FitchRatings

RATING ACTION COMMENTARY

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

Thu 30 Sep, 2021 - 4:52 AM ET

Fitch Ratings - Colombo - 30 Sep 2021: 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(lka)'. The Outlook is Stable.

Fitch rates DIST based on the consolidated profile of Melstacorp due to strong legal and operational linkages between the two entities, as defined in our Parent and Subsidiary Rating Linkage criteria.

Melstacorp's rating reflects its leadership in the domestic spirits market which has helped the group's cash flows to remain resilient through the Covid-19 pandemic, despite temporary but material losses in sectors such as leisure. The ratings could come under pressure if Melstacorp continues to make large investments that dilute the cash-flow stability of its spirits business or are not immediately cash-flow accretive.

KEY RATING DRIVERS

'Strong' Linkages: DIST, which is stronger than its parent Melstacorp, contributes more than 70% to the group's consolidated EBITDA via its spirits business. We view the linkages between the two entities as 'Strong', as reflected in a high level of ownership and control of DIST by Melstacorp - including sharing the same board of directors and unrestricted cash-flow fungibility between the two entities.

Defensive Performance in Spirits: We expect spirits to remain resilient in the next 12-18 months despite ongoing disruptions from the pandemic. The segment grew by 3% in the financial year ending 31 March 2021 (FY21), despite liquor stores being closed for almost three months. The sector's recovery following the lifting of lockdowns has been robust, reaching pre-pandemic levels within a short period, reflecting the 'defensive' nature of the sector and pent-up demand.

We expect revenue growth in spirits to moderate from weaker incomes and an escalating cost of living, which could lead lower-income consumers in particular to cut spending or shift to the cheaper illicit market. DIST has products across all price points, which should mitigate such risk, but may face difficulty in passing on cost increases or potential tax hikes as consumers become more price-sensitive. Spirits are less exposed than beer to import restrictions or currency depreciation, due to the lower amount of imported inputs in the manufacturing process, which should contain cost surges.

Potential Excise Tax Hike: We believe the government may increase excise tax on alcoholic beverages in the near term amid its weakening finances. However, tax revenue from this sector grew to 10% in 2020 from a typical 7%, as revenue from other sources has declined amid the pandemic. We believe any tax hikes will not be too prohibitive, to prevent consumers shifting to the illicit market which could lead to national revenue loss.

Gradual Recovery in Leisure: We expect Melstacorp's leisure segment, held via its 51% share in Aitken Spence PLC (ASP), to post positive EBITDA in FY22 following a LKR2.0 billion EBITDA loss in FY21 based on Melstacorp's share. The recovery will be led by ASP's Maldives operations, which accounts for around 60% of segment EBITDA, amid improving tourist arrivals and occupancy levels since late-2020. The booking for the winter season is in line with pre-pandemic levels, as travel restrictions have been eased in most of its feeder markets such as Europe, India and the Middle East.

We expect the recovery in ASP's Sri Lankan operations to be much slower amid high ongoing Covid-19 rates in the country, domestic lockdowns and travel restrictions in key markets. The government has fast-tracked the inoculation drive with the intention of opening the country for tourism by year-end. However, the success of this programme is yet to be seen, and we forecast a full recovery in the domestic leisure sector only towards end-2022. We expect the domestic segment to continue its operating losses in FY22, but will be offset by strong performance in the Maldives.

Margins to Improve: We expect Melstacorp's EBITDA margin to widen to 24% by FY23 from 22.3% in FY21, benefitting from a revenue mix shift to high-margin spirits, power, and maritime and logistics. Leisure's recovery should also support margins, but we expect leisure's contribution to fall to around 16% of group EBITDA from a traditional 20%. We expect cost escalations across most segments, including beverages, amid domestic inflation and currency depreciation. However, cost pass-through may become difficult in a weak operating environment, and could pressure margins.

Low Leverage Despite Investments: We expect Melstacorp's net leverage - defined as net adjusted debt/operating EBITDAR (including Melstacorp's 51% share of ASP's net debt and EBITDAR, but excluding its insurance subsidiary) - to fall below 2.5x from FY23 (FY21:2.5x) amid rising EBITDAR. We believe investments will resume from FY23, at around LKR5 billion per annum. Melstacorp is looking to expand further into consumer and healthcare, but the contribution from these investments will be less than 5% to EBITDA in the near term.

DERIVATION SUMMARY

In comparison with Dialog Axiata PLC (AAA(lka)/Stable), Melstacorp's operations are smaller in scale (albeit more diversified), as a significant portion of the country's alcoholic-beverage consumption occurs outside the formal sector, which is not recorded. In contrast, Dialog's larger operating scale reflects 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 hikes, 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 that of Dialog, and most of its investments are discretionary.

Local conglomerate Hemas Holdings PLC (AAA(lka)/Stable) and market leader in the domestic beer market 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 FCF generation stronger than its peers. Melstacorp's rating also reflects its larger scale than Hemas and Lion, supported by its strong market position in the relatively large domestic spirits market.

