

# Polarised Impact on Sri Lanka Corporates from Weak Sovereign-External Finances

Import Expenditure by Sector



\* RM: Raw Material Imports, FG: Finished Goods Imports  
Source: Fitch Ratings, company reports



## Related Research

Singer (Sri Lanka) PLC (April 2021)

Abans PLC (March 2021)

Ceat Kelani Holdings (Private) Limited (July 2021)

DSI Samson Group (Private) Limited (May 2021)

Sierra Cables PLC (March 2021)

Fitch Affirms Sri Lanka at 'CCC' (June 2021)

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Fitch Ratings believes the Sri Lanka sovereign's weak external finances will affect corporates importing non-essential finished goods such as consumer durables more than corporates importing essential finished goods such as pharmaceuticals, food or clothing.

The authorities have temporarily banned the import of non-essential goods such as automobiles and furniture, to manage weak external finances, and have said they will prioritise essential intermediate- and capital goods in order to manage the country's deteriorating foreign currency reserves.

The rapid decline in Sri Lanka's foreign-currency reserves position to USD4 billion in May 2021 from USD6.5 billion in May 2020 has prompted the Central Bank of Sri Lanka to announce a more "judicious management" of imports and foreign reserves, according to a statement issued on 28 June 2021. Therefore, we do not rule out the possibility of tighter import controls in the near term.

At the same time, we believe restrictions are less likely in the near term on the importation of raw materials for the domestic manufacture of essential products such as personal care, or for those industries serving as import-substitutes such as tyre and footwear manufacturers.

## Consumer Durable Sector Remains the Most Vulnerable

Singer (Sri Lanka) PLC (AA(Ika)/Stable) and Abans PLC (AA(Ika)/Stable) are the most exposed among Fitch-rated corporates to tighter import controls, due to the discretionary nature of their products.

A tightening in import controls may exert pressure on both entities' ratings, owing to low headroom. However, the availability of buffer inventories, a degree of local manufacturing, and potential group synergies in the case of Singer, could help mitigate the impact in the near term.

## Import Substitution to Benefit Domestic Manufacturers

We expect sales volumes for domestic manufacturers to rise in the near term as they attempt to fill shortages created by import restrictions.

Therefore, corporates such as the domestic tyre manufacturer Ceat Kelani Holdings (Private) Limited (CKH, AA+(Ika)/Stable), footwear manufacture and retailer DSI Samson Group (Private) Limited (DSG, AA(Ika)/Stable), as well as electric cable producer Sierra Cables PLC (AA-(Ika)/Negative), may be long-term beneficiaries as their products serve as import substitutes.

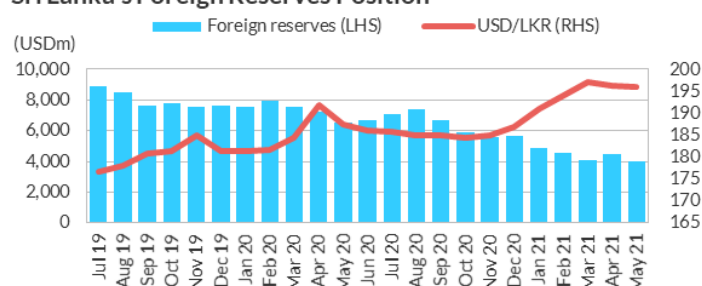
## Depleting Foreign Reserves May Prompt Tightening of Import Restrictions

The pace of decline in Sri Lanka's foreign reserves has been exacerbated by the Covid-19 pandemic which has curtailed tourism earnings – a major source of foreign currency, while prices of crude oil – a major import, have risen sharply. This has made refinancing debt for high-yield countries such as Sri Lanka (CCC) more challenging.

Fitch does not rule out a re-imposition of import restrictions, as foreign-reserves import cover had deteriorated to 2.5 months by May 2021 from 6.5 months in May 2020. On 11 June 2021, Sri Lanka lifted import restrictions on most goods which required extended supplier credit days of 90-180. Certain categories such as automobile imports remain suspended since early-2020, given their big-ticket size and non-essential nature.

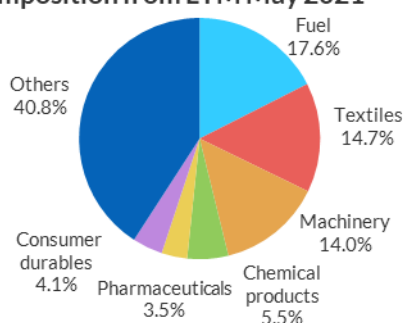
On 2 July 2021, the government tightened exchange controls and extended regulations for another six months. The updated controls further constrain fresh outward foreign investment by domestic companies, and lowered individuals' migration allowances.

