FitchRatings

Fitch Assigns Hayleys First-Time 'AAA(lka)' National Rating; Outlook Stable

Fitch Ratings - Colombo - 24 May 2023: Fitch Ratings has assigned Sri Lankan conglomerate Hayleys PLC a National Long-Term Rating of 'AAA(lka)'. The Outlook is Stable. Fitch has also assigned a 'AAA(lka)' National Long-Term Rating to Hayleys' senior unsecured debentures.

The rating reflects Hayleys' large operating scale locally as a result of extensive business and geographical diversification, and strong market share in most of its businesses. We believe this will lead to steady operating cash flows. We expect Hayleys to maintain a measured approach to debt-funded acquisitions amid a weak domestic operating environment and high borrowing costs. This should keep its credit metrics adequate for the rating.

Hayleys' debentures are rated at the same level as the issuer rating as we expect the company to maintain prior-ranking debt, including debt at its subsidiaries and secured debt at the company, below 2.0x-2.5x, the threshold above which we may consider downgrading the notes' rating. The ratio was 2.0x in the financial year ended March 2023 (FY23).

KEY RATING DRIVERS

Strong Business, Geographical Diversification: Hayleys operates in 12 main sectors catering to industrial and retail customers. It is exposed to defensive segments such as agriculture, hand protection, textiles and purification, as well as cyclical but growth markets like transportation, consumer-durable retail and construction. Hayleys is geographically diversified with more than 50% of its revenue from exports, limiting risk from the weak domestic market. This has supported strong EBITDA growth in the last few years, despite the challenging domestic environment.

Strong Market Presence: Hayleys is the leader in Sri Lanka's transport, consumer-durable retail, textile, aluminum extrusion and tea production industries. It also has a sizeable share in the fragmented global hand protection and activated carbon-based purification markets. It has strong relationships with customers but high customer concentration in some businesses, although the risk is mitigated by high switching costs and its established relationships. Hayleys' competitive position is also strengthened by its vertical integration and strong relationships with suppliers.

Tight but Adequate Coverage: Hayleys' EBITDAR to fixed-charge cover should remain at around 2.0x (FY23: 2.0x) over the next two years amid high but moderating interest rates. Its interest cost rose threefold in FY23 as around 75% of its debt was on variable interest rates. We expect Hayleys' interest costs to drop in line with our forecast of moderating domestic interest rates and the conversion of some local-currency debt to cheaper foreign-currency debt. Hayleys' lower fixed-charge coverage is offset by higher cash flows from exports than its rated peers.

Steady Leverage: We expect Hayleys' EBITDAR net leverage to remain below 3.0x over the medium term, although rising moderately from 2.3x at FYE23 due to capex for business expansion. We expect the group to spend around LKR14 billion-16 billion in capex and acquisitions over FY24-FY26 and pay 20% of net income as dividend, largely funded by internal cash flows. The group's balance sheet has strengthened over the past few years, helped by an improvement in operating performance and a more conservative approach to investments.

Pressure on End-Market Demand: We expect flat revenue in FY24 amid weak demand across most segments. We expect Sri Lanka's GDP to grow 2% in 2023 after a 9.2% contraction in 2022. However, there will be a lag before the benefits of growth trickle down to consumer and private-sector spending, as the country grapples with high inflation, interest rates and taxes. We expect the agriculture segment (12% of EBIT in FY23) to remain resilient, but a recovery in domestic-focused consumer durables, construction and transportation will take longer.

Fitch forecasts GDP growth in the US and eurozone, Hayleys' key export markets, to slow to 1% in 2023, dampening non-discretionary spending and global trade. This will moderate Hayley's transport sector cash flows (25% of EBIT in FY23), with freight rates falling to pre-pandemic levels. However, demand for hand protection (7%) and purification (15%) should remain resilient amid stock replenishment and demand for air and water purification, respectively. We expect pricing pressure in most export segments due to falling commodity prices and increasingly price-conscious customers.

Lower, Albeit Healthy, Margins: We expect Hayleys' EBITDAR margin to narrow by around 200bp to 13.0% in FY24 on lower sales volume and price pressure. Hayleys' EBITDAR margin expanded to 15.0% in FY23, the highest in recent years, as export earnings outpaced domestic operating costs amid the nearly 80% depreciation in the local exchange rate. However, the Sri Lankan rupee has appreciated by around 15% since March 2023, reversing some gains.

We believe the drop in freight rates and falling tea prices will also push margins lower. We expect the group's overheads to remain elevated amid high inflation, rising electricity tariffs and wage increases, which Hayleys may not be able to fully pass on.

Adequate Holding-Company Profile: Hayleys has strong ownership and control over all its operating subsidiaries, allowing the holding company to extract subsidiaries' operating cash flows to a large extent. We therefore expect the holding-company EBITDA net leverage and EBITDA interest coverage to be maintained at around 4.0x and 1.5x, respectively, over FY24-FY26, supported by a measured approach to investments in the last few years and improving cash flow.

DERIVATION SUMMARY

Hayleys has more diversified operations than peer Dialog Axiata PLC (AAA(lka)/Stable) in terms of business and geographical diversification. Dialog operates exclusively in the domestic market while Hayleys has exposure to multiple overseas markets with strong growth potential. However, Dialog is the market leader in domestic mobile telecoms with a 60% share compared with Hayleys' relatively modest position in most of its end-markets. Dialog's capex intensity is high and mostly non-discretionary, resulting in weaker free-cash-flow (FCF) generation than Hayleys. However, Dialog has maintained lower leverage than Hayleys, supported by stronger EBITDA growth, underpinned by solid market leadership and integrated service platforms, leading to strong pricing power. Consequently, Dialog's rating can withstand weaker financial metrics than that of Hayleys.

