bonds, a global non deal road show was conducted in June 2009. It revealed that global investors have a significant positive sentiment on the new status of the Sri Lankan economy.

Second Sovereign Bond Issue - 2009

Sri Lanka entered into the international capital market with her second sovereign bond issue in October 2009. Once again the bond issue was for US dollars 500 million with a maturity period of five years and three months (five year long bond), but with a much lower coupon rate of 7.40

per cent per annum compared with 8.25 per cent coupon rate in the previous bond issue. The second sovereign bond issue repositioned the credit story of Sri Lanka among the international investors and attracted 269 investors based in the US (45 per cent), Europe (31 per cent) and Asia (24 per cent). A major part of the issue, i.e., 78 per cent was allocated to fund managers while the balance 22 per cent was distributed among banks, retail investors, insurance/pension funds and other investors. As in the first sovereign bond issue, three leading international investment banks and investment houses, namely, the Hong Kong and Shanghai Banking Corporation Limited (HSBC), JP Morgan and the Royal Bank of Scotland (RBS) functioned as Joint Lead Managers, Book Runners and Underwriters for this bond issue while Bank of Ceylon acted as a Co-manager.

The second sovereign bond issue was launched at a time the capital markets globally, were recovering from the global financial crises following the sub-prime issue. However, it was a huge success with subscriptions amounting to over 13 times the offer, the highest level of over subscription to any sovereign US Dollar bond offer during 2009. The strong response by the investors signified their heightened confidence on Sri Lanka and the country's enhanced growth prospects following the end of the civil war. This bond issue was also adjudged the Best Deal of the Year 2009 in Asia-Pacific Region by The Banker Magazine.

Third Sovereign Bond Issue - 2010

With two success stories of sovereign bond issues to its records, Sri Lanka once again entered the international capital market in September 2010. The third sovereign bond issue was for US dollars 1 billion with a maturity period of 10 years. The coupon rate of the bond was fixed at a

Table 16.1
Sovereign Bond Issues

	2007	2009	2010	2011
Issue Size (US$ mn)	500.0	500.0	1000.0	1000.0
Maturity (yrs)	5.0	5.25	10.0	10.0
Coupon (per cent)*	8.25 fixed/par	7.40 fixed/par	6.25 fixed/par	6.25 fixed/par
Issue rating	B+ (Stable) - S& P BB-(Negative)- Fitch	B(Positive)- S& P B+(Stable) - Fitch	B+ (Stable) - S& P B+ (Positive) - Fitch B+ (Stable)-Moodys'	B+ (Positive) - S& P BB- (Stable) - Fitch B+(Positive)- Moodys'
Format	144A/RegS	144A/RegS	144A/RegS	144A/RegS
Lead Managers/ Book Runners	HSBC, JP Morgan, Barclays Capital	HSBC, JP Morgan, RBS	HSBC, RBS, BAML	HSBC, RBS, BAML Barclays Capital
Listing	Singapore Stock Exchange	Singapore Stock Exchange	Singapore Stock Exchange	Singapore Stock Exchange

*All were issued at par.

Source: Central Bank of Sri Lanka

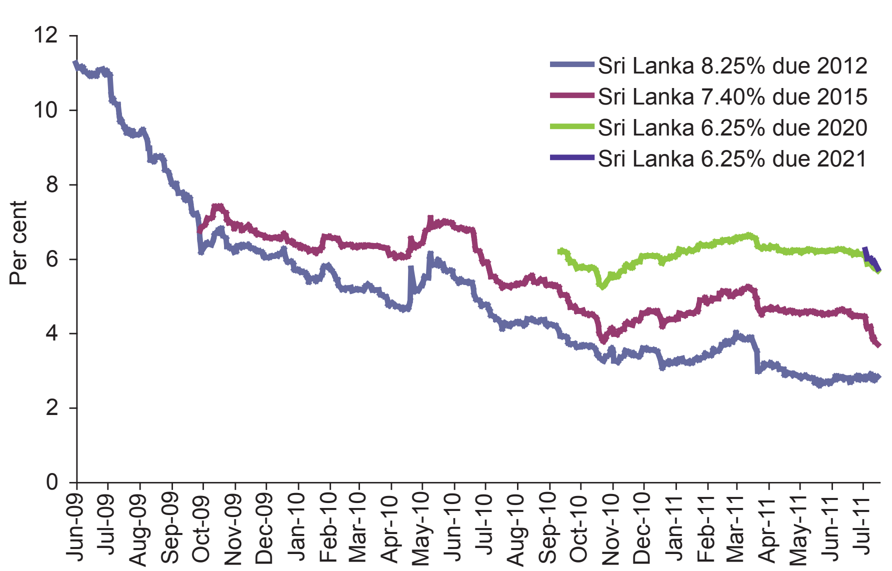
lower level of 6.25 per cent per annum. Bank of America Merrill Lynch (BAML), Royal Bank of Scotland (RBS) and Hong Kong and Shanghai Banking Corporation Limited (HSBC) were appointed as the Joint Lead Managers and Book Runners for the bond issue while Bank of Ceylon was appointed as a co-manager. The main objective of this third bond issue was to extend the Sri Lankan sovereign yield curve in the international capital market up to 10 years, and develop a liquid benchmark yield curve for private sector investors in the economy. Even though the global capital market has not fully recovered from the international financial turmoil, the bond issue was oversubscribed by 6.3 times. Orders were received from 362 investors globally. By geographic distribution, 52.5 per cent of the bonds were allocated to investors in the United States, 25 per cent to investors in Europe and 22.5 per cent to investors in Asia. By investor type, 85 per cent was fund and asset managers and the balance was to pension funds, insurance companies and banks. The proceeds of the bond were used for infrastructure development activities of the government and to restructure the government debt portfolio by retiring high cost domestic debt and short term debt. This bond issue was supported by the positive image of the country with enhanced credit ratings given by rating agencies.