### Sri Lanka's Foreign Reserves Position



Source: Fitch Ratings, Fitch Solutions, Central Bank of Sri Lanka (CBSL)

### Import Composition from LTM May 2021

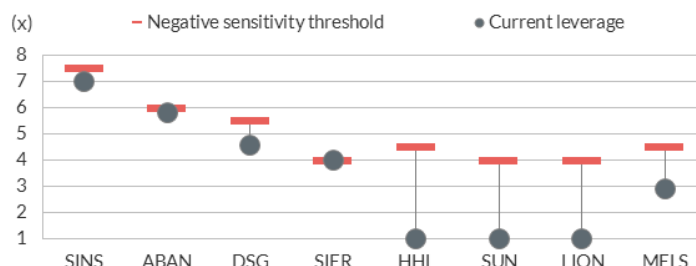


Source: Fitch Ratings, Fitch Solutions, CBSL

## Non-Essential Finished Goods Most at Risk; Some Near-Term Mitigating Factors

A partial or complete import ban across more sectors could weaken local corporates' cash flows. Singer and Abans are the most at risk among Fitch's publicly rated corporates, in such a scenario, particularly in light of their limited rating headroom.

### Rating Headroom by Leverage for FY22



Source: Fitch Ratings, Fitch Solutions

Both retailers generate around 40% of their revenue from digital products such as mobile phones and computer devices, while 'white goods' and other consumer electronics account for another 40%.

### Supplier Credit and Buffer Stocks May Provide Some Comfort

Both rated consumer durable retailers have demonstrated their ability to import goods on longer credit terms as required in the last 13 months prior to this restriction being lifted in June 2021. However, a further tightening of import controls may deplete finished-goods inventories.

In the event of dollar rationalisation, we believe Singer is better placed than Abans. This is because Singer is a subsidiary of Hayleys PLC, which generates around 50% of its earnings from exports. Fitch believes local banks may view this mix favourably from the perspective of the wider Hayleys group, when extending trade credit facilities to Singer.

Both Singer and Abans have increased inventory holdings in the past few months, which should help both companies to stave off a near-term decline in operating cash flows should imports be curtailed. As of financial year-end 2021 (FYE21, March 2021), Singer had LKR18.2 billion of inventory, while Abans had LKR9.0 billion, which should be enough to cover around 130-150 days of sales for each company.

Both retailers also have local manufacturing and assembly capabilities, but the scale of operations remains low and is unlikely to provide sufficient cash flows if tighter import restrictions were imposed. Around 25% of Singer's cost of goods sold consist of locally manufactured goods, while for Abans this number is relatively low at just 10%.

## Corporates with Domestic Manufacturing to Benefit from Import-Substitution Efforts

Current regulations permit corporates to import raw materials, as long as a minimum of 35% of value is added domestically. The authorities are increasingly looking inward in order to substitute imports and limit the country's forex outflows. This move is likely to benefit certain rated corporates such as CKH, DSG as well as Sierra Cables PLC.

CKH stands to benefit from a re-imposition of import restrictions on tyres, either by way of a temporary suspension or tighter credit requirements. We believe the authorities are less likely to curtail CKH's raw material imports, given their strong domestic market

share in bias and radial tyres mainly for both commercial and personal vehicles. CKH's revenue rose by 25% in FY21, due mainly to import restrictions which came into effect in May 2020.

DSG also has strong domestic manufacturing capabilities, producing footwear, tyres and other rubber-related products. The company remains a net importer of raw materials, and is also able to match some of its import requirement with its own export revenue, which in FY20 was close to 30% of total revenue. Therefore, this should to an extent limit any disruptions to trade finance – such as delays in letter-of-credit (LC) clearances when sourcing raw materials.

Fitch believes Sierra's retail network, which accounts for around 30% of revenue, to benefit, as we expect competition from imported steel cables to recede and create a market void. The construction sector remains a key growth avenue for the government, and any restrictions on imports of steel cables would therefore work in Sierra's favour since its entire portfolio consists of locally manufactured goods using imported raw materials, which accounts for around 80% of its total inputs.

Any restrictions of raw materials importation could be a last resort as it may force companies to cut wages, and could lead to a rise in unemployment.

## Neutral Impact on Pharmaceutical, Alcobev and FMCG Sectors

We believe pharmaceutical manufacturers and distributors such as Hemas Holdings PLC (AAA(Ika)/Stable) and Sunshine Holdings PLC (AA+(Ika)/Stable) are less likely to see tighter import restrictions despite significant import exposure. This is because of the essential nature of their goods, and limited availability of their products in the local market.

Hemas and Sunshine have limited domestic manufacturing capabilities for certain generic drugs, while around 90% of the pharmaceutical products they sell are imported. This is because domestic pharmaceutical manufacturing is at a nascent stage, with producers lacking the technological know-how and infrastructure. Pharmaceutical goods contributed around 50% and 30% of cash flow for Hemas and Sunshine, respectively, in FY21.

