FitchRatings

Fitch Affirms Sierra Cables at 'A+(lka)'; Outlook Stable

Fitch Ratings - Singapore/Colombo - 07 May 2024: Fitch Ratings has affirmed Sri Lankan cable manufacturer Sierra Cables PLC's National Long-Term Rating at 'A+(lka)'. The Outlook is Stable.

The affirmation and Stable Outlook reflect our view that Sierra will be able to maintain adequate financial metrics in the next 12 months. The improving trajectory in Sri Lanka's external finances and lower domestic interest rates should see more construction projects come back on to the market, in turn benefitting Sierra's cash flow.

Sierra's rating reflects its small operating scale and exposure to cyclical end-markets, as well as foreign-currency risk, which are mitigated by its prominent position in the domestic cable industry. Sierra has limited liquidity headroom - given high short-term debt - and is exposed to lenders' appetite to roll over working-capital facilities.

KEY RATING DRIVERS

Gradual Recovery in Domestic Demand: Fitch expects Sri Lanka's GDP to expand by around 3.3% in 2024, following successive contractions over the last two years (2023: -2.3%; 2022: -7.4%). We expect a gradual resumption of infrastructure projects both in the private and public sector, supported by falling interest rates and an improving trajectory in Sri Lanka's external finances.

Sierra's revenue from government tenders rose significantly by around 188% to LKR1.6 billion by 9MFY24 (fiscal year ends 31 March), from LKR559 million a year prior. Furthermore, Sri Lanka's construction sector achieved a third successive month-on-month growth in March, from a contraction of almost 12-months from January 2023, which Fitch believes signals a bottoming-out of sector activity.

Stabilised Working Capital: We expect Sierra's net working-capital days to decline to around 205 days in FY24 and 190 days in FY25, from around 240 days in FY23. The focus on cash sales has helped keep receivable days below 100 over the past two years. We expect inventory days to improve to around 120-130 days from FY24 (FY23: 185 days) more than offsetting less favourable credit terms from global suppliers, which have not yet recovered to levels before the height of Sri Lanka's recent economic challenges.

Moderating Margins: We forecast EBITDA to normalise to around 18% in FY24-FY25, from a high of 27% in FY23, as temporary benefits from selling lower-cost inventory acquired prior to the rupee's sharp depreciation dissipates. This, together with competition, will pressure margins over the medium term. Extraordinary EBITDA margins of around 27% in FY23 have since tapered down to around 21.3% as of 9MFY24, driven by a reduction in sales price as inflationary pressures eased.

Low Leverage, Rising Coverage: We estimate Sierra's EBITDA net leverage to improve to around 0.6x in FY25 (FY23: 0.8x), driven largely by higher revenue generation and improvements in working-capital requirements which should allow for some deleveraging over the next 12-18 months. We forecast interest cover to improve to 8.2x in FY25 (FY24 forecast: 3.7x), with financing costs falling further on lower debt and domestic interest rates, coupled with higher EBITDA generation.

Sri Lanka's monthly average weighted prime lending rate (AWPLR) fell to 10.1% by end-April 2024, from 21.5% a year prior. Most of Sierra's debt comprises short-term working-capital loans, which re-price faster than term debt, although it also exposes Sierra to higher costs should AWPLR rise.

Modest Rise in Exports: Sierra's shift towards international markets have brought benefits, as we estimate export revenues make up at least 10% of total revenue, up from historical levels of around 3%. As of end-April 2024, Sierra has received its quality certification specific to some regional markets, which will allow the company to manufacture cables with specifications fit for global industry standards. We expect Sierra to start producing these global standard cables by 2Q25, with shipments of goods expected in the next 12-18months.

Execution Risks in Expansion Plans: We believe Sierra's expansionary plans carry significant execution risks. This was seen in the recent amalgamation of its majority-owned subsidiary Sierra Industries, and liquidation of its Kenyan operations, Sierra Cables East Africa Limited. Sierra Cables has assumed Sierra's Industries' loans of around LKR58 million, as of end-December 2023. We expect Sierra to continue its expansion plans into east Africa, but successful execution of these plans with meaningful contribution to the group's business profile remains uncertain.

DERIVATION SUMMARY

Sierra's rating is comparable with that of peers such as Abans PLC (AA-(lka)/Stable), Vidullanka PLC (A+(lka)/Stable) and Singer (Sri Lanka) PLC (A(lka)/Stable).

Sierra is rated one notch below domestic consumer durable retailer Abans PLC, owing to the latter's stronger competitive position in consumer electronics manifesting in larger operating scale, broader product diversification, and greater financing flexibility in a domestic context. We expect Abans to consistently generate EBITDA of more than LKR4 billion in the next three years, with products ranging from whitegoods to consumer electronics. Sierra, on the other hand, manufactures mostly electrical cables and generates around LKR1.5 billion in EBITDA. Abans' business strengths more than offset Sierra's lower leverage.

Vidullanka, a Sri Lankan renewable energy producer, is rated at the same level as Sierra. Vidullanka has a comparatively larger operational scale, with EBITDA of around LKR2.5 billion and higher revenue visibility from long-term power purchase agreements from Ceylon Electricity Board and Uganda Electricity Board. Sierra's smaller scale is counterbalanced by lower counterparty risks, whose revenue is better diversified between private and government customers, with products of different specifications.

Singer, another domestic consumer durable retailer, is rated one notch below Sierra. Despite its larger scale and leading market position in consumer electronics, Singer's lower rating stems from its significantly higher net leverage, which Fitch forecasts at more than 10.0x, while coverage ratio is expected at less than 1.0x. Sierra's net leverage is estimated to remain below 1.0x over the next three years, with interest coverage improving from 3.7x in FY24 to 8.2x in FY25.

Sierra's credit strengths lead to a higher rating than some 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 increase to around LKR8.4 billion in FY25 (FY24 forecast: LKR8.2 billion), from LKR7.1 billion in FY23 as sales from tenders and dealer networks pick up.

- EBITDA margins to narrow to around 18.2% in FY24 and 17.9% in FY25, from 27% in FY23.

- Capex of around LKR250million-350million per annum.

- Annual dividend payment of LKR50 million from FY25.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/upgrade:

- A sustained and substantial improvement in the Sri Lanka sovereign's external financing position and the macroeconomic environment

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

- EBITDA net leverage over 4.0x for a sustained period

- EBITDA interest coverage falling below 1.5x on a sustained basis

- Significant weakening in the company's liquidity position

LIQUIDITY AND DEBT STRUCTURE

Tight Liquidity: Sierra had LKR538 million in unrestricted cash at end-December 2023, against LKR1.5 billion in repayments due in the next 12 months, of which around LKR1 billion were working-capital lines. Sierra has enough cash to pay its contractual maturities of around LKR468 million in the next 12 months. However, the company is entirely reliant on lenders' appetite to roll over working-capital-related debt amid Sri Lanka's weak operating environment.

Sierra's working-capital cycle has improved in the last nine months, and we expect it to be sustained at similar levels. As of end-December 2023, working-capital debt of around LKR1.5 billion compares well with over LKR3.5 billion in net working-capital assets.

ISSUER PROFILE

Sierra is the third-largest cable manufacturer in Sri Lanka, with a broad range of products for several end-market uses.

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
Sierra Cables PLC	Natl LT	A+(lka)	Affirmed	A+(lka)

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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)
- Corporate Rating Criteria (pub. 04 Nov 2023) (including rating assumption sensitivity)

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

Sierra Cables PLC -

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