FitchRatings

04 Nov 2019 | Affirmation

# Correction: Fitch Affirms Melstacorp and Distilleries at 'AAA(lka)'; Outlook Stable

Fitch Ratings-Colombo-04 November 2019:

This is a correction of a release published on 22 October 2019. It corrects the leverage level above which negative rating action may be taken.

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. DIST contributes around 70% to Melstacorp's consolidated EBITDAR, shares the same board of directors and has previously provided financial support to weaker group entities in the form of corporate guarantees.

The affirmations reflect Melstacorp's ability to maintain leverage below 2.0x over the medium-term, despite large investments in core and non-core operations. Leverage is defined as net adjusted debt/operating EBITDAR, including Melstacorp's 51%-share of Aitken Spence PLC's net debt and EBITDA, but excluding its insurance subsidiary. Melstacorp saw net leverage weaken to 1.8x in the financial year ending March 2019 (FY19), from 1.3x in FY18, following significant debt-funded investments.

The group's investment drive is supported by the strong operating cash flow of its core subsidiary, DIST, which is Sri Lanka's market leader in spirits, enjoying a strong brand presence and high entry barriers. We expect DIST to account for around 70% of Melstacorp's group EBITDA, including its 51% share of Aitken Spence, over the medium-term. The ratings of Melstacorp and DIST could come under pressure if Melstacorp continues to make large debt-funded investments that dilute the cash-flow stability of its core spirits business or are not immediately cash-flow accretive.

## Key Rating Drivers

Investments Weigh on Leverage: We expect Melstacorp to pursue acquisitions and investments in non-alcoholic beverage segments in the medium term, in line with its stated strategy. The group expanded into the healthcare and cement sectors in FY19 for a total of LKR1.2 billion, and increased its stake in blue-chip conglomerate, John Keells Holdings PLC, to 9.9%, from 3.5%, for LKR12 billion, which was largely debt-funded. We expect any new investments to be primarily funded by dividend income into the Melstacorp holding company from its investment portfolio, including from DIST, which we estimate at around LKR4.0 billion-4.5 billion a year, and possible asset sales, including a limited sell-down of DIST.

Strong Contribution from Alcoholic Beverages: We expect DIST to contribute around 70% to the group's proportionately consolidated EBITDA in the medium term, benefiting from its strong brand presence and access to a countrywide distribution network. DIST increased its market share in spirits to around 70% in 2018, from around 65% in 2017, amid structural and operational pressure faced by some competitors. There is also a complete advertising ban on alcoholic beverages, which acts as a high entry barrier and limits competition.

Easing Excise-Tax Volatility: We expect incremental excise-tax hikes on spirits to be gradual, as lower sales volume off sharp tax increases, as seen after the late-2017 tax revision, could reduce government revenue. Excise taxes from the alcoholic-beverage sector increased by less than 1% in 2018, despite an 8% rise in sales volume, with the majority of the volume increase coming from beer. Excise tax on alcoholic beverages is a key source of government income, accounting for around 7% of tax revenue.

DIST saw a drop in sales volume in 2018 following the 2017 excise-duty revision, which brought down taxes on beer. This led to consumer demand shifting to beer, away from spirits, which has become cheaper on an equivalent-alcohol basis. DIST has also lost volume to the illicit market owing to the high tax regime and weak economic conditions, which has made its products less affordable. The government reduced the excise tax difference between spirits and beer to 20% in March 2018, from 34%, which partly contributed to DIST's net revenue growth of 10% in 1QFY20.

Short-Term Challenges from Leisure: We do not expect Melstacorp's leisure segment, held via its 51% share in Aitken Spence, to fully recover in FY20 from the drop in tourist arrivals following the 2019 Easter Sunday terrorist attacks. The leisure segment accounts for around 20% of Melstacorp's group EBITDA. Aitken Spence is Sri Lanka's largest resort operator. The occupancy rates of its properties sank following the attacks and we do not expect a full recovery during FY20, with the government estimating a 25%-30% drop in tourist arrivals in 2019. This risk is mitigated by the earnings contribution from the group's Maldives operations, including its 500-room new luxury resort, which opened in 2019.

Stronger Margin: We expect Melstacorp's EBITDAR margin to expand by around 200bp by FY21, from 22.3% in FY19, due to a stronger EBITDAR margin at DIST. DIST has already seen an 11pp yoy improvement in its margin in 1QFY20, helped by volume recovery and better sourcing strategies, which we believe will be sustained in the medium term. However, the group's EBITDAR margin may face short-term pressure from the leisure segment. We also do not expect a material recovery in the group's loss-making telco and plantation businesses in the medium term, but the impact is not significant to the ratings.

