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

Fitch Ratings - Colombo - 12 March 2020:

This is a correction of a press release published on 11 March 2020 to change the reference on maize's contribution to costs.

Fitch Ratings has affirmed Sri Lanka-based Sunshine Holdings PLC's National Long-Term Rating at 'A-(lka)' with a Stable Outlook.

Sunshine's rating reflects its diversified operations and leading market positions in pharmaceutical distribution and consumer goods, via the retailing of branded packaged tea, which are counterbalanced by its small operating scale and the volatility stemming from its palm-oil cash flows.

The rating affirmation takes into account the proposed realignment of Sunshine's business, which will raise its exposure to consumer goods while reducing its exposure to the more volatile plantation sector. The revamp should reduce Sunshine's earnings volatility, although this is tempered by the higher competitive pressures in consumer goods.

We expect Sunshine's leverage to increase due to the proposed realignment although its rating headroom should remain comfortable in the next two years. However, the company has indicated it plans to pursue inorganic expansion, which may increase leverage beyond our current forecasts.

KEY RATING DRIVERS

New Structure Neutral to Rating: Fitch thinks the business realignment is neutral to Sunshine's credit profile. We expect the company to use LKR1.4 billion of cash in hand to finance the new structure, which should result in a marginal increase in leverage to 1.6x by the financial year ending March 2020 (FY20), from our forecast of 1.2x if the realignment does not materialise. Fitch expects Sunshine's EBITDA margins to contract by around 50bp to 11% over the medium term due to a shift in the revenue mix towards consumer goods, and away from the palm oil-driven agribusiness, although this is counterbalanced by the lower capital intensity of the consumer goods segment.

Greater Competition in Consumer Goods: Competition in consumer goods increased after Unilever Sri Lanka Limited - which is the second largest player in packaged branded tea - intensified its efforts to expand its domestic market share by competing on price. Sunshine, which maintained its leadership position with a 36% share as of end-2019, has had to retaliate by cutting prices, driving a 300bp yoy contraction in the EBIT margin of its consumer goods segment to 10% as of 9MFY20. Price cuts have been mainly in its mid-to-low tier tea brands, Watawala and Ran Kahata, which account for the bulk of its sales.

We expect the consumer good segment's EBIT margin to stabilise at around 10% as we do not expect competition to intensify further amid our expectation of increased consumer spending due to a reduction in direct and indirect taxes since January 2020 and December 2019, respectively. We forecast a rise in the segment's contribution to group EBIT to 22% by FY21 after the business realignment, from 14% in FY19, assuming margins remain stable.

Improving Palm-Oil Cash Flows: We expect the palm-oil segment to continue to remain one of Sunshine's key sources of operating cash flows in the medium term despite a slight reduction in exposure after the restructuring. Sunshine's crude palm oil (CPO) output fetched a higher price of USD1,165/tonne in FY19 than the global benchmark CPO price of around USD600/tonne due to import tariffs to protect local plantations. Fitch expects global CPO prices to average USD550/tonne in 2020 and USD560/tonne in 2021, underpinned by the bio-fuel targets set by the Indonesian government.

Regulatory Risk in Oil Palm: The Sri Lankan government has banned the planting of oil palm starting November 2019, but it is unlikely to have a material impact on Sunshine's cash flows during the FY20-FY23 rating horizon. This is because the average age of Sunshine's oil-palm plantations is 11 years and around 56% of the cultivated area will remain in the prime age of 11-16 years over the same period. Fitch expects Sunshine's yield per hectare to increase in the medium term, providing adequate revenue visibility over the rating horizon. Around 8% of the mature planted area is subject to the ban on replanting.

Healthcare Profitability to Increase: We expect Sunshine's healthcare segment EBITDA margins to improve to around 9% in FY20-FY23 (FY19: 7%), underpinned by growth in the medical device sub-segment. EBITDA margins widened by 4 percentage points (pp) yoy to 10% in 9MFY20 as the segment benefitted from an increase in both volumes and price in the pharmaceutical distribution and medical devices sub-segments. The medical devices sub-segment is experiencing strong growth momentum amid repeat purchases from the government. The medical devices sub-segment carries much higher margins than other sub-segments. Nonetheless, price controls by the regulator continue to be a key risk for the healthcare segment.

