INVESTOR UPDATE

APRIL, 2017

BARBADOS UPDATE

CURRENT RECOMMENDATION: SELL

This piece will attempt to provide a synopsis of the challenges as well as provide an update on any recent information that may be of interest to investors.

NEGATIVE OUTLOOK

Previous Downgrades - Between 2006 and 2016, Barbados experienced ten consecutive rating actions by international rating agency Standard & Poor's (S&P). In March, 2017 that number increased to eleven with S&P downgrading Barbados' sovereign credit rating from "B-" to "CCC+"; the negative outlook has been maintained. When a country is rated at "CCC+" it means that S&P is of the view that the country is vulnerable to non-payment of its debt and is dependent on favourable business and economic conditions to meet its obligations. The rating further means that in the event of adverse economic or financial conditions, it is not likely that the country will be able to meet its obligations on time and in full.

Strong probability of another downgrade - Because the negative outlook has been maintained, it means there is a strong probability that the country could be downgraded again over the next 6 to 24 months.

Of further concern is the fact that the government has not demonstrated the willingness to take timely and proactive measures to strengthen its fiscal profile. Recent data indicates that for the first 9 months of the 2016/17 fiscal year (April to December- 2016), the central bank and the National Insurance Scheme (NIS) wholly financed the government's borrowing requirements. It is likely that the government took the decision to tap central bank and NIS resources because it has been frozen out of both the domestic and international capital markets.

In recent months private financial institutions have reduced their exposure to government securities by selling bonds. Tapping the central bank's resources however, runs counter to the government's long standing policy of defending the fixed exchange rate peg (US$2:BD$1) and limits its ability to act as lender of last resort to the financial system in the event of an escalating financial crisis. Tapping the central bank's resources also raises questions regarding the printing of money and its impact on inflation.

The recommended strategy during crises situations is increased taxation and deep expenditure cuts. Utilizing external help in the form of the IMF, World Bank and other multilateral agencies is also a part of the normal route. The longer it takes to approach the multilaterals, the more aggressive and painful the likely recommended corrective fiscal strategy.

THE BUDGET

Inconsistent Account Methods Used - On March,7, 2017 the government put forward its estimates of expenditure for the 2017-18 fiscal year. However, Barbados' numbers were put forward both on a cash basis as well as by accrual accounting.

The main difference between accrual and cash basis accounting depends on the timing of when income and expenditure are recognized. The cash method accounts for income only when money is actually received and for expenses only when money is paid out. However, the accrual method accounts for income when it is earned (which is before it is received) and expenses, goods and services when they are incurred (which is before the money is actually paid out). This inconsistency in accounting methods makes it harder to quickly assess the countries true financial position. All figures must be accounted for using the same method. For ease of comparison with Jamaica we will speak to the numbers on a cash basis.

THE POSITIVES

The government is targeting a primary surplus of BD$276 million or approximately 2.3% of GDP. Current transfers, a major concern for the rating agencies, are projected to decrease by $29.3 million or 2.5% to $1.1294 billion.

CONCERNS

Deficit Experienced - There is projected to be a 5.8% increase in total expenditure compared to 2016/17. Government revenue is projected to increase by 4.7%; when debt repayments in the form of amortization of BD$1.1265 billion is taken into account, an overall deficit of $422.0 million on the cash basis is expected. This represents a deficit of 4.4% of GDP.

A more aggressive stance is needed to curtail the growth rate of its debt - A targeted deficit of 4.4% of GDP represents a reduction compared to fiscal 2016/17. Before his dismissal, central bank governor Dr. Worrell in January, 2017, called for a further reduction in wages and transfers to eliminate the deficit as well as eliminate central bank financing. The minister of finance, Mr. Sinckler, however made it clear that attrition and public sector reorganization would be the strategy going forward to reduce wages rather than any cuts to the size of the public sector.

Absence of aggressive revenue or expenditure plans - Given the stage of the electoral cycle, this may be a low probability event with parliamentary elections due by February, 2018. The Bajan government seems to be relying heavily on asset sales to narrow the deficit. This approach is criticized because the Barbados government seems to have a weak track record of execution as evidenced by recent attempts. The sale of the Barbados National Terminal Company should have been finalized about a year ago. There are also issues in terms of the timely streamlining of the finances of state owned enterprises. Transfers to these entities continue to weigh heavily on fiscal resources despite the reduction in the 2017-18 budget.