Fourth Sovereign Bond Issue - 2011

The government of Sri Lanka decided to issue its fourth sovereign bonds in the international capital markets in July 2011. In order to maintain the long term yield curve, the tenure of the issue was again fixed at 10 years. The bond issue was for US 1,000 million and the coupon rate of the bond was fixed at 6.25 per cent per annum. This was a reduction of the spread by 41 bps to 332 bps compared to the previous bond issue in 2010, which was issued at a spread of

Chart 16.1

Secondary Market Yield Curve for the Sovereign Bond Issues



373 bps. The role of lead managers and book runners was assigned to four international banks/ investment houses; Bank of America Merryl Lynch (BAML), Barclays Capital (BARCAP), Hong Kong and Shanghai Banking Corporation(HSBC) and Royal Bank of Scotland (RBS). As in the last three occasions, Bank of Ceylon was appointed as co-lead manager of the bond issue. The main objective of this bond issue was to maintain the liquid long term sovereign yield curve in the international capital market in order to guide the corporate sector in the economy. Despite the volatile international capital market due to sovereign debt related issues in EU and USA, the Sri Lankan bond issue was oversubscribed by 7.5 times. The heavy oversubscription was supported by the upgrade of country's sovereign rating by all three international rating agencies; Fitch, Moody's and S& P prior to the issue of bonds. Orders were received from investors globally. By geographical distribution, 43 per cent of the bonds were allocated to investors in the United States, 30 per cent to investors in Europe and 27 per cent to investors in Asia. By investor type, 86 per cent was fund and asset management and the balance was to corporates, insurance companies and banks. Out of the total proceeds, US Dollar 500 million was reserved as a special deposit under the Ministry of Finance to match the payment obligation of the first sovereign bond to be matured in October 2012. The balance available funds will be used for infrastructure development projects operating under the government budget 2011. The success of this bond issue with overwhelming demand shows the level of confidence of global investors on the improved economic fundamentals and credit story in the Sri Lankan economy.

Concluding Remarks

The main features of the bonds issued are summarised in Table 16.1 for easy reference while performances of the bond prices in the secondary market are depicted in Chart 16.1 These features, mainly the developments in prices, reflect the improving confidence of investors in the country's prospects in the future.

Since the issuance of the debut sovereign bond, the international community continuously watches the developments in the Sri Lankan economy, which are reflected in the movements of prices of bonds issued in the international market. Accordingly, the country is disciplined by the market forces and its accountability towards investors would have a positive influence on the economy and a positive impact on the sovereign rating in the future. Further, the Sri Lankan economy is growing at a rapid pace and the corporate sector too started to move into international markets to raise necessary long term funding. The sovereign bond issues have well established the benchmark to facilitate their entry to the international markets.

Sri Lanka is determined to continue with marking its presence in the international capital market, which has enabled the country to raise funds at competitive rates to finance infrastructure projects and restructure some of the debt accumulated by financing development projects. It has also provided an added incentive for the authorities to be more prudent and implement policies with a long term perspective as the country is now subject to further attention of market forces, which while blessing "good behaviour" punish severely any "wrong-doing".