16 May 2019 | Affirmation

Fitch Affirms Richard Pieris & Company at 'A(lka)'; Outlook Stable

Fitch Ratings-Colombo-17 May 2019: Fitch Ratings has affirmed Sri Lanka-based conglomerate Richard Pieris & Company PLC's (RICH) National Long-Term Rating at 'A(lka)' with a Stable Outlook.

The affirmation of RICH's ratings reflect the group's substantial defensive cash flows stemming from its leading supermarket retail business, and diversification afforded by its export and plastics businesses. These strengths are counterbalanced by the challenges the company faces in the volatile plantation sector, as well as the structurally declining domestic tyre-retreading business, which together account for around 20% of the group's EBITDA.

We expect RICH's leverage, defined as net adjusted debt/operating EBITDAR (excluding its finance company subsidiary, Richard Pieris Finance Limited (RPF)) to increase to around 2.6x in the next 12-18 months from 2.2x as at end-December 2018, as operating challenges are likely to continue in its plantation, tyre and plastics sectors, along with elevated capex and shareholder returns. However, we expect RICH to maintain leverage below 3.0x, which is in line with its ratings.

KEY RATING DRIVERS

Exports to Drive Expansion: We regard RICH's export segment to be the main growth driver in the medium-term, helped by favourable demand dynamics. RICH plans to substantially increase the capacity of its natural-foam mattress segment, which contributes around 65% of export segment revenue, by the year ending March 2020 (FY20), as the plant is currently running at significantly high capacity utilisation and there is strong customer demand from the US and Europe as well as new markets, such as China.

RICH says it will focus more on exporting high-margin value-added products to China, rather than the more commoditised products sent to other markets, and expects a multi-fold increase in export quantity in the next 12-18 months. This should bode well for the segment's top-line and margin.

Steady Retail Growth: We expect RICH to retain its conservative approach to expanding its retail segment over the next 12-18 months amid a slowdown in consumer-purchasing power. We believe the pace of RICH's new-store openings to be moderate - in contrast to the aggressive growth plans

of its two closest peers - to preserve margins under the weak demand conditions. The company's approach saw it sustain its retail EBIT margin in the mid-single- digits in 9MFY19, while competitor margins fell to low-single-digits. Over the medium-term, we expect RICH's retail sector to benefit from favourable demand, including higher per capita income, rising urbanisation and low supermarket penetration in the country.

Increased Pressure in Plantations: We expect volatile global tea and rubber prices in the next couple of years stemming from lower demand and oversupply to adversely impact RICH's plantation sector, which has significant exposure to these two crops at around 80% of sector revenue. We also forecast cost pressure to mount in the short- to medium-term due to higher plantation-sector wages and rising input costs, such as pesticides and weedicides.

RICH's tea and rubber EBIT margin contracted to 1.5% in 9MFY19, from 8.9% in FY18, but we expect most of the margin pressure to be absorbed by the steady performance of RICH's palm-oil operations, which are benefitting from strong domestic demand and price protection. The majority of the company's palm-oil crop is entering a high-yield phase, which should boost revenue and profit contribution to the group. However, the sector's long-term growth has been curtailed with a government ban on new plantations due to environmental concerns, with no visibility as to when the ban will be lifted.

Slow Turnaround in Plastics and Tyres: We expect a turnaround in RICH's plastic segment, led by polyurethane mattresses, which contribute around 50% of segment revenue. The plastic segment is seeing better margins after a significant supply shortage in a key raw material for almost 18 months. However, domestic demand for mattresses as well as water tanks is likely to stay weak due to lower discretionary income and a slowdown in the construction industry. RICH plans to expand into regional markets to offset the low domestic demand, but it may take time to generate meaningful returns.

We expect a turnaround in the tyre sector to be much slower than the plastic segment, as the revenue decline in the tyre retreading business may not be fully mitigated for a number of years with a shift to the trading business, which faces intense competition and low margins.

Flat Margins: We expect RICH's EBITDA margin to remain at around 10.5% to 11.0% (FY18: 10.9%) over the next two to three years, with higher export segment margins offset by pressure in the retail segment caused by rising wages and input costs in the plantation sector. We do not foresee the group's EBITDAR margin returning to the historical highs of more than 12% owing to continuous margin pressure in the tyre-treading business and across most product categories in the plastic segment due to lower demand.

