ICRA Lanka reaffirms the Issuer rating of [SL] BB, with Negative outlook for Lankem Ceylon PLC

October 31, 2018

Instrument*	Current Rated Amount (LKR Mn)	Rating Action
Issuer Rating	N/A	[SL]BB with Negative outlook reaffirmed

Rating action

ICRA Lanka Limited, Subsidiary of ICRA Limited, group company of Moody's Investors Service, has reaffirmed the Issuer rating of [SL]BB (pronounced S L A plus) with Negative outlook for Lankem Ceylon PLC ("LCEY"/ "the company").

Rationale: ICRA Lanka has taken a standalone view on LCEY given the very low dependence of the Company on its subsidiaries (dividends/advances) and the absence of major contractual obligations to support group entities which are currently recovering from the reported losses.

The reaffirmation of the rating and the rating outlook reflect the company's current financial position and the heavy financial losses that the company has sustained over the past few years. The deterioration of the company's financial position is largely due to the downturn in the key business segments over the past two years. Due to higher regulatory pressure on the environmentally sensitive agro-chemicals, and adverse weather conditions that prevailed during FY2016 and FY2017, the company's crop protection segment has been negatively affected. The paints segment has registered a noticeable decline in revenue in FY2017 and FY2018, due to increased competition and the weaker macro-economic conditions that prevailed during this period. The company has traditionally been a market leader in the Industrial Chemicals and Bitumen products segment. Notwithstanding the recovery in the construction industry, the financial performance of the Bitumen sector has also been negatively affected due to increased working capital constraints as well as higher competition from other players in the industry during FY2017/18. Although, the company has noticeably reduced its operational expenditures during FY2018 by efficiency improvements and retrenchment exercises, the company has sustained heavy financial losses during FY2018 and Q1FY2019 due to increased finance expenses, amidst the increased leverage (at the standalone level).

In summary, LCEY's financial profile has deteriorated over the past few years, resulting in losses (i.e. net loss of LKR 679 Mn and LKR 798 Mn in FYE2017 and FY2018 respectively), weaker capital structure and coverage metrics. However, ICRA Lanka notes the company's currently ongoing restructuring/assets monetisation exercises, which have raised collectively ~LKR 1.2 Bn in CY2018. This will help the company to cushion the impact from the high finance expenses due to increased debt levels. However, given the high dependence on imports which are not hedged fully, LCEY's revenues and profits are likely to be negatively affected owing to foreign exchange risks. Moreover, the company's operational turnaround prospects currently hinges on the recovery of their crop protection segment especially in the Maha season of CY2018/19. However, these rating weaknesses are offset to some extent by the Company's strong brand name and leading market share in the crop protection as well as the industrial chemicals segments. ICRA Lanka also takes into account the experience of the promoters, the Company's track record and reputation in the industry which have enabled it to access funding both from the capital markets as well as financial institutions that have supported its growth over the years.

LCEY's standalone profile is relatively weak, but the company's largest subsidiary, C W Mackie PLC, has been reporting noticeable growth owing to the strong FMCG products segment as well as the recovering trading operation. The group's plantation sector (including Kotagala Plantations PLC) has also reported heavy financial losses in FY2018 due to increased leverage, albeit, the leisure sector has shown a recovery after the recent renovation of both Sigiriya Village Hotel and Marawila Resorts. The new investments in the packaging sector would further diversify the group's business exposure, although these investments are expected to contribute significantly to the group's revenue only in the medium to long term. While LCEY has a firm policy in place that would largely limit the intergroup transactions, the ability of the Company to strictly enforce the same coupled with ability to diversify its own income streams would be key sensitivities to the reaffirmed rating. The ability of the Company to reduce reliance on short term debt and align cash flows in line with investment (fixed and working capital) requirements would also be the other sensitivities to the reaffirmed rating.

Credit strengths

Experience of the promotor/s and the management: ICRA Lanka takes into account the experience of the promoter, the company's strong track record and reputation in the industry, which have enabled the company to access funding from financial institutions. The company's professional management team coupled with relatively strong governance structure adds further comfort.

Leading market share and the significance of plantation/agro sector in the Sri Lankan economy: Lankem is a leading player in the crop protection market in Sri Lanka. The company has collaborated with global players such as Monsanto and DuPont to introduce portfolio of products, which have expanded overtime. Although, Sri Lankan agriculture sector's direct contribution towards the economy is relatively low, this segment provides more than one third of the total employment of the country and therefore, considering the national strategic food security requirements, the agriculture/plantation sector is regarded as a key sector in the Sri Lankan economy. However, during past three years, Sri Lanka's agriculture sector was negatively affected due to banning of Glyphosate based chemical products. During early CY2018, this ban was relaxed due to non-availability of alternative chemicals, especially in the plantation industry. However, during FY2018, the company has developed a new molecule in partnership with a foreign company to replace the use of Glyphosate. This is expected to be introduced to the market in Q4FY2019. The ability of the company to successfully diversify its new product categories and leverage on the new product, while managing the operational performance without being affected by the current working capital constraints, will remain to be reviewed going forward.

Currently ongoing restructuring exercise and efficiency improvement measures: Lankem group has relatively larger asset bank (including their manufacturing facilities), which are based in prime locations in Sri Lanka. Therefore, the company intends to shift their manufacturing facilities from these area to suburbs as part of the restructuring exercise. The company has brought in ~LKR 1.2 Bn through asset monetisation exercise during CY2018 and moreover, the company intends to further raise additional LKR 500 Mn during FY2019 by disposing low-yielding investments/assets. This will help the company to reduce its high debt exposure and thereby reduce the finance expenses going forward. Moreover, the company is currently carrying out further efficiency improvement exercises (including retrenchment plans). Although, the company intends to divest its lower yielding business segments, the company's recent diversification into packaging cluster, will help to diversify business risks to an extent. Therefore, the ability of the company to successfully carry out the group's restructuring exercise, while achieving the company's profitability targets as envisaged, remains as a sensitivity.

