MOODY'S
RATINGS

Rating Action: Moody's Ratings places Sri Lanka on review for upgrade; assigns (P)Caa1 to the new USD-denominated issuances

28 Nov 2024

Singapore, November 28, 2024 -- Moody's Ratings (Moody's) has today placed the Government of Sri Lanka's Ca long-term foreign currency issuer rating on review for upgrade. Previously, the outlook was stable.

Concurrently, we have assigned (P)Caa1 foreign currency senior unsecured ratings to Sri Lanka's new USD-denominated issuances in its exchange offer, specifically the macro-linked bonds (MLBs), the governance-linked bond (GLB), as well as the step-up and past-due interest (PDI) bonds.

The existing Ca ratings on Sri Lanka's foreign currency senior unsecured debt issuances that are in default and will be exchanged for the new debt issuances reflect the expected financial loss and are unchanged.

The decision to place the issuer rating on review for upgrade reflects the announcement of the exchange offer by the government, which if successful will conclude the restructuring of its international bonds held by private-sector creditors and reduce the default risk on new and future issuances. In particular, the relatively comprehensive debt restructuring and ongoing reforms under the government's programmes with development partners including the International Monetary Fund (IMF) are leading to a significant reduction in external vulnerability and government liquidity risk, while raising prospects for fiscal and debt sustainability, albeit from a weak starting point. Willingness and capacity to implement reforms speak to Sri Lanka's governance, a driver of this rating action.

The government has been in default since April 2022, when it announced that it would suspend the servicing of external debt repayments.

The review period is expected to last until the exchange offer period closes and there is clarity on the outcome of the restructuring of international bonds.

The assignment of the (P)Caa1 ratings to Sri Lanka's new foreign currency issuances reflects our assessment that, according to the terms and conditions of the exchange offer, the issuances constitute direct, unconditional and unsecured obligations of the government and will rank pari passu among themselves and equally with all of the government's other unsecured and unsubordinated obligations. The provisional rating takes into account our assessment that debt restructuring will provide material debt and repayment relief, as well as Sri Lanka's relatively solid growth prospects and the return of reform appetite that is gradually restoring policy credibility and effectiveness. These credit supports are balanced against our expectation that the government's debt affordability will remain very weak and its debt burden high compared to peers.

The payments for the MLBs are contingent on GDP outcomes, including potential changes to the principal value ranging from -21% to 22% relative to the notional amount exchanged in the offer. The payments depend on a point-in-time comparison of realised GDP outcomes published by the IMF against the IMF's currently published baseline scenario of projected GDP outcomes. In rating these debt instruments, we do not assess the likelihood of any of the GDP outcomes determining the payments. Once the point-in-time comparison is conducted and any adjustments to contractual obligations are made, there will be no other source of variation to debt payments.

Sri Lanka's local and foreign currency country ceilings remain unchanged at Caa1 and Ca, respectively. The three-notch gap between the local currency ceiling and the sovereign rating balances a contained government footprint, against still relatively limited but increasing foreign exchange buffers that confer macroeconomic risks, as well as a domestic political environment that has weighed on policymaking. The three-notch gap between the foreign currency ceiling and local currency ceiling takes into consideration the high level of external indebtedness and still low, albeit rising, level of foreign exchange buffers.

Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL499622 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE

RATIONALE FOR INITIATING THE REVIEW FOR UPGRADE ON THE ISSUER RATING

Sri Lanka's government announced an exchange offer for its outstanding international bonds on 25 November 2024. The announcement follows the agreement the government had reached with representative groups of holders of its international bonds comprising both foreign and domestic investors in September 2024, and approvals from the IMF and representatives of bilateral official sector creditors on compliance with the country's IMF programme targets and comparability of debt treatment. A successful exchange will conclude the government's restructuring of its international bonds and reduce the default risk on new and future issuances.

Prior to the announcement, Sri Lanka had already reached agreements with its main bilateral creditors, which include Paris Club members and India (together the Official Creditor Committee) as well as China, and China Development Bank. The agreements have either come into effect or will be in the coming weeks.

The government also restructured part of its domestic debt over July to September 2023 in its Domestic Debt Optimisation (DDO) initiative. The DDO covered the local currency debt held by the Central Bank of Sri Lanka (CBSL) and superannuation funds, as well as the USD-denominated Sri Lanka Development Bonds (SLDBs) and Foreign Currency Banking Units (FCBUs) held by domestic investors including banks.

