FitchRatings

Fitch Affirms Sunshine Holdings at 'A-(lka)'; Outlook Stable

Fitch Ratings-Colombo-14 November 2018: Fitch Ratings has affirmed Sri Lanka-based Sunshine Holdings PLC's National Long-Term Rating at 'A-(lka)'. The Outlook is Stable.

The rating on Sunshine reflects its strong market positions in its diversified portfolio of products, which has elements of relatively defensive end-market demand, and the strong brand names associated with most of its offerings. These strengths are counterbalanced by the heightening regulatory risk faced by the pharmaceutical import and distribution business and the exposure to commodity price volatility in its palm oil and tea plantation businesses.

The rating also takes into account Fitch's expectations that Sunshine's net leverage - defined as lease-adjusted net debt/operating EBITDAR including proportionate consolidation of Estate Management Services (Private) Limited (EMSPL), the holding company for the agriculture and consumer goods segments - is likely to remain below 3.0x over the medium term. The financial profile has improved following a recent equity infusion and net leverage has fallen, , but over the medium term, free cash generation should improve as capex requirements have moderated.

KEY RATING DRIVERS

Equity Injection Reduces Net Leverage: Sunshine's net leverage improved to around 2.1x by end-September 2018, from 2.4x at end-March 2018, supported by LKR775 million in proceeds from an equity issuance to SBI Ven Holdings Pte Limited in July 2018. Fitch expects Sunshine to use the proceeds to pay down debt, which increased after Sunshine used debt to increase its stake in EMSPL. We expect the company's moderation in capex, resilient profitability in the palm oil business and high-margin diagnostics, wellness and beauty sectors to help maintain Sunshine's net leverage at below 3.0x over the medium term.

Healthcare Margins to Shrink: Fitch believes the second round of government price caps on 23 essential drugs and two medical devices in September 2018 and the depreciating Sri Lankan rupee will reduce Sunshine's healthcare-sector profitability. We expect healthcare EBITDA margins to fall to 5.9% in the financial year to March 2019 (FY19) from 6.5% a year earlier, but should recover from FY20 due to improvement in sales volume of drugs and growing contribution from the higher-margin diagnostics, wellness and beauty segments. Nevertheless the more frequent government price controls underscore the regulatory risk for the business.

Palm Oil Key Agri Contributor: We expect the palm oil segment to continue to be the key driver of growth in operating cash flows from the agricultural segment in the medium term. Global crude palm oil (CPO) prices decreased to average USD535/tonne in 3Q18 from around USD650/tonne in 2017 due to robust output and a more challenging export market. However Sunshine's domestic prices started to increase from 2QFY19 due to the depreciating Sri Lankan rupee and a recent increase in import duty. Fitch sees the risk of sustained pressure on global CPO prices, although the impact domestically will be softened by the higher duty and rupee weakness.

Fitch believes the segment's profitability to be supported by resilient domestic demand for palm oil. Sunshine is well-positioned to benefit from growing local demand as it is the largest palm oil producer in Sri Lanka, accounting for more than 50% of domestic output. Palm oil is the largest contributor to Sunshine's profit, making up almost 25% of the group's proportionate EBITDA in FY18.

Volatile Tea Segment: Fitch expects the tea plantations' cash flow volatility to continue over the medium term due to lower land and labour productivity, and cost pressures arising from periodic wage increases. The tea plantation business's operating performance improved significantly in FY18 as a result of persistently high auction prices, with operating margin reaching 11.1% from 3.9% in FY17. However, operating margin was just 2.6% in 1H FY19 due to weaker prices. We expect supply-side pressures, ensuing cost escalations and volatile demand to hinder the segment's long-term viability.

Tea Retail Offsets Volatility: Fitch believes Sunshine's branded-tea segment will partly offset the volatility in the tea planation segment's profitability. The branded-tea segment's EBITDA margin declined in FY18 to 8.4% from 8.9% FY17 as a result of higher tea prices in the Colombo Tea Auction over 2017. The situation reversed when tea prices declined in 1H FY19, enabling the segment to improve margins, which partly countered the weaker profitability in the tea plantation segment. However, we expect the intense price competition, particularly in the lower-end of the market, to keep the branded-tea segment's margins in check over the medium term.

Power, Dairy Improve Cash Generation: Fitch expects the capacity expansions in Sunshine's power and dairy segments to increasingly contribute to cash generation and as such stabilise consolidated cash flows in the long term by reducing the share of contribution from the volatile tea and palm oil businesses. We estimate that the energy segment to annually contribute LKR180 million to EBITDA in the next two years. Contribution to EBITDA from the dairy business, which we estimate to be around LKR80 million-120 million, should start from FY20 when the farm reaches its full capacity.

DERIVATION SUMMARY

Sunshine is rated one notch lower than Richard Pieris & Company PLC (RICH, A(lka)/Stable) because RICH has a stronger business risk profile due to lower exposure to the cyclical plantation segment than Sunshine, as well as substantially higher cash flow from its defensive grocery retail business and larger operating scale.

Singer (Sri Lanka) PLC (A-(lka)/Stable) is a leading consumer durables retailer that has a stronger business-risk profile than Sunshine and a significantly larger operating scale, despite greater operating cash flow volatility. However, this is offset by Singer's much higher leverage, which results in both companies having the same rating.

DSI Samson Group (Private) Limited (DSG, BBB+(lka)/Stable) is the market leader in the domestic rubber tyre and footwear markets and has a business-risk profile similar to that of Sunshine. However, DSG is rated one notch below Sunshine due its significantly higher leverage.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Revenue to rise by 20% in FY19 (FY18: 12.7%) reflecting Sunshine's larger stake in EMSPL; and then to increase by mid-single digits over the next two years
- EBITDAR margins to be maintained in the low-double-digit range over FY18-FY21 (FY18: 12.0%)
- Capex of LKR3.4 billion over FY19-FY22 for expansion across the board
- Dividend pay-out to be 30% of net profits over FY19-FY22

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action
- A sustained reduction in Sunshine's lease-adjusted debt net of cash/EBITDAR (including proportionate consolidation of EMSPL) to below 1.5x

Developments that May, Individually or Collectively, Lead to Negative Rating Action
- An increase in Sunshine's lease-adjusted debt net of cash/EBITDAR (including proportionate consolidation of EMSPL) to over 3.0x for a sustained period
- Sunshine's EBITDAR coverage of gross interest + rent (including proportionate consolidation of EMSPL) falling below 2.0x for a sustained period
- Adverse impact on growth and profitability arising from sustained regulatory pressure in the healthcare and agriculture segments

LIQUIDITY

Satisfactory Liquidity: Sunshine had LKR1.1 billion of unrestricted cash and LKR2.6 billion in unutilised credit facilities as at end-March 2018 to meet LKR1.5 billion of debt repayment falling due in the next 12 months, which places the company in a comfortable liquidity position. More than 50% of the debt maturities in the next 12 months are short-term working capital lines and we expect banks to roll over these facilities as they fall due in the normal course of business.

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Applicable Criteria
Corporate Rating Criteria (pub. 23 Mar 2018)
National Scale Ratings Criteria (pub. 18 Jul 2018)

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