Domestic conglomerate Melstacorp PLC (AAA(lka)/Stable) has more defensive cash flow and a stronger FCF profile than Hayleys due to its market leadership in the protected domestic alcoholic beverage market. In contrast, Hayleys is exposed to cyclical end-markets in some its business segments, which are also more fragmented. However, Hayleys' greater geographical and end-market diversity mitigate some of these risks while Melstacorp's operations are largely concentrated in Sri Lanka. Melstacorp's stronger FCF profile supports its ability to withstand weaker financial metrics than Hayleys for the same rating.

We rate domestic conglomerate Hemas Holdings PLC (AAA(lka)/Stable) at the same level as Hayleys on Hemas' defensive businesses, significantly stronger FCF, a record of measured expansion and stronger liquidity, which offset its smaller scale and limited geographical diversification compared with Hayleys. Nearly 90% of Hemas' EBITDA stems from healthcare and consumer-segments, while a number of Hayleys' end-markets, such as transportation and consumer-durable retail, are characterised by more cyclical demand. However, Hayleys is more diversified across businesses and geographies than Hemas, counterbalancing some of these risks. Hemas' stronger FCF supports wider financial metrics than Hayleys for the same rating.

Domestic conglomerate Sunshine Holdings PLC (AA+(lka)/Stable) is rated one notch below Hayleys to reflect its significantly smaller operating scale, limited geographical diversification and regulatory risks in some of its businesses, which are counterbalanced by its better financial profile with lower leverage. Sunshine has been more conservative with its expansion than Hayleys, growing only within its core businesses without significantly pressuring its balance sheet. In contrast, Hayleys has a history of debt-funded growth, resulting in a weaker balance sheet than Sunshine.

Hayleys is much larger in scale and has more defensive cash flows than Ceat Kelani Holdings Pvt Limited (CKH: AA+(lka)/Stable), warranting a one-notch higher rating for Hayleys. CKH faces competitive pressure from imports, is exposed to cyclical demand for vehicle tyres and its addressable market is relatively small. However, CKH has maintained a significantly stronger financial profile than Hayleys, reflected in cash on hand exceeding debt, mitigating CKH's business risks.

Hayleys' credit considerations lead to a higher rating than for large domestic banks, non-bank financial institutions and insurance companies, which are more exposed to sovereign stress due to holdings of large sovereign-issued securities for regulatory reasons. The large financial institutions also have a broader exposure to the various economic sectors.

KEY ASSUMPTIONS

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

- Revenue to remain flat in FY24 as any growth stemming from expansion and defensive end-markets will be offset by weak demand in key export markets such as the US and Europe and price pressure in some segments.

- Revenue to rise by around 10% from FY25, benefitting from demand recovery across most markets.

- EBITDAR margin to narrow by 200bp to 13% from FY24 amid lower volume, appreciation of the local currency and cost increases, which the company may not be able to fully pass on due to weak demand.

- Net working-capital cycle to remain around 100 days in FY24, helped by lower inventory days and continuation of the FY23 improvement in receivable days.

- Annual capex of around LKR13 billion over FY24-FY26, mainly on capacity expansion across most segments.

- LKR3.0 billion per annum spent on M&A to account for Hayleys' acquisitive nature even though the company has not provided any guidance on this.

- Annual dividend payment of LKR4.0 billion in FY24 as announced and 20% of net income thereafter, although the company has not publicly committed to a fixed dividend policy.

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 the Sri Lankan National Rating scale.

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

- Group net debt to EBITDAR increasing above 4.0x on a sustained basis (FY23: 2.3x);

- Group EBITDAR fixed-charge coverage falling below 2.0x on a sustained basis (FY23: 2.0x).

LIQUIDITY AND DEBT STRUCTURE

Manageable Liquidity: Hayleys had LKR39 billion in unrestricted cash at end-March 2023 against LKR94 billion in debt maturing in the next 12 months. About LKR65 billion of the debt consists of short-term working-capital lines, which we expect banks to roll over as they are backed by around LKR120 billion in net working capital and the company's healthy cash conversion cycle of around 100 days.

Hayleys had unused but uncommitted credit lines of LKR49 billion at FYE23, which also support liquidity in the normal course of business. We believe Hayleys will retain strong access to domestic banks, given its diversified cash flows and strong credit profile locally.

ISSUER PROFILE

Hayleys is a large domestic conglomerate with leading market positions in transportation, consumer and retail, textiles, rubber products, plantations and exports.

DATE OF RELEVANT COMMITTEE

19 May 2023

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
Hayleys PLC	Natl LT	AAA(lka)	New Rating	WD(lka)
senior unsecured	Natl LT	AAA(lka)	New Rating	

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer’s available public disclosure.

APPLICABLE CRITERIA

- National Scale Rating Criteria (pub. 22 Dec 2020)
- Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)
- Corporate Rating Criteria (pub. 29 Oct 2022) (including rating assumption sensitivity)
- Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 13 May 2023)

APPLICABLE MODELS

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

- Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

- Solicitation Status
- Endorsement Policy

- Potential Conflicts Resulting from Revenue Concentrations

ENDORSEMENT STATUS

Hayleys PLC -

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