## Derivation Summary

Melstacorp is a leading conglomerate in Sri Lanka, with exposure to the alcoholic beverage, plantation, telecom, leisure, power and logistics sectors. Its core subsidiary, DIST, is the country's leading spirits manufacturer, with a strong portfolio of well-known brands and access to an extensive distribution network. In comparison with its 'AAA(lka)' rated peer, Dialog Axiata PLC (AAA(lka)/Stable), Melstacorp's operations, though more diversified, are smaller in scale, as a significant portion of the country's alcoholic-beverage consumption occurs outside the formal sector, which is not recorded. In contrast, Dialog enjoys a larger operating scale, reflecting the size of the local telecom market and the companies' market leadership in the fixed line and mobile segments.

Melstacorp is also exposed to more regulatory risk in its spirits business due to hikes in excise taxation, 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 free cash flow (FCF) generation than at Dialog. Melstacorp's capex as a proportion of revenue is also considerably lower than Dialog's and most of its investments in other businesses are discretionary. Dialog's high capex intensity is driven by the need to continually upgrade infrastructure to keep abreast of evolving technology and to service rising network traffic, while competition keeps tariff increases in check, resulting in larger and more sustained negative FCF than for Melstacorp.

Melstacorp is rated three notches above Lion Brewery (Ceylon) PLC (AA-(lka)/Stable) - the country's biggest beer manufacturer - reflecting Melstacorp's much larger operating scale and dominant market position in spirits, which is more popular than beer and hold a share of about 70% in the domestic alcoholic-beverage market. DIST has also been less sensitive to tax changes historically than Lion.

Fitch's Parent and Subsidiary Rating Linkage methodology was used to derive DIST's rating. The ratings of Melstacorp and its stronger subsidiary, DIST, are aligned due to strong linkage between the two entities. No Country Ceiling or operating environment aspects affect the ratings.

Key Assumptions

- Consolidated revenue growth to remain subdued in FY20 amid challenges in Aitken Spence's leisure segment, but to recover by a high-single digit percentage from FY21 , supported by a broad economic recovery

- Consolidated EBITDAR margin to improve to around 24% by FY21 on stronger alcoholic-beverage volume and a recovery in the leisure segment (FY19: 22.3%)

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

- Capex to peak at LKR9 billion in FY20 on account of Melstacorp's 51% share of power and leisure-segment capex at Aitken Spence, and moderate to around LKR4 billion a year from there onwards

- M&A and other investment spending to average around LKR5 billion a year over FY21-FY23, although the companies have not provided any specific guidance

- Group dividend payout of LKR1.5 billion a year over FY20-FY22

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action

There is no scope for an upgrade, as the company is already at the highest rating on Sri Lanka's national rating scale.

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- Consolidated financial leverage - measured as adjusted net debt/EBITDAR, including 51% consolidation of Aitken Spence but excluding Continental Insurance Lanka Limited, increasing to over 2.0x for a sustained period (FY19: 1.8x)

- A structural change in the domestic alcoholic-beverage industry that considerably weakens DIST's competitive position

- A significant weakening of the business risk profile due to new investments in sectors that are less competitive or generate more volatile operating cash flow than the spirits business.

Liquidity and Debt Structure

Comfortable Liquidity Position: Melstacorp had about LKR22 billion in unrestricted cash and LKR24 billion in unutilised credit facilities at end-June 2019 to meet LKR30 billion of debt maturing in the next 12 months. We expect Melstacorp to settle around LKR10 billion of short-term debt during FY20, which was to be used for investments that did not take place. We also expect around LKR11 billion of working capital-related debt to be rolled over in the normal course of business given the group's healthy working-capital cycle, which further supports liquidity. The group has strong access to local banks due to its position as one of Sri Lanka's largest corporates and its solid credit profile.

Distilleries Company of Sri Lanka PLC; National Long Term Rating; Affirmed; AAA(lka); RO:Sta
Melstacorp PLC; National Long Term Rating; Affirmed; AAA(lka); RO:Sta

Contacts:
Primary Rating Analyst
Nadika Ranasinghe,
Director
+94 11 2541 900
Fitch Ratings Lanka Ltd.
15-04 East Tower  World Trade Center
Colombo 00100

Secondary Rating Analyst
Azim Nawaz,
Analyst
+94 11 2541 900

Committee Chairperson
Hasira De Silva, CFA
Senior Director
+65 6796 7240

Media Relations: Bindu Menon, Mumbai, Tel: +91 22 4000 1727, Email:
bindu.menon@fitchratings.com

Leslie Tan, Singapore, Tel: +65 6796 7234, Email: leslie.tan@thefitchgroup.com

Additional information is available on www.fitchratings.com

**Applicable Criteria**
Corporate Rating Criteria (pub. 19 Feb 2019)
National Scale Ratings Criteria (pub. 18 Jul 2018)
Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

**Additional Disclosures**
Solicitation Status
Endorsement Policy

sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from 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.

---

**ENDORSEMENT POLICY -** Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.