Dairy to Breakeven in FY22: Fitch expects Watawala Dairy Limited's (WDL) revenue to continue rising due to the shortage in domestic dairy production and WDL to breakeven from FY22, although material risks remain. Operating losses at WDL narrowed to LKR44 million in 9MFY20 from LKR67 million in 9MFY19 due to an increase in the number of milking cows to 880 from 600, which contributed to increased production. Sunshine expects to lower their feed costs by 10pp to around 50% of direct dairy costs by FY21. Fitch expects the domestic maize industry to see an increase in prices stemming from the recent ban on imported maize, which may impact the dairy sector's profitability. Maize accounted for the majority of feed costs in FY19.

Volatility in Power Despite Diversification: Fitch expects the energy segment to contribute around 10% to group EBITDA in the medium term. The energy segment continues to aid Sunshine in diversifying group cash flow generation. However, uncertain weather patterns continue to be a risk as 90% of cash flows stem from its hydropower plants. Sunshine is expected to increase its investments in its solar power plants through FY23, which will support more stable cash flows than hydropower. The company has flexibility to defer most of the capex if required.

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 substantial cash flows from the defensive grocery retail business and greater cash flow diversification, resulting in a larger operating scale. These factors more than offset RICH's higher financial risk profile compared with Sunshine.

Singer (Sri Lanka) PLC (A-(lka)/Negative) is a leading consumer-durables retailer that has a stronger business-risk profile than Sunshine due to a solid competitive position in its core business, supported by a well-known brand and a leading distribution network. This is offset by Singer's higher financial risk, which is driving its Negative Outlook. Therefore, Fitch rates both entities at the same level.

Sunshine is rated one notch above Abans PLC (BBB+(lka)/Stable), a co-leader in consumer durables together with Singer, due to Abans' investments in more volatile non-core operations such as real-estate development and a weakly capitalised finance subsidiary, which requires the parent to meet frequent capital calls. Abans' financial-risk profile is also weaker than that of Sunshine.

KEY ASSUMPTIONS

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

- Revenue to decline by around 4% in FY20 due to the Hatton Plantation PLC divestiture, and increase by 10% on average over FY21-FY23.

- EBITDA margin to widen to 11.7% in FY20 (FY19: 11.2%) and narrow to an average of 10.6% over FY21-FY23 due to higher consumer goods cash flows.

- Capex to hover around LKR1 billion per annum over FY20-FY23, which is similar to recent historical periods.

- Working-capital outflows to average around LKR420 million per annum in the next few years to support the healthcare segment.

- Dividend pay-out of 30% of Net Income over FY20-FY23.

RATING SENSITIVITIES

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

- A sustained reduction in Sunshine's total net debt/EBITDA, including proportionate consolidation of Sunshine Wilmar Private Limited (SWPL), to below 1.5x (last 12 months to 3QFY20: 1.5x)

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

- An increase in Sunshine's net leverage to more than 3.0x over a sustained period

- Sunshine's EBITDA coverage of gross interest (including proportionate consolidation of SWPL) falling below 2.0x over a sustained period (last 12 months to 3QFY20: 4.2x)

- A weakening of the business profile as reflected in a deterioration in EBITDA margin to below 9% on a sustained basis

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Sunshine had LKR2.1 billion of unrestricted cash as of end-December 2019 to meet LKR2.2 billion of debt repayment falling due in the next 12 months. Around LKR1 billion of its near-term maturities consist of short-term working capital lines, which we expect banks to roll over as they are backed by LKR3 billion of net working capital and because we expect the company's cash conversion cycle to remain healthy at around 80 days.

Sunshine has unutilised but uncommitted credit lines of LKR1.6 billion, which also support liquidity during the normal course of business, although we do not expect these lines to be available in a stressed scenario. We expect Sunshine to generate negative free cash flows of around LKR120 million in the next 12 months due to dividend payments and capex related to the energy business, which is supported by its adequate access to domestic banks.

RATING ACTIONS			
ENTITY/DEBT	RATING		
HIDE RATING ACTIONS			
Sunshine Holdings PLC	Natl LT	A-(lka)	Affirmed
VIEW ADDITIONAL RATING DETAILS			

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Corporate Rating Criteria (pub. 19 Feb 2019)

ADDITIONAL DISCLOSURES

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