FitchRatings

# Fitch Revises Outlook on DSI Samson Group to Positive; Affirms at 'BBB(lka)'

Fitch Ratings - Colombo - 10 February 2020:

Fitch Ratings has revised the Outlook on Sri Lanka-based footwear and tyre manufacturer and retailer DSI Samson Group (Private) Limited (DSG) to Positive from Stable and has simultaneously affirmed the National Long-Term Rating at 'BBB(lka)'.

The Outlook revision reflects the possibility that DSG's rating could be upgraded in the next year or two if it sustains its current improvement in leverage, defined as net adjusted debt/EBTIDAR, at below 4.5x. Leverage fell to 3.8x in the financial year ending March 2019 (FY19) and to 3.5x in 6MFY20 on better efficiencies and a move to value-added products in its footwear business. However, DSG's tyre business continues to face challenges and may pose significant downside risk to our forecasts.

DSG's rating reflects the company's leading positions in domestically sold and manufactured pneumatic tyres to the replacement market and footwear, which are supported by its well-known brand and island-wide distribution network.

KEY RATING DRIVERS

Improved Financial Risk Profile: Fitch expects DSG's net leverage to hover between 3.5x-4.0x over FY21-FY23 on stronger cash flow stemming from its shift to higher-margin products and sustainable restructuring efforts to improve the efficiency of its footwear manufacturing business. Our forecast factors in capex of around LKR1 billion a year over the next few years, which is lower than in the past owing to the completion of the company's mid-term capacity expansion plans.

Restructuring of Footwear Business: The focus of DSG's footwear retailing business has shifted to more value-added product categories with higher price points than generic footwear. The strategy aims to counter the persistent fall in footwear volume due to competition from cheaper Chinese alternatives that are readily available in retail markets. Enforcement against grey-market importers that circumvent taxes increased in FY19, also helping DSG's segment profitability; footwear revenue was up by 7.6% yoy, driven by a 9% yoy increase in the average selling price, while volume declined by 2.4%.

The footwear manufacturing segment implemented cost saving initiatives in 2HFY18, which has reversed the decline in profitability over the past two to three years. DSG increased mechanisation of the cutting and sewing processes, which were previously done manually, and optimised the usage of raw materials. These measures improved operating profitability of DSG's manufacturing segment to around LKR200 million in FY19, from a loss of LKR180 million in FY18. We believe these initiatives are sustainable and that DSG will further improve its operational efficiency in the medium term.

Pressure on Domestic Tyre Volumes: Fitch expects domestic pneumatic tyre volumes, which comprised 15% of group revenue in FY19, to stay pressured due to a structural decline in the three-wheeler market after loan to value ratios for financing three wheelers were tightened to 25%, from 75%, in 2017. However, this is somewhat counterbalanced by a resurgence in exports to Africa; DSG temporarily lowered exports in FY19, which accounted for 16% of group revenue, to avoid higher credit losses due to poor economic conditions in African end-markets. However, DSG says the situation has improved.

Improved EBITDA Margin: Fitch expects an EBITDA margin of 11.3% in FY20, averaging at 10.8% in FY21-FY23; this is slightly lower than the 11.6% in FY19 (LTM 2QFY20: 12.4%) to reflect execution risk in the implementation of DSG's new strategies. The shift in product focus and

improving operational efficiency at the footwear segment should bode well for EBITDA generation in the medium term. Profitability at DSG's bicycle manufacturing business also improved on higher volume after the segment begun exporting to new markets, as evident from its EBITDA margin of 6.5% in FY19, against 1.5% in FY18.

Leading Market Positions: DSG is the market leader in Sri Lanka's tyre business, with a combined market share of 70% in the bicycle, motorcycle and three-wheeler tyre segments. It also had a leading market share of 28% in the fragmented and competitive footwear retailing sector in FY19, supported by a strong island-wide retail network of over 200 stores. DSG passed on savings from lower indirect taxes to end customers, who will also have higher disposable income in light of lower direct taxation, which should improve affordability. However, we expect the domestic footwear industry to face continued competition, which is a key risk for DSG.

Sufficient Production Capacity: Capacity utilisation at the footwear-manufacturing business stood at 87% in FY19, but the shift to high-margin value-added products should mean existing capacity will be sufficient in the medium term. Increased investment in the tyre segment over the last three financial years has resulted in sufficient spare capacity in the medium term. DSG is undertaking two production shifts at its expanding bicycle-manufacturing business, which is running close to full capacity, to meet rising demand. Capacity should therefore be sufficient for the medium term.

## DERIVATION SUMMARY

DSG's rating reflects its leading position in the fragmented and competitive footwear retailing business, which is backed by a network of over 200 stores. DSG also holds a market leading position in domestically sold and manufactured pneumatic tyres, with a focus on the defensive replacement market. However, the company is challenged by a structural decline in the three-wheeler market and risks in its African export market.

Singer (Sri Lanka) PLC (A-(lka)/Negative) is rated two notches higher than DSG to reflect its stronger business-risk profile due to its leading market position in consumer durables and much larger scale. However, Singer's financial-risk profile has recently deteriorated compared with that of DSG, leading Fitch to revise its Outlook to Negative from Stable.

Abans PLC (BBB+(lka)/Stable), together with Singer, dominates Sri Lanka's consumer-durables industry. It is rated one notch higher than DSG to reflect its stronger business-risk profile, despite its higher leverage than DSG.

## KEY ASSUMPTIONS

- Revenue to rise by 6.5% in FY20 then average at around 5.0% over FY21-FY23 (FY19: 10.1%).

- EBITDA margin of around 11% in FY20, hovering at a similar average during FY21-FY23.

- Capex to average at LKR1.1 billion a year over FY21-FY23 as the company invests in new moulds and machinery to add value to its products.

- Working capital outflow of LKR700 million in FY20, averaging at LKR400 million over FY21-FY23.

- Dividend pay-out to shareholders to stand at 50% of net income.

## RATING SENSITIVITIES

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

- Sustained improvement in adjusted net debt/EBITDAR to less than 4.5x and gross adjusted debt/EBITDAR to less than 5.0x.

- EBITDA margin sustained above 11%.

Developments that May, Individually or Collectively, Lead to the Rating Outlook being Revised to Stable

- Inability to meet the above-mentioned positive sensitivities over an extended period.

LIQUIDITY AND DEBT STRUCTURE
Manageable Liquidity: DSI had LKR550 million of unrestricted cash and LKR5.0 billion of unutilised but committed credit lines at end-2QFY20 to meet LKR9.5 billion of debt maturing in the next 12-months. However, around LKR7.0 billion of upcoming debt maturities comprise short-term working-capital lines, which would continue to be rolled over as and when they fall due; these are supported by a net working-capital position of LKR10.5 billion. DSI has maintained a healthy cash-conversion cycle of around 140 days and we expect this trend to prevail, as the company is improving working-capital management by refining its inventory-management systems.

| RATING ACTIONS | | | | |
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| ENTITY/DEBT | RATING | | | PRIOR |
| HIDE RATING ACTIONS | | | | |
| DSI Samson Group (Private) Limited | Natl LT | BBB(lka) | Affirmed | BBB(lka) |
| VIEW ADDITIONAL RATING DETAILS | | | | |

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Corporate Rating Criteria (pub. 19 Feb 2019)
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