Sri Lanka's credit fundamentals have improved over the past two years, aided by effective policy adjustments that have led to a stabilisation of the macroeconomic environment, as well as debt restructuring and ongoing reforms under the government's programmes with the IMF and other development partners. External vulnerability and government liquidity risk have both declined from elevated levels. The restructuring has also had a limited impact on the banking sector, reflecting Sri Lanka's wider domestic investor base compared to peers.

Foreign exchange reserves have quadrupled since the default as sizeable financing inflows from development partners, the suspension of external debt repayments to bilateral and commercial creditors, an improvement in current account dynamics, as well as substantial purchases of foreign exchange by CBSL have helped Sri Lanka rebuild its foreign exchange buffers. As of the end of October 2024, foreign exchange reserves had risen to nearly $6.4 billion, up from $1.6 billion in April 2022 and sufficient to cover around 3.5 months of imports. We project that foreign exchange reserves will rise to cover more than 4 months of imports and all of the country's external debt due by the end of 2025 and over the following 2-3 years. At the same time, the external repayment profile will remain benign at less than 2% of GDP annually over the next few years even as debt repayments fully resume post-restructuring, and we expect the government's gross financing needs to fall to average around 15% of GDP.

Besides the reduction in liquidity risks, Sri Lanka's fiscal and debt dynamics are also improving, albeit from a weak starting point. We expect Sri Lanka's fiscal deficit to narrow to 5-6% of GDP in 2025-26, compared to our estimate of 7% of GDP for 2024 and an average deficit of 11% of GDP in 2021-22 around the time of the default. The reduction in the deficit has been driven by revenue measures that significantly widened the government's revenue base from 8.3% of GDP in 2021-22 to our estimate of around 14% of GDP in 2024. These revenue measures include raising the value added tax and corporate income tax rates, lowering the personal income tax free allowance, and strengthening tax administration.

Although the change in president and government point to underlying social challenges that may make further fiscal consolidation difficult, initial announcements suggest that the new administration is committed to structural reforms and the IMF programme. Some reprioritisation of reform measures and targets is likely, but we expect the broad reform trajectory to remain intact.

The widening of the revenue base is supporting a substantial improvement in debt affordability for Sri Lanka, although we expect interest payments will continue to absorb a very high level of around 40-50% of government revenue into the foreseeable future. Sri Lanka's debt affordability will remain among the weakest across sovereigns we rate and constrains its credit profile. Likewise, while we expect Sri Lanka's debt burden to decline to around 95% of GDP by the end of this year after the restructuring of international bonds, and to below 90% within the next 2-3 years from a peak of 114% at the end of 2022, the debt burden will remain high compared to peers.

This combination of improvements in Sri Lanka's credit profile and ongoing credit constraints is likely to be consistent with a Caa1 rating.

RATIONALE FOR ASSIGNING THE PROVISONAL (P)Caa1 RATINGS ON THE NEW ISSUANCES IN THE DEBT RESTRUCTURING

Successful restructuring of the international bonds will likely lead to credit fundamentals consistent with a Caa1 rating as described above.

The terms and conditions of the exchange offer indicate that the new issuances will constitute direct, unconditional and unsecured obligations of the government, and will rank pari passu among themselves and equally with all of the government's other unsecured and unsubordinated obligations of the government.

The notes that we have assigned (P)Caa1 ratings to are the USD-denominated MLBs, GLB, as well as the step-up and PDI bonds. The MLBs will vary in payment based on a point-in-time comparison of GDP outcomes to be conducted by November 2028, affecting both coupon payments and principal repayments from 2028. In particular, the principal value will range between 79% and 122% of the notional amount exchanged in the offer depending on realised GDP outcomes as published by the IMF compared to the IMF's currently published baseline projections. Importantly, once the point-in-time comparison is conducted and any adjustments to contractual obligations are made, there will be no other source of variation to debt payments. Also, any revisions to GDP outcomes at a later date will not impact the payments determined by the point-in-time comparison. The GLB does not involve any changes to the principal value compared to the notional amount exchanged in the offer, but has a step-down feature in coupon payments from December 2028 if key performing indicators and data disclosure requirements are met. In rating the MLBs and GLB, we do not assess the likelihood of any of the GDP outcomes or criteria determining the payments. Our ratings reflect our assessment of Sri Lanka's ability and willingness to meet its contractual obligations.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Sri Lanka's ESG credit impact score (CIS-4) indicates that the rating is lower than it would have been if ESG risk exposures did not exist. This reflects weak governance that leads to very low resilience to environmental and social risks.

