



Fitch Downgrades Kotagala to 'CC(lka)' on Worsening Liquidity

Fitch Ratings-Colombo-24 May 2017: Fitch Ratings Lanka has downgraded Sri Lanka-based Kotagala Plantations PLC's National Long-Term rating to 'CC(lka)' from 'B+(lka)'. The agency has also downgraded the National Long-Term rating on Kotagala's outstanding listed senior secured debentures of LKR1 billion to 'CC(lka)' from 'B+(lka)'.

The downgrade follows continued deterioration in the company's liquidity, as its operating EBITDA weakened further in the financial year ending-March 2016 (FY16) due to falling tea and rubber prices, high labour costs and poor labour productivity. Consequently, Kotagala's operating EBITDA of LKR30 million was insufficient to cover its borrowing costs of LKR503 million and the company had to utilise cash reserves to meet most of its financial obligations.

The company's EBITDA recovered to LKR247 million in 9MFY17, from LKR198 million in 9MFY16, driven by improving tea and rubber prices. However, we expect EBITDA to fall short of meeting the company's borrowing costs and operating lease rent in the next 12 months-18 months. Kotagala has around LKR546 million of bank loan maturities due in FY18. The company has benefitted from banks' willingness to restructure its borrowings in the past. However, principal repayments on its listed senior secured debenture will fall due in FY19, starting with LKR250 million principal due in May 2018.

KEY RATING DRIVERS

Weak Liquidity; High Refinancing Risk: Kotagala faces substantial debt maturities from FY18 and we believe it will be challenging for the company to meet its obligations due to its low cash balance and negative free cash flow generation in the next two years. Further, the company does not have any committed credit lines at its disposal, limiting its financial flexibility and exposing it to significant refinancing risk. The company's efforts in FY16-FY17 to lower debt via asset disposals and extending the maturity of part of its existing debt has not led to a sustained improvement in liquidity.

Challenging Operating Conditions: The profitability of Kotagala's tea and rubber plantations has improved in the previous few months with rebounding global prices, but we do not believe the improvement is sufficient to offset the sector's structural decline stemming from continued supply-side pressure, such as lower productivity and high labour costs. We expect the expansion of Kotagala's more profitable palm oil operations to support cash flow, but we do not expect a significant contribution in the medium-term as its oil palm plantation are still in an immature stage.

Marginal Recovery in Profitability: We expect Kotagala's annual EBITDA to improve to around LKR400 million in FY17 and LKR600 million in FY18. Tea prices recovered to an average of USD3.8/kg and rubber to USD2.3/kg in Q4FY17, from lows of USD2.8/kg and USD1.4/kg, respectively, in Q4FY16. This is mainly because demand from Russia and key Middle Eastern countries recovered in line with higher global crude oil prices. Our EBITDA forecasts for the next two years are based on the assumptions that tea prices will average at USD3/kg and rubber prices will average around USD2/kg. However, we expect continued increase in labour costs to partly offset these benefits.

Weak Financial Profile: We expect the company's leverage, defined as lease-adjusted debt net of cash/operating EBITDAR, to remain unsustainably high over the medium-term, at around 10x-12x (end-2016: 14.6x), and EBITDAR/interest paid plus rents to remain below 1x. We believe local banks may continue to fund the company's operations to comply with the regulatory requirement to lend to the agricultural sector.

Pressure from Cambodian investment: The company may incur an additional USD4.1 million (around LKR635 million) in debt if it completes its acquisition in Cambodia, which was initiated in 2012. This debt will need to be funded through borrowings. The project is not expected to yield significant cash flow in the medium-term, which, together with the additional borrowings, could further weaken the company's leverage position. However, Kotagala believes it has the flexibility to defer the acquisition or sell it to a third-party if required.

DERIVATION SUMMARY

The rating factors in Kotagala's weak liquidity, unsustainable leverage and limited medium-term business prospects due to inherent weaknesses in its tea and rubber plantation businesses.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Average price of tea at USD3/kg and average price of rubber at USD2/kg in 2017 and 2018
- Annual EBITDA to average around LKR400 million in FY17 and around LKR600 million in FY18
- Capex to average about 4% of sales between from FY17 to FY20, mainly channelled for the development of palm oil plantations and replanting of tea and rubber
- No dividend outflows from FY17 to FY20

RATING SENSITIVITIES

Developments that may, individually or collectively, lead to positive rating action include:

- Significant improvement in the company's liquidity profile

Developments that may, individually or collectively, lead to negative rating action include:

- If the company enters into a temporary negotiated waiver or standstill agreement following a payment default on a large financial obligation

LIQUIDITY

High Liquidity Risk: Kotagala had LKR764 million of unrestricted cash at end-2016 to meet around LKR542 million of contracted debt maturities due in the 12 months to end-2017. Fitch expects the company to post negative free cash flow of around LKR500 million in FY18, which may also need to be funded by debt. The company's liquidity position may tighten considerably from FY18, when most of its long-term debt starts to mature amid our expectation of negative free cash flow.

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Applicable Criteria

Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)

National Scale Ratings Criteria (pub. 07 Mar 2017)

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