### Alcobev Remains a Key Source of Government Revenue

Government revenue generated via excise duties from the alcobev sector rose to 10% of total tax revenue in 2020 from 7% in 2019, as import restrictions and the pandemic weighed on most other segments of the economy. Therefore, we do not expect Fitch-rated alcobev producers such as Melstacorp PLC (Melsta, AAA(Ika)/Stable) and Lion Brewery (Ceylon) PLC (AAA(Ika)/Stable) to face meaningful restrictions when it comes to sourcing imported raw materials.

Lion's raw material import requirements are higher than those of Melsta, with imports accounting for around 30% of direct costs, whereas ethanol (which is a key input in Melsta's spirits) has been sourced locally since 2019.

### Essential FMCG Products Unlikely to be Affected

Fitch-rated entities such as Hemas and Sunshine also have significant exposure to the fast-moving consumer goods (FMCG)

sector. However, we believe these segments will remain less affected by potential import controls due to their essential nature. FMCG products such as personal care, stationary, packaged tea and confectionary are considered bare-minimum household essentials.

## Fertiliser Ban Weigh on Plantations' Productivity in the Near Term

Fitch views the current ban on the importation of chemical fertilisers as a credit negative for rated corporates such as Kotagala Plantations PLC and Sunshine, given their exposure to palm oil plantations. On 6 May 2021, Sri Lanka banned the importation of chemical agricultural inputs such as fertilisers on health grounds, and the government estimates this will conserve around USD400 million of outflows per annum.

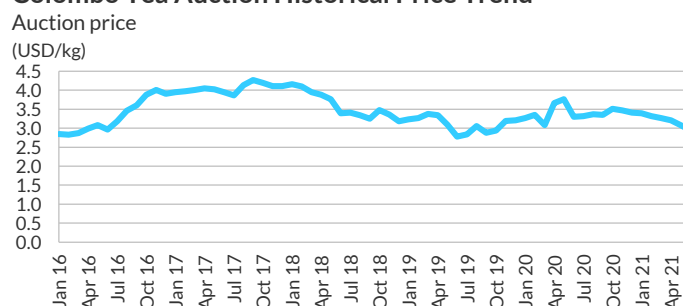
According to The Colombo Tea Traders Association, local tea output could fall by as much as 40%-50% if the ban continues. Industry sources believe the government has sufficient stocks to supply chemical fertilisers for the next 12 months, but there is limited visibility beyond that horizon.

Unlike Kotagala, Sunshine can resort to using readily available organic fertiliser from its dairy operations as an alternative to chemical fertilisers, which should help to mitigate the drop in crop yields to an extent.

### High Tea Prices to Compensate for Potential Volume Loss

Fitch believes tea plantations may find it challenging to offset the decline in yields via higher tea prices. We estimate that tea prices of more than USD5 per kg will be required to offset the potential output fall resulting from the inability to use chemical fertiliser in the near term. We expect local tea prices to rise if the ban on imported fertiliser remains in place for an extended period due to supply constraints as well as its new organic appeal. However, the highest recorded tea price at the Colombo auction historically was USD4.30 per kg in September 2017.

### Colombo Tea Auction Historical Price Trend



Source: Fitch Ratings, Fitch Solutions, World Bank

## Status of Import Restrictions

Product	April 2020 – June 2021	June 2021 Onwards
Kitchen appliances	On Credit: 90 Days	Removed
New pneumatic tyres - rim size except 12 and 13 inches used on motor cars, rim size above 20 used in buses or lorries	On Credit: 90 Days	Removed
Footwear	On Credit: 90 Days	Removed
Consumer Electronics including televisions	On Credit: 90-180 Days	Removed
Mobile phones, computers and IT-related products	On Credit: 180 Days	Removed
White goods such as refrigerators, washing machines and air conditioners	On Credit: 180 Days	Removed
New pneumatic tyres - rim size 12 and 13 inches used on motor cars, rim size 20 used on buses or lorries, motorcycle tyres and auto trishaw tyres	Temporary Suspension	Removed
Bicycle and other cycles	Temporary suspension	Temporary suspension
Soaps and detergents	Temporary suspension	Temporary suspension
Wooden, plastic, cane and rattan furniture	Temporary suspension	Temporary suspension
Sanitaryware	Temporary suspension	Temporary suspension
Motor cars and other motor vehicles used for the transportation of people and goods	Temporary suspension	Temporary suspension

Source: Fitch Ratings, Fitch Solutions, The Imports and Exports (Control) Regulations No. 04 of 2020, published in the Gazette Extraordinary No. 2184/21

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