Sri Lanka's exposure to environment risk (E-4 issuer profile score) is driven mainly by its physical climate vulnerability. Variations in the seasonal monsoon can have marked effects on rural household incomes and real GDP growth: while the agricultural sector comprises only around 8% of the total economy, it employs more than a quarter of Sri Lanka's total labour force. Natural disasters including droughts, flash floods and tropical cyclones that the country is exposed to also contribute to higher food inflation and import demand. Moreover, ongoing development projects to improve urban connectivity have increased the rate of deforestation, although the country continues to engage development partners to preserve its natural capital, such as its mangroves.

The exposure to social risk (S-4 issuer profile score) reflects the constraints the government will face in delivering high-quality social services and developing critical infrastructure as the population continues to grow, given its still relatively narrow revenue base. Our assessment also balances Sri Lanka's relatively good access to basic education, which has continued to improve throughout the country in the post-civil war period, against weaknesses in the provision of some basic services in more remote and rural areas, such as water, sanitation and housing.

The weak governance profile (G-4 issuer profile score) reflects challenges in policymaking that led to a deterioration in the government's credit fundamentals and debt default, although the return of reform appetite and implementation of credit supportive measures is helping to restore some policy credibility. Domestic political developments also tend to weigh on fiscal and economic policymaking. International surveys continue to point to aspects of governance that are stronger in Sri Lanka relative to rating peers, including in judicial independence and control of corruption.

GDP per capita (PPP basis, US$): 14,455 (also known as Per Capita Income)

Real GDP growth (% change): -2.3% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.2% (2023)

Gen. Gov. Financial Balance/GDP: -8.3% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: 1.8% (2023) (also known as External Balance)

External debt/GDP: 65% (2023)

Economic resiliency: ba3

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 25 November 2024, a rating committee was called to discuss the rating of the Sri Lanka, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer has become less susceptible to event risks. ESG (Governance) was a key driver of this rating action.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

We would conclude the review period by likely upgrading Sri Lanka's issuer rating to Caa1 if the exchange offer is successful.

Given the review for upgrade, a downgrade of Sri Lanka's ratings is remote.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

The local market analyst for these ratings is Christian Fang, +971 (423) 795-34.

REGULATORY DISCLOSURES

The List of Affected Credit Ratings announced here are a mix of solicited and unsolicited credit ratings. For additional information, please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website https://ratings.moodys.com. Additionally, the List of Affected Credit Ratings includes additional disclosures that vary with regard to some of the ratings. Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL499622 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and provides, for each of the credit ratings covered, Moody's disclosures on the following items:

• EU Endorsement Status

• UK Endorsement Status

• Rating Solicitation

• Issuer Participation

• Participation: Access to Management

• Participation: Access to Internal Documents

• Lead Analyst

• Releasing Office

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions .

For any affected securities or rated entities receiving direct credit support/credit substitution from another entity or entities subject to a credit rating action (the supporting entity), and whose ratings may change as a result of a credit rating action as to the supporting entity, the associated regulatory disclosures will relate to the supporting entity. Exceptions to this approach may be applicable in certain jurisdictions.

For ratings issued on a program, series, category/class of debt or security, certain regulatory disclosures applicable to each rating of a subsequently issued bond or note of the same series, category/class of debt, or security, or pursuant to a program for which the ratings are derived exclusively from existing ratings, in accordance with Moody's rating practices, can be found in the most recent Credit Rating Announcement related to the same class of Credit Rating.

For provisional ratings, the Credit Rating Announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating.

Moody's does not always publish a separate Credit Rating Announcement for each Credit Rating assigned in the Anticipated Ratings Process or Subsequent Ratings Process.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

At least one ESG consideration was material to the credit rating action(s) announced and described above. Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1355824 .

Please see https://ratings.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the issuer/deal page on https://ratings.moodys.com for additional regulatory disclosures for each credit rating.

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