Fitch Affirms Hemas Holdings at 'AA-(lka)'; Outlook Stable

Fitch Ratings-Colombo-13 May 2019: Fitch Ratings has affirmed Sri Lanka-based conglomerate Hemas Holdings PLC's (Hemas) National Long-Term Rating at 'AA-(lka)' with a Stable Outlook.

The affirmation of Hemas' rating reflects the company's improved business risk profile after the successful integration of Atlas Axillia (Private) Limited (Atlas), a leading school and office stationery manufacturer, which it acquired in early 2018. The acquisition has helped to increase the EBITDAR contribution from the defensive fast-moving consumer-goods (FMCG) segment from 35% to around 55%. However, this positive development is counterbalanced by profitability pressure on Hemas' pharmaceutical-distribution business, a slowdown in its Bangladesh FMCG operations and weak demand for its leisure segment, which limit any positive rating action in the short term.

The affirmation also reflects Fitch's view that Hemas' net leverage, defined as adjusted net debt/operating EBITDAR, will remain comfortably below 1.0x over the next two years (nine months ended 31 December 2018 (9MFY19): 0.8x) amid moderating capex, barring any significant M&A activity.

Key Rating Drivers
Successful Integration of Atlas: We believe Hemas has successfully consolidated Atlas with its FMCG operations over the past 15 months with Atlas contributing around 16% of the group's topline and around 25% to EBIT in 9MFY19, in line with our expectations. Management has said there is room for further synergies as the combining of Atlas' distribution network with that of its parent has yet to be completed. Atlas has introduced a degree of seasonality to Hemas' operations but we believe management has been able to successfully manage the implications by efficiently managing working capital and finance costs.

Atlas is the largest domestic manufacturer and distributor of exercise books, pens, colour products and other school stationery with a strong distribution network spanning over 70,000 outlets islandwide. We believe Atlas' stationery business is defensive across economic cycles, which will help to improve Hemas' overall cash flow stability.

Regulatory Pressure in Pharma: Hemas' pharma-distribution segment has been experiencing significant margin pressure over the past 12-18 months due to currency-led cost escalations across most of its product portfolio. Hemas has absorbed most of the cost increases in the absence of a regulator-approved pricing formula. We do not expect a change in the government's stance in the near term in light of the impact that a price increase will have on consumer costs. Hemas is in the process of introducing cost-efficiency measures to improve its margins.

On the other hand, the introduction of price ceilings by the authorities on certain essential drugs has led to only a limited impact with only a small percentage of the Hemas Pharmaceutical distribution portfolio being regulated. The price ceilings have actually helped Hemas to increase market share with the exit of brands from the market.

Expansion in Other Healthcare Businesses: We expect Hemas' local drug-manufacturing arm and its hospital chain to help offset pressures in the pharma-distribution segment in the medium term. Its new drug manufacturing plant, which would double Hemas' current capacity, will commence commercial operations by 3Q20 and will cater mainly to government demand through long-term contracts. There has also been increasing demand from foreign principals to produce certain drugs locally to counter the currency impact on Hemas' margins, and the company is actively looking at allocating part of its capacity for this purpose. We expect Hemas'

hospital chain to maintain its current trajectory of earnings growth in the medium term on the back of favourable demand dynamics and the introduction of value-added services.

Mixed Performance in FMCG: We believe the recent margin improvement in Hemas' FMCG business, led by the domestic home and personal-care business, will be sustained in the medium term amid better sourcing strategies and cost efficiencies across the distribution network. However, we expect domestic demand for home and personal-care products to remain somewhat sluggish in the near term due to the weak economic and political environment prevailing in the country. We also do not expect a material increase in the earnings contribution from Hemas' Bangladesh operations in the next 12-18 months as we believe the company will continue to make investments to defend its market share and expand its distribution network, which will keep its profitability below historical levels.

Manageable Impact on Leisure: We believe Hemas' leisure sector will be the most affected by the recent terror attacks in the country, which targeted places of worship and luxury hotels. The incidents have resulted in flight cancellations of almost 85% to the country and cancellations in hotel bookings of almost 50% for the next two months, according to government estimates. The government expects tourist arrivals to the country in 2019 to drop to 2 million from an earlier estimate of 2.5 million. This will adversely affect occupancy levels at Hemas' hotels and its inbound-travel businesses. Still, we believe the impact will be manageable as the leisure sector contributes only around 6% of group EBIT .

Balance Sheet to Strengthen: We expect Hemas' net adjusted leverage to remain flat at less than 1.0x through FY20 amid modest capex spending on expansion in its healthcare and mobility sectors. We expect capex to reduce to around 2% of revenue once the new drug manufacturing plant is completed in FY20. Consequently, we expect Hemas to meet its capex obligations and shareholder returns entirely through internally generated funds from FY21.

Derivation Summary

Hemas is a well-diversified conglomerate with exposure to defensive pharmaceutical and FMCG sectors. It is rated at the same level as Lion Brewery (Ceylon) PLC (AA-(lka)/Stable), whose rating reflects market leadership in the local beer industry, helped by high entry barriers and strong EBITDAR margins. Hemas also has similar leverage as Lion. Hemas is rated two notches above local conglomerate Richard Pieris & Company PLC (A(lka)/Stable) to reflect Hemas' lower leverage and higher exposure to defensive end-markets compared with Richard Pieris' exposure to more volatile segments such as plantations and the domestic tyre market. Hemas is rated three notches above diversified conglomerate Sunshine Holdings PLC (A-(lka)/Stable) due to its stronger business profile stemming from substantially higher cash flows from its defensive pharmaceutical and FMCG businesses, and its larger operating scale. Sunshine's financial profile has weakened compared with that of Hemas due to its debt-funded acquisition in the cyclical plantation sector.

Key Assumptions

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

- Revenue growth to average in the high single digits in the next two years with strong contributions from its FMCG and healthcare businesses, which will more than offset headwinds in the leisure segment.
- EBITDAR margins to expand around 120bp to 12.3% over FY19-FY22, helped by cost efficiencies in the domestic FMCG business, increased contribution from the high-margin Atlas and better capacity utilisation in the hospital and mobility segments. These improvements will more than offset the currency-related cost pressures in the pharma-distribution business, continued investments into the more competitive Bangladesh market and high fixed costs in the leisure sector.
- Capex of LKR2.9 billion in FY20 and LKR1.7 billion in FY21, mainly spent on the expansion of the healthcare segment.
- No significant M&A activity in the next 18-24 months.
- Holding company's dividend payout to shareholders to remain at 40% of net income over the forecast period to FY22.

RATING SENSITIVITIES
Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Improvement in business risk profile while maintaining the current financial profile.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Group net adjusted debt/EBITDAR rising above 3.0x on a sustained basis
- Any deviation from the company's conservative approach to new investment

Liquidity and Debt Structure
Strong Liquidity Position: As at end-December 2018, Hemas had about LKR7.8 billion of unrestricted cash and LKR10.4 billion in unutilised credit facilities to meet LKR10.8 billion of debt maturing in the next 12 months, leaving the company in a comfortable liquidity position. We expect Hemas' capex requirements in the next 12 months to be met through internally generated funds, further easing the pressure on its liquidity position. Most of the debt maturing in the near term are short-term working capital-related debt, which we expect to be rolled over by lenders in the normal course of business.

Hemas Holdings PLC; National Long Term Rating; Affirmed; AA-(lka); RO:Sta

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Applicable Criteria
National Scale Ratings Criteria (pub. 18 Jul 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)

Additional Disclosures

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