Lakdhanavi Limited (AA+(lka)/Stable) is a Sri Lanka-based power generation and engineering and construction company, and its rating reflects cash-flow stability from fixed long-term contracts and significant revenue generation from overseas operations. Fitch rates Lakdhanavi one notch below Melstacorp, to reflect its counterparty risk from its exposure to Ceylon Electricity Board (AA-(lka)/Stable) and its large investments which will keep leverage high in the next few years.

Melstacorp, given its credit strengths, is rated higher than a number of large banks, non-bank financial institutions and insurance companies in the country. Despite their individual credit strengths, these large financial institutions are more exposed to sovereign stress than Melstacorp, due mainly to the substantial sovereign-issued securities held for regulatory reasons; and in the case of the banks and non-bank financial institutions, their broader exposure to numerous sectors in the local economy amid the weak operating environment.

KEY ASSUMPTIONS

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

- Revenue to increase by the low-single digits in FY22 amid a gradual recovery in the leisure sector and growth in maritime and logistics operations. Revenues to reach pre-pandemic levels by FY23, helped by a full recovery in the leisure sector

- EBITDA margin to stabilise at around 24% from FY23, benefitting from a revenue mix-shift towards the high-margin beverage, power and maritime and logistics segments and recovery in the leisure sector

- Smaller excise-tax hikes, as the government is likely to be mindful of falling revenue collection if demand were to decline

- Capex to average around LKR2.5 billion per annum over the next two years, spent mainly on maintenance

- Group to resume M&A and other investments from FY23, with an average annual spend of LKR5 billion

- Dividend pay-out of LKR3.5 billion per year over FY22-FY25

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 Aitken Spence PLC but excluding Continental Insurance Lanka Limited (National Insurer Financial Strength: A(lka)/Stable)) - rising to over 5.5x for a sustained period.

- Group operating EBITDAR/interest paid + rent (including 51% consolidation of Aitken Spence PLC but excluding Continental Insurance Lanka Limited) falling below 1.8x for a sustained period (FY21: 3.2x).

- Weakening in the group's business risk profile, as reflected in a significantly lower EBITDA contribution from the beverage segment, due to large investments in other riskier businesses without a commensurate improvement in leverage, or due to a weaker competitive position in spirits.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity Position: Melstacorp had about LKR17 billion in unrestricted cash at end-June 2021 to meet LKR25 billion of debt maturing within the following 12 months. Around LKR20 billion of the near-term maturities are working capital-related debt, which we expect to be rolled over in the normal course of business - given the group's stable cash-flow generation. The group's liquidity position is also strengthened by LKR33 billion in uncommitted but unutilised credit facilities, which we believe the local banks will honour due to Melstacorp's position as one of Sri Lanka's largest corporates and its solid credit profile.

ISSUER PROFILE

Melstacorp PLC is a leading Sri Lankan conglomerate with exposure to the spirits, telcos, plantation, leisure, maritime and logistics, and power sectors. Melstacorp's core spirits business is carried out by its subsidiary Distilleries Company of Sri Lanka PLC (DIST:AAA(lka)/Stable).

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(lka) Rating Outlook Stable	Affirmed	AAA(lka) Rating Outlook Stable
Distilleries Company of Sri Lanka PLC	Natl LT	AAA(lka) Rating Outlook Stable	Affirmed	AAA(lka) Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Nadika Ranasinghe
Director
Primary Rating Analyst
+94 11 2541 900
nadika.ranasinghe@fitchratings.com
Fitch Ratings Lanka Ltd.
15-04 East Tower World Trade Center Colombo 00100

Azim Nawaz
Analyst
Secondary Rating Analyst
+94 11 2541 900
azim.nawaz@fitchratings.com

Hasira De Silva, CFA
Senior Director
Committee Chairperson
+65 6796 7240
hasira.desilva@fitchratings.com

MEDIA CONTACTS

Kyoshi Quyn
Colombo
+94 11 2541 900
kyoshi.quyn@fitchratings.com

Peter Hoflich
Singapore
+65 6796 7229
peter.hoflich@thefitchgroup.com

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

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

National Scale Rating Criteria (pub. 22 Dec 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	-

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, THE FOLLOWING HTTPS://WWW.FITCHRATINGS.COM/RATING-DEFINITIONS-DOCUMENT DETAILS FITCH'S RATING DEFINITIONS FOR EACH RATING SCALE AND RATING CATEGORIES, INCLUDING DEFINITIONS RELATING TO DEFAULT. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE OR ANCILLARY SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF PERMISSIBLE SERVICE(S) FOR WHICH THE LEAD ANALYST IS BASED IN AN ESMA- OR FCA-REGISTERED FITCH RATINGS COMPANY (OR BRANCH OF SUCH A COMPANY) OR ANCILLARY SERVICE(S) CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

READ LESS

COPYRIGHT

US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Corporate Finance Industrials and Transportation Retail and Consumer Asia-Pacific

Sri Lanka