Weakening Leverage: We expect net leverage to increase to around 2.6x over the next 12-18 months due to the weak operating performance across most segments, capacity expansions in high-growth sectors and high shareholder returns. We believe internally generated funds will be insufficient to meet its capex requirement of LKR5.6 billion over FY19 to FY20 and shareholder returns, which mean RICH will require external funding. Net adjusted leverage should improve closer to 2.0x from FY21 if capex pressure eases and core operations turn around as we expect.

Criteria Variation: Fitch's Corporate Rating Criteria allows for the deconsolidation of subsidiaries that are regulated banks from the financials of an industrial parent company when assessing the parent's credit rating. RPF, which is 100%-owned by RICH, is a regulated finance company and not a bank, but local regulations for finance companies are similar to those applicable to local banks. Therefore, Fitch has removed RPF's borrowings, cash balance and EBITDA from RICH's consolidated financials. We do not expect RICH to inject new capital into RPF in the next two years in light of the subsidiary's comfortable capital adequacy ratios vis-a-vis its growth plans.

DERIVATION SUMMARY
RICH is a diversified conglomerate with exposure to both defensive sectors and growth markets. The company is rated two notches below Hemas Holdings PLC (AA-(lka)/Stable), another Sri Lanka-based conglomerate, and Lion Brewery (Ceylon) PLC (AA-(lka)/Stable), the country's leading brewer, to reflect RICH's higher exposure to the cyclical plantation sector and the structurally declining tyre sector, which increases its business risk.

Sunshine Holdings PLC (A-(lka)/Stable), another domestic conglomerate, is rated one notch below RICH to reflect its smaller operating scale, higher exposure to the cyclical plantation sector and regulatory risk in pharmaceuticals, which more than offset Sunshine's lower leverage. RICH is rated one notch above the leading consumer durables retailer, Singer (Sri Lanka) PLC (A-(lka)/Stable), to reflect RICH's lower leverage.

KEY ASSUMPTIONS
Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Revenue growth to average in the low-double-digits from FY20-FY22 owing to retail and export sector capacity expansion and a turnaround in the plastic segment, which will be somewhat offset by challenges in the plantation sector and the structural decline in the tyre business.
- EBITDAR margin to remain around 10.5%-11.0%, helped by a margin improvement in the export and plastic segments, which will mitigate cost escalation in the plantation and tyre segments and expansion-related expenses in the retail business.
- Capex to average LKR2.0 billion-2.5 billion a year from FY20-FY22 to fund the expansion of the

retail and export segments.
- Dividend payout ratio of around 40% of net income to be maintained.
- No further equity infusions into RPF in the next two years

RATING SENSITIVITIES
Developments That May, Individually or Collectively, Lead to Positive Rating Action
- A sustained improvement in adjusted net debt/EBITDAR (adjusted for finance subsidiary) to below 2.0x (End-December 2018: 2.2x).
Developments That May, Individually or Collectively, Lead to Negative Rating Action
- An increase in adjusted net debt/EBITDAR (adjusted for finance subsidiary) to over 3.0x for a sustained period. This sensitivity has been tightened to reflect Fitch's revised approach of excluding RPF's debt, cash, and EBITDA.
- Adjusted EBITDAR coverage of gross interest and rent (adjusted for finance subsidiary) falling below 2.5x for a sustained period (end-December 2018: 2.5x).
- Significant investments in non-core businesses that could hurt group profitability or cash flow generation.

LIQUIDITY
Manageable Liquidity: RICH had around LKR6.8 billion of unrestricted cash and LKR3.2 billion in unutilised credit facilities at end-2018 to meet LKR11.2 billion of debt (excluding RPF) maturing in the next 12 months. However, around LKR9.0 billion of short-term debt consists of working-capital facilities, which we expect to be rolled over by lenders in the normal course of business, easing liquidity pressure. RICH's free cash flows are likely to remain negative in the next 12 months owing to its weak operating performance, continuous capex and shareholder returns.

CRITERIA VARIATION
Fitch's Corporate Rating Criteria allows for the deconsolidation of subsidiaries that are regulated banks from the financials of an industrial parent company when assessing the parent's credit rating. Fitch has applied this approach in assessing RICH's National Long-Term Rating, whereby we have removed RPF's borrowings, cash balance and EBITDA from RICH's consolidated financials. Although not a bank, RPF is a regulated finance company and local regulations for finance companies are drawn along similar lines of those applicable to local banks.

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Applicable Criteria

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

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