



Fitch Affirms Melstacorp and Subsidiary Distilleries at 'AAA(Ika)'; Outlook Stable

Fitch Ratings - Colombo - 20 Oct 2020: Fitch Ratings has affirmed the National Long-Term Ratings of Sri Lanka-based conglomerate, Melstacorp PLC, and its subsidiary, Distilleries Company of Sri Lanka PLC (DIST), at 'AAA(Ika)'. The Outlook is Stable.

Fitch rates DIST, which is the stronger of the two entities, based on the consolidated profile of Melstacorp due to strong operational and modest legal linkages between the two entities, as defined in our Parent and Subsidiary Linkage Rating Criteria. DIST contributes around 70% to Melstacorp's consolidated EBITDA, shares the same board of directors and Melstacorp has unrestricted access to DIST's cash flows.

The affirmations reflect the group's ability to maintain leverage comfortably below the 4.5x negative rating sensitivity over the medium term, despite the coronavirus pandemic-led economic downturn, due to strong cash flows from its resilient spirits business. However, Melstacorp's rating could come under pressure if the impact of the pandemic intensifies, leading to further lockdowns and stricter social distancing requirements, which would have a negative impact on its beverage segment cash flows.

KEY RATING DRIVERS

Resilient Beverage Segment: We expect the pandemic's impact on the group's beverage sector to be modest, with a 13% yoy revenue decline in the financial year ending 31 March 2021 (FY21) after a 30% drop in 1QFY21 amid an island-wide lockdown followed by strict social distancing to contain the virus. Liquor shops were closed for almost two months with very little revenue for spirit producers. However, demand has stabilised since July despite weakening personal income. Nevertheless, the sector could come under pressure if there are further lockdowns amid the recent resurgence of the pandemic.

DIST accounts for more than 70% of the country's spirit market after strengthening its market position in FY20. The Sri Lankan government in early 2020 banned the import of ethanol, forcing liquor producers to source all their requirements locally, despite a domestic shortage. However, DIST has the necessary sourcing strategies that will help to ensure supply is not interrupted. The ongoing ban on the import of foreign liquor should also help DIST to further strengthen its market share.

Gradual Excise Tax Hikes: We expect excise tax increases on spirits to be more gradual in the medium term as prohibitive increases could hamper demand and government tax income. Excise tax on alcoholic beverages is a key source of government income, accounting for around 7% of tax revenue. The excise tax did not rise directly in the last 12 months but the VAT and nation-building tax on liquor sales were reclassified as excise tax. This did not affect retail prices but widened the excise tax difference between spirits and beer to 24% from 20% in March 2019.

Pandemic's Significant Impact on Leisure: We expect the revenue of the group's leisure segment, held via its 51% share in Aitken Spence PLC (ASP), to drop 75% in FY21 due to COVID-19. The occupancy of ASP's Maldives operations, which account for around 60% of sector EBITDA, has yet to recover meaningfully since the country reopened to tourists in mid-July. Sri Lanka remains shut to tourists but hotels are open for locals. However, occupancy and room rates remain materially below historical levels. Winter bookings are rising at both destinations but the risk of cancellation is high if the pandemic worsens.

The company has introduced cost-cutting measures, including wage cuts, part utilisation of properties and rationalisation of marketing costs to contain operating losses. However, we expect a segment EBITDA loss of around LKR2.1 billion in FY21 on a proportionate consolidation basis before turning profitable in FY22 as tourist arrivals recover gradually. The Sri Lankan government provided a debt moratorium for the leisure sector, deferring interest and repayments until March 2021, easing the segment's liquidity pressure.

Stronger Margin: We expect margins to recover and stabilise to around 24% by FY22, compared with a 300bp contraction in FY21, on higher contribution from high-margin segments such as beverage and power. We expect beverage margins to remain in the high 30s, helped by cost-effective sourcing strategies. The 10MW waste-to-energy power plant starting in late 2020 should improve group margins by around 100bp from FY22. In addition, EBITDA contribution from the leisure sector, which is under continuous margin pressure, will probably fall to around 12% in the medium term.

Spike in Leverage temporary: We expect group net leverage, defined as net adjusted debt/operating EBITDAR (including Melstacorp's 51%-share of ASP's net debt and EBITDA, but excluding its insurance subsidiary), to weaken to 3.3x in FY21 before recovering to 2.2x by end-FY22. We expect the pandemic-related challenges to ease by mid-FY22, helping the group's EBITDAR recovery. Group net leverage in the next two years will also be supported by lower capex and investment spending and reduced dividends as the company focuses on preserving cash in the challenging environment.

