FitchRatings

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

Fitch Ratings-Colombo-18 June 2019: Fitch Ratings has affirmed Sri Lanka-based Sunshine Holdings PLC's National Long-Term Rating at 'A-(lka)'. The Outlook is Stable.

The affirmation reflects the company's improved business-risk profile after exiting its tea-plantation business, which lowers the group's reliance on volatile cash flow from the structurally weak segment. Disposal proceeds and robust operating performance by some of the group's key operating segments, such as palm-oil plantations and healthcare, should help keep Sunshine's net leverage - defined as lease-adjusted net debt/operating EBITDAR, including proportionate consolidation of 60% owned subsidiary, Estate Management Services (Private) Limited (EMSPL) - at around 1.5x, the level below which we may upgrade the rating. However, a number of medium-term challenges may prevent the company from sustainably reducing leveage below this threshold, including heightened regulatory risk in the pharmaceutical-distribution business, execution risk surrounding the dairy-production business and commodity-price volatility in its palm-oil business.

EMSPL - the holding company for the agriculture and consumer-goods segments - sold its 51.0% stake in Hatton Plantation PLC (HPL) to Lotus Renewable Energy (Private) Limited (LREL) for a cash consideration of LKR1 billion on 28 May 2019. EMSPL will dispose of its remaining 24.6% stake to LREL by exercising a put option that will generate additional inflow of LKR484 million, bringing the total proceeds from the disposal to LKR1.5 billion.

Sunshine's rating continues to reflect its leading market position in its diversified portfolio of products, which has elements of defensive end-market demand and strong brand names associated with most of its offerings.

## Key Rating Drivers

Lower Cash Flow Volatility: Fitch expects that the sale of the tea-plantation business will lower Sunshine's cash-flow volatility to some extent; the segment's operating performance has been weak due to volatile tea prices, low resource productivity and cost pressure arising from periodic wage increases. The segment's EBITDA margin plunged to 3.7% in the financial year ending March 2019 (FY19), from 15.9% in FY18, due to weaker auction prices and demand. We believe Sunshine's expanding exposure to the dairy business, which made an operating loss of LKR134 million in FY19 on high start-up costs, will somewhat offset the improved business-risk profile stemming from the tea-plantation disposal. Watawala Plantations PLC, Sunshine's main agriculture business, increased its stake in Watawala Dairy Limited to 100%, from 68.25%, for consideration of LKR180 million and infused LKR1 billion as equity capital into the operation. We expect the dairy business to reach breakeven at the EBITDA level from FY21, contributing around LKR150 million to EBITDA. This is supported by rising domestic demand and the regulatory minimum selling price of LKR70/litre for domestically prodcued milk.

Strengthening Balance Sheet: Fitch expects Sunshine to maintain net leverage at around 1.5x in the medium term, supported by net cash inflow of LKR0.9 billion, which is Sunshine's 60% share of the LKR1.5 billion in proceeds from the disposal of HPL. Furthermore, the resilient operating performance by the palm-oil business and high-margin diagnostics, wellness and beauty sectors should help Sunshine contain net leverage; net leverage improved to 1.7x in FY19, from 2.5x a year earlier, following LKR775 million in proceeds from a July 2018 equity issuance to SBI Ven Holdings Pte Limited.

Palm Oil Supports Profitability: We expect the palm-oil segment to remain the group's key source of operating cash flow in the medium term. Global crude palm oil (CPO) prices weakened to average USD470/tonne in 1Q19, from around USD630/tonne in 1Q18, due to robust output and challenging export-market conditions. Nevertheless, Sunshine was able to realise higher prices from its domestic sale of palm oil in FY19, at USD1,165/tonne, including import duties. The rapid depreciation in the Sri Lankan rupee in 3QFY19 also boosted palm-oil revenue in local currency terms. Fitch expects CPO prices to average USD555/tonne in 2019 and USD600/tonne in 2020 and uses USD1,068/tonne and USD1,155/tonne, respectively, to derive Sunshine's palm-oil revenue. The impact of global price volatility is somewhat negated by resilient domestic demand, with more than 50% of demand being imported. Sunshine is well-positioned to benefit from rising local demand, as it is the country's largest palm-oil producer, accounting for more than 50% of domestic output. Palm oil is the largest contributor to Sunshine's profit, making up almost 40% of the group's proportionate EBITDA in FY19.

