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ICRA Lanka Revises the issuer rating of Lankem Ceylon PLC to [SL]BB (Negative)

ICRA Lanka Limited, Subsidiary of ICRA Limited, Group company of Moody's Investors Service has revised the Issuer rating to [SL]BB (pronounced S L double B) with Negative outlook from [SL] BB+ (pronounced S L triple B Plus) with Stable outlook for Lankem Ceylon PLC ("LCEY"/"the Company").

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 rating downgrade and the revision of the rating outlook reflects the downturn in the key business segments over the past two years which have resulted in the company posting large net losses. Due to higher regulatory pressure on the environmentally sensitive agro-chemicals (after a study found that Glyphosate is responsible for Chronic Kidney Diseases (CKDs) in Sri Lanka), and adverse weather conditions that prevailed during FYE Mar 2016 and Mar 2017, the company's crop protection segment has been negatively affected. The painting segment has registered a noticeable decline in revenue in FYE Mar 2017, due to high competition in the industry notwithstanding high promotional activities undertaken 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 higher competition from other players in the industry during FYE Mar 2017. Moreover, high inventory levels (due to prolonged drought conditions) and new R&D projects & promotional activities, during this period have increased the inventory holding costs and administration expenses at the company level (standalone), exerting more pressure on the overall profit margins.

In summary, LCEY's financial profile has deteriorated over the past few years, resulting in losses (i.e. net loss of LKR 679 Mn in FYE Mar 2017), weak capital structure and coverage metrics. Further, the company's liquidity position has further weakened during FYE Mar 2017 and this is characterized by higher working capital intensity and higher debt levels. 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. 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 strong track record and reputation in the industry which have enabled it to enjoy steady access to 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 a noticeable growth owing to the strong FMCG products segment as well as the recovering trading operation. The group's plantation sector has reported an improvement in profitability in FYE March 2017, while the leisure sector has also shown a recovery after the recent renovation of both Sigiriya Village Hotel and Marawila Resorts. The new investments in the packaging companies would further diversify the group's business exposure, although these companies 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, ability of the Company to strictly enforce the same coupled with ability to diversify its own income streams would be key sensitivities to the rating.

The company registered a YOY 18.1 % decline in revenue in FYE Mar 2017 on the back of weaker financial performance of Crop protection, Paints and Bitumen segments. The company's OPBDITA and PAT margins have been negatively affected due to increased raw material costs coupled with high overhead expenses. The company has registered a net loss of LKR 679 Mn in FYE Mar 2017 compared with a net loss of LKR 368 Mn in the previous year. The company's working capital requirements have remained high over the years owing to the high debtors and inventory levels. The inventory levels have also remained high due to the prolonged drought conditions and the seasonality of some business segments such as paints.

The Company's negative profitability, weaker working capital position has led to reliance on external debts. Further, net losses in the recent past have eroded the net worth position of the company. As a consequence, the Company's capital structure has remained relatively weak with gearing increasing to 3.9x in FYE Mar 2017. The Company's coverage and key debt metrics have also deteriorated further given the debt levels on the books as compared to the profits generated. The Company's debt profile in the past was largely skewed towards short term loans, which were refinanced on a regular basis.

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 be other sensitivities to the rating. ICRA Lanka has noted positively the recently proposed capital raising exercise through a Rights Issue to further ease the high working capital intensity.

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. E B Creasy PLC (holding 45.73% direct stake in Lankem), which is owned by Colombo Fort Land & Building (CFLB) is the parent company of Lankem Ceylon PLC, accounting for approximately 85% of the revenue and nearly 70% of the net profits 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. Lankem Ceylon PLC is the EBCR's largest subsidiary (including its stepdown subsidiaries) contributing to 85% of the Group revenues. 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 Group, which has recorded a 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.

On a standalone basis, for the FYE Mar-2017, LCEY reported a net loss of LKR 679 Mn on a total income of LKR 4,577 Mn compared to a net loss of LKR 368 Mn reported on a total income of LKR 5,738 Mn in FYE Mar-2016. On a consolidated basis, for the FYE Mar-2017, LCEY reported a net loss of LKR 733 Mn on a total income of LKR 17,261 Mn compared to a net loss of LKR 254 Mn reported on a total income of LKR 17,073 Mn in FYE Mar-2016.

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