Credit challenges

Weaker Financial Profile: The Company's revenues have declined at a compounded annual rate of ~ 6.10% over the last five years (FY2013-FY2018). Moreover, during FY2017 and FY2018, the company's revenue has declined by YOY 18.2% and 7.0% owing to the de-growth in the crop protection, painting and industrial chemical segments. Although, during FY2018 and Q1FY2019 Lankem has managed to further increase the operational efficiencies, and thereby, increase the operating profit margins by 2-3 basis points, the net profitability during this period have further deteriorated due to increased finance costs. Lankem has recorded after tax loss of LKR 798 Mn and LKR 182 Mn in FY2018 and Q1FY2019 respectively. The company's capital structure has also further deteriorated on account of losses and higher debt levels. The debt profile of the Company is largely skewed towards short term loans, with the same contributing to over 80% of the debt outstanding in FY2018.

The company's cash flows and coverage metrics remains weak in the last few years stemming from negative profitability, and relatively high debt levels. However, the company has brought in ~LKR 1.2 Bn through assets monetisation/capital raising exercises during CY2018 in order to reduce the higher debt exposures and working capital constraints and further intends to raise ~LKR 500 Mn through the ongoing restructuring exercise during FY2019. Therefore, ICRA Lanka views the ability of the company to successfully carry out the envisaged restructuring exercises, while increasing the profitability levels in the short to medium term, as a key rating sensitivity to the reaffirmed rating.

Relatively high exposure to agro-climatic conditions and regulatory uncertainties; Sri Lanka had experienced severe drought conditions during CY2016/17. Therefore, the adverse weather conditions that prevailed in the country, have negatively affected the company's crop-protection sector during FY2017 and early part of FY2018, as most farmers have abstained from cultivating paddy during two/three consecutive monsoon periods, affecting the demand for crop protection chemicals. The global climate changes are likely to affect Sri Lanka's weather patterns more frequently than before due to increasing urbanization/global warming. Given the company's relatively high dependency on crop protection segment, ICRA Lanka views that the impact from the agro-climatic risks on the company's financial position is relatively high going forward. Moreover, during past three years, the company's crop-protection segment was negatively affected due to banning of Glyphosate based chemical products and hence, the regulatory risks would continue to be a concern.

Company's exposure to foreign currency and other macroeconomic volatilities; The macro economic conditions such as increasing interest rate, depreciation of Sri Lankan rupee and other policy directives of the key market segments, would likely have an impact on the overall performance of the company. Given the competitive market conditions, the company is unlikely to directly pass-through the price increases to the consumers over the short/medium term period, and therefore, the profitability margins would be affected to an extent.

Increasing Competition in the key product segments; Lankem is one of the leading players in the decorative paints industry in Sri Lanka and this segment contributes to a larger portion of the revenues. Decorative paints industry is a very competitive market with~ 30 large and small players in Sri Lanka. Moreover, this sector has been negatively affected during CY2017/18 due to weaker macro-economic conditions and increased competition, leading to a price war. The bitumen industry is currently being catered by small scale players and this industry is also affected due to increased competition. This together with the company's working capital constraints, have negatively affected the company's bitumen and industrial chemical segments during FY2018.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.
Links to applicable criteria: *www.icralanka.com/images/pdf/Corporate%20Rating%20Methology.pdf*

About the company:

Company Profile
Lankem Ceylon PLC was created by Royal Dutch Shell in 1964 primarily as an agro chemical business. As Sri Lanka started encouraging local ownership, the company was acquired by local investors and was listed on the Colombo Stock Exchange. Over the past 25 years, Lankem has diversified into other related businesses. The company has been present in most industry segments in the country but primarily focused on chemicals and manufacturing. Lankem's Agro Chemicals, Paints and Bituminous Products have been the frontrunners in new product development in their specific industries.

Group Profile
Over the years, LCEY has grown by strategic acquisitions and now constitutes a diversified group with 27 subsidiaries which are in manufacturing of FMCG products, import/export of agricultural inputs/commodities, distribution and freight forwarding, trading of chemicals/auto components and, managing hotels and plantations. During Q4FY18, Lankem Ceylon PLC undertook a rights issue and the same was largely subscribed by Colombo Fort Land & Building PLC(CFLB). Therefore, post the rights issue, Colombo Fort Land & Building PLC has become the immediate parent of Lanken Ceylon PLC. Lankem Ceylon PLC is currently the largest subsidiary (including its stepdown subsidiaries) of CFLB, accounting for approximately 45% of the revenue of CFLB. Thus, LCEY is strategically important to the Group. The Company on its own also acts as a strategic investment holding company for the Group with several subsidiaries and stepdown subsidiaries being held by LCEY. With several of Lankem's subsidiaries (including Lankem) being listed, the Group is also open to a rights issue to raise funds for supporting its debt obligations. However, there are no financial obligations toward any of the group entities. Further, dividend income from these entities forms less than 2% of the Company's revenues, making LCEY independent of any of the subsidiaries.

C.W. Mackie PLC is the largest subsidiary of the Lankem Group, which has recorded noticeable growth over the past few years, despite the slowdown in plantation sector. Leisure sector is another important segment of the group's investment, which has been recovering from the reported financial losses. LCEY has made some sizeable investments recently in the packaging segment.

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