Healthcare Margin Constrained: Fitch expects Sunshine's healthcare-sector EBITDA margin to remain constrained in the near-term at around 6.9% (FY19: 7.1%) due to currency-led cost pressure and regulatory controls on the prices of some drugs distributed by Sunshine. However, this is partly offset by the regulator's decision to allow distributors to increase the prices of 60 price-regulated molecules by 14.4% in 1QFY20 to relieve some cost pressure from retailers. Sector profitability should also benefit from higher sales volume of drugs and growing contribution from the higher-margin diagnostics, wellness and beauty segments.

We believe a proposed merger between the healthcare segments of Sunshine and CIC Holding

PLC, once completed, should improve the sector's EBITDA margin due to the increased contribution from the high-margin medical-equipment segment. However, Sunshine will only own 60% of the combined entity post merger, including a lower 60% share of the group's existing wholly owned healthcare segment, limiting the positive impact on group cash flow. The proposed transaction is still in the due diligence stage and planned for finalisation by July 2019.

Tea Price Dictates Margin: The EBITDA margin of Sunshine's fast-moving consumer goods (FMCG) segment improved by 440bp to 12.8% in FY19, due to weak tea prices in the Colombo tea auction during most of the year. Fitch believes Sunshine will be able pass on some of the cost escalations in the premium and mid-range market segment, which accounted for more than 80% of FMCG revenue, although the ability to increase prices is relatively limited in the lower end of the market due to high price competition.

Power Improves Diversification: Fitch expects Sunshine to diversify some of its business risk through capacity expansion in the power segment and stabilise long-run consolidated cash flow by somewhat counterbalancing the commodity-price volatility in the palm-oil plantation business. Sunshine invested LKR329 million in its power segment in FY19, for expanding its hydro power generation capacity and to venture into a 500 kilowatt rooftop solar project. We estimate the energy segment will contribute LKR300 million a year to EBITDA in the next two years.

## 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 its 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 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 Sri Lanka's rubber tyre and footwear markets and is rated two notcthes below Sunshine due to its weaker business-risk profile given rising domestic competition in its footwear and pneumatic tyre segments. DSG also has significantly higher leverage.

## Key Assumptions

- EMSPL will sell its remaining stake in HPL to LREL at LKR8.3/share by exercising a put option after

the end of the mandatory offer period in July 2019
- Revenue to slow by 6% in FY20 (FY19: 28% growth), reflecting the full disposal of the stake in HPL, then to increase by mid-single-digits over the next two years
- EBITDA margin to be maintained in the low-double-digit range over FY20-FY22 (FY19: 11%)
- Capex of LKR4.2 billion over FY20-FY23 for expansion across the board
- Dividend pay-out of 30% of net profit over FY20-FY23

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 (FY19: 1.7x) for a sustained period
- Sunshine's EBITDAR coverage of gross interest + rent (including proportionate consolidation of EMSPL) falling below 2.0x (FY19: 4.0x) for a sustained period
- Adverse impact on growth and profitability arising from sustained regulatory pressure in the healthcare segment

Liquidity and Debt Structure
Satisfactory Liquidity: Sunshine had LKR1.6 billion of unrestricted cash and LKR1.8 billion in unutilised credit facilities as at FYE19 to meet LKR2 billion of debt repayment falling due in the next 12 months, which places the company in a comfortable liquidity position. More than 50% of 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.

Sunshine Holdings PLC; National Long Term Rating; Affirmed; A-(lka); RO:Sta

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**Applicable Criteria**
[Corporate Rating Criteria (pub. 19 Feb 2019)]
[National Scale Ratings Criteria (pub. 18 Jul 2018)]

**Additional Disclosures**
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