Aggressive Investment Drive: We expect Melstacorp to remain acquisitive in the medium term in line with its strategy. Melstacorp acquired a 70-bed regional hospital for LKR1.6 billion in FY 20 to expand its small healthcare segment. It also invested LKR1.4 billion in a cement packaging joint venture, which has yet to start operations. We expect the EBITDAR contribution from the new investments to be insignificant at 2%-3% in the next few years. Our rating-case forecast assumes the group will invest around LKR5 billion per annum in M&A from FY23, largely funded by its strong free cash flow (FCF), which we estimate at around LKR4 billion-5 billion per annum, although the group has not confirmed any details.

DERIVATION SUMMARY

Melstacorp is a leading conglomerate in Sri Lanka, with exposure to the alcoholic beverage, plantation, telecom, leisure, power and logistics sectors. Its core subsidiary, DIST, is the country's leading spirits manufacturer, with a strong portfolio of well-known brands and access to an extensive distribution network. In comparison with its 'AAA(Ika)' rated peer, Dialog Axiata PLC (AAA(Ika)/Stable), Melstacorp's operations, though more

diversified, are smaller in scale, as a significant portion of the country's alcoholic-beverage consumption occurs outside the formal sector, which is not recorded. In contrast, Dialog enjoys a larger operating scale, reflecting the size of the local telecom market and its market leadership in the fixed-line and mobile segments.

Melstacorp is also exposed to more regulatory risk in its spirits business due to excise tax increases, but this is counterbalanced by its entrenched market position and high entry barriers, as well as the importance of excise taxes to government revenue. Consequently, the company is able to pass on cost inflation and maintain EBITDAR margins, supporting substantially stronger FCF generation than at Dialog. Melstacorp's capex as a proportion of revenue is also considerably lower than Dialog's and most of its investments in other businesses are discretionary. Dialog's high capex intensity is driven by the need to continually upgrade infrastructure to keep abreast of evolving technology and to service rising network traffic, while competition keeps tariff increases in check, resulting in larger and more sustained negative FCF than for Melstacorp.

Both Hemas Holdings PLC (AAA(lka)/Stable) and Lion Brewery Ceylon PLC (AAA(lka)/Stable) are rated at the same level as Melstacorp, reflecting their conservative approach to expansion, which has helped them to maintain lower leverage. Melstacorp continues to be aggressive with its expansion, helped by stronger-than-peer FCF generation. Melstacorp's rating also reflects its larger scale compared with Hemas and Lion, supported by greater diversification.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Revenue to contract 21% in FY21 largely due to the pandemic-related pressure on the leisure sector. Revenue to recover to pre-pandemic levels by FY22 amid gradual improvement in operating conditions.
- EBITDAR margin to contract 300bp to 19.5% in FY21 before stabilising to 24% from FY22.
- Smaller excise-tax hikes, as the government is likely to be mindful of falling revenue collection if demand were to decline
- Working-capital cycle to increase to 120 days in FY21 from 105 in FY20 amid collection delays and inventory build-up.
- Capex to moderate to around LKR2.0 billion per annum over the next two years
- M&A and other investment spending to average around LKR5 billion a year in FY22-FY24
- Dividend payout of LKR500 million in FY21 increasing to LKR1.0 billion in FY22

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- There is no scope for an upgrade, as the company is already at the highest rating on Sri Lanka's national rating scale.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Consolidated financial leverage - measured as adjusted net debt/EBITDAR (including 51% consolidation of ASP but excluding Continental Insurance Lanka Limited) - increasing to over 4.5x for a sustained period.
- Group operating EBITDAR/interest paid + rent (including 51% consolidation of ASP but excluding Continental Insurance Lanka Limited), falling below 2.5x for a sustained period (3.6x at end-FY20).
- A structural change in the domestic alcoholic-beverage industry that considerably weakens DIST's competitive position.
- A significant weakening of the business risk profile due to new investments in sectors that are more competitive or generate more volatile operating cash flow than the spirits business

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: Melstacorp had around LKR15 billion in unrestricted cash at end-June 2020, compared with LKR28 billion in debt maturing in the next 12 months. Around LKR14 billion of the near-term maturities are working capital-related debt, which we expect the banks to roll over in the normal course of business given the group's healthy working-capital cycle. Melstacorp's liquidity is also supplemented by LKR33 billion in uncommitted unutilised credit lines, which we believe will be available when required due to the group's strong relationships with local banks as one of Sri Lanka's largest corporates and its solid credit profile.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Melstacorp PLC	Natl LT	AAA(Ika) ●	Affirmed	AAA(Ika) ●
Distilleries Company of Sri Lanka PLC	Natl LT	AAA(Ika) ●	Affirmed	AAA(Ika) ●

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

- [Corporate Rating Criteria \(pub. 01 May 2020\) \(including rating assumption sensitivity\)](#)
- [National Scale Rating Criteria \(pub. 08 Jun 2020\)](#)
- [Parent and Subsidiary Linkage Rating Criteria \(pub. 26 Aug 2020\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

- Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

- [Solicitation Status](#)
- [Endorsement Policy](#)

ENDORSEMENT STATUS

Distilleries Company of Sri Lanka PLC -
Melstacorp PLC -

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