Significant decline in reserves and government's non-compliance with the terms and conditions needed to access multilateral borrowing channels. Failure to comply has meant the non-disbursement of external hard currency which is vital to bolstering international reserves. Barbados' Net International Reserves (NIR) have declined by 40.3% over a three year period (from US$571.9 million in 2013 to $341million in 2016). Of greater concern is S&P's estimate of usable reserves which has declined by 470% over a six (6) year period (from US$237 million in 2011 to an estimated -US$877 million in 2017).

PRIVATE SECTOR DEVELOPMENTS

Expansion plans for major income generators are behind schedule - The Hyatt, the Sam Lord Castle project by Wyndham and Sandals Barbados have announced plans to build or expand. However, only Sandals is on schedule which brings into question the impact that projected construction will have on economic growth.

Instability of two major sector (tourism and international financial services.) Approximately 25% of visitors are from the US, 31% from the UK and 14% from Canada. The US' economy has fully recovered from the global crisis with greater concerns now surrounding the possibility of the economy overheating. This is a positive for Barbados; however the UK and the rest of Europe (approx. 6% of visitor arrivals) is a challenge. Brexit and post-Brexit negotiations involving the UK and the rest of Europe carries with it a level of uncertainty. Note also that Scotland is scheduled to hold a second referendum to determine whether they will remain a part of the United Kingdom. These negotiations will likely affect job prospects and vacation plans which could weigh negatively on FX inflows from tourism.

On the international financial services side, Barbados' record of 11 successive downgrades between 2009 and 2017 does not necessarily generate confidence. Companies have relocated out of the sovereign because of the impact that the sovereign credit rating has on the company's rating. The fact also that Barbados is no longer rated at "investment grade"/ "BBB-" and above reduces its attractiveness as an investment destination.

SOME RECENT HAPPENINGS

Confidence in the government may have been eroded with the firing of the central bank governor, Dr. DeLisle Worrell- It has been reported that there have been numerous complaints by the Board and Senior Management regarding Worrell's management of the institution. However, the timing of the dismissal could not have been worse given the current challenges facing the government and their tapping of the central bank to fund expenditure.

Barbados may need IMF intervention and delays to seek assistance could worsen its situation- The Prime Minister, Freundel Stuart, has also noted that the country will not be going to the IMF, at least not now based on the circumstances. The point was made by former Barbados PM, Owen Arthur, that the country had no option but to go to the IMF. Owen Arthur noted that the country could not successfully negotiate through this challenging time without the aid of the multilaterals. Multilateral funding would be needed to calm the markets and multilateral technical support (IMF) would be necessary to provide a credible plan which would allow the other multilaterals (WB, IDB) to release funding for budgetary support. Owen Arthur recently aided Grenada in crafting its IMF agreement.

Stuart firmly rejected the idea that Barbados at present needed an IMF agreement. He did however, note that the country was spending more than it was earning. He also made it clear that if the time for the IMF came, he would have the difficult conversation with the people. We reiterate our view that the longer the country takes to accept multilateral support, all things being equal, the more difficult the fiscal adjustment process tends to be. We also remind the reader that elections are due in February,2018.

CONCLUSION

From a regional perspective, Barbados has an enviable per capita GDP at US$15,800 based on a 2016 estimate which means the average Bajan is three times as rich as the average Jamaica, Guyana, Belize and Dom Rep citizen. Barbados is one of the most highly educated sovereigns in the region; the country has an enviable literacy rate, the government offered free education up to the tertiary level until recently, the infant mortality rate is low and Barbados is one of only a handful of countries listed in the high human development category.

Despite these lofty heights, things have taken a turn for the worse. The debt/GDP ratio has climbed from 80% in 2011 to an estimated 118% in 2017. Persistent fiscal deficits, averaging above 5% since 2012, have ballooned the debt. The authorities were slow to pick up the severity of the crisis and when they did act to increase taxes, it was done in a piecemeal fashion and did not have the desired effect. With the debt growing, the interest burden (interest payments as a percentage of revenues) has climbed above 15% and represents a burden on cash resources.

The situation was further escalated by the poor performance of tourism and financial services which depend on external factors. The global financial crisis, the European financial crisis, Greece, Brexit and the uncertainty surrounding ongoing negotiations have weakened visitor travel plans- negatively impacting tourism. Successive downgrades have also proven a challenge prompting some businesses to relocate given the loss of investment grade status.

RECOMMENDATION

The probability of a downgrade at this time, based on the rating is 50:50. The above leaves us with no option but to maintain our sell recommendation.