

ICRA Lanka reaffirms [SL]BBB+ ratings of Bogawantalawa Tea Estates PLC; Outlook revised to Negative from Stable

May 15, 2019

Instrument*	Current Rated Amount (LKR Mn)	Rating Action
Issuer Rating	N/A	[SL]BBB+ reaffirmed; Outlook revised to Negative from Stable
Proposed Senior Convertible Unsecured Redeemable Debentures Programme	LKR 850 Mn	[SL]BBB+ reaffirmed; Outlook revised to Negative from Stable

Rating action

ICRA Lanka Limited, Subsidiary of ICRA Limited, Group company of Moody's Investors Service, has reaffirmed the issuer rating of [SL]BBB+ (pronounced S L triple B plus) for Bogawantalawa Tea Estates PLC ("BTE"/"the Company"). The outlook of the rating has been revised to Negative from Stable. ICRA Lanka has also reaffirmed the Issue Rating at [SL]BBB+(pronounced S L triple B plus) for the Company's proposed Senior Convertible Unsecured Redeemable Debenture programme, amounting to LKR 850 Mn, while the Outlook has been revised to Negative from Stable.

Rationale

ICRA Lanka has taken a consolidated view on Bogawantalawa Tea Estates PLC and its subsidiary- Bogawantalawa Tea Ceylon (Pvt) Ltd, given the significant operational and financial linkages among them.

The reaffirmed ratings primarily factor in the Company's strong brand name, which is synonymous with high quality Ceylon Tea and the leading position in the Sri Lankan tea plantation industry. ICRA Lanka takes into account the experience of the promoters, the Company's strong track record and reputation in the industry which have enabled the Company to enjoy steady access to funding from financial institutions. Moreover, since Metrocorp group considers its plantation sector as a strategically important sector due to its environmental sustainability and carbon neutrality objectives, the assigned ratings factor Metrocorp group's consolidated financial strength and the ability of the group to provide any financial support towards the plantation sector. Bogawantalawa tea estates are situated in the Golden Valley located in the central hills of Sri Lanka. This has not only helped the Company to produce high quality tea, but also to command premium prices over other tea plantation companies in Sri Lanka.

However, the revision of the rating outlook to Negative from Stable, is on account of moderation in the financial profile of BTE at the consolidated level during 9MFY2019 as well as the current macro challenges faced by the plantation sector. During FY2017, and FY2018, the Company's tea production was affected negatively due to adverse weather conditions that prevailed during these periods. However, during these periods, the Company's net realizations (NSAs) have increased to LKR 540/Kg in FY17 and LKR 620/Kg in FY18 and this has in turn helped the Company to cushion the impact from the overall reduction in tea productions during these periods. Similarly, during 9MFY19, the adverse (inconsistent) weather conditions have continued and the Company's tea production has been affected. In contrast, during this period, the Company's net realizations (NSAs) have declined by YOY 10-12% to LKR 560/Kg, resulting in reduced profitability margins of the Company during this period; the Company's revenue has declined by ~YOY 10-11% to LKR 2,404 Mn in 9MFY2019. During this period, the Company's PAT has declined to LKR 36 Mn compared to LKR 163 Mn in FY2018. The Company's capital structure remains moderate due to declining profitability margins and increasing debt level, with gearing of 0.38x in FY18 and 0.60x in 9MFY19. The

impact from the recent wage hike, which was implemented from early CY2019, is also expected to affect the overall financial performance going forward. However, the Company is planning to implement several cost saving measures and thereby, the impact from the recent wage hike is expected to be reduced to an extent. ICRA Lanka also notes that the Company's debt metrics is likely to be moderated to an extent in the short term, post the proposed convertible debenture programme, notwithstanding these funds being expected to be utilized largely in the Company's efficiency/productivity improvement measures such as replantation and the settlement of short term debts.

Historically, the Company's high grown tea segment has accounted for ~95% of the total revenue and therefore, ICRA Lanka takes note of the Company's recent/ongoing diversification initiatives into the new segments such as specialty tea varieties, timber plantations, and oil palm cultivation. The proposed convertible debenture programme will further help the Company to accelerate these capital expenditure programmes, going forward.

The financial performance of Bogawantalawa Tea Ceylon (Pvt) Ltd (BTC) has been negative over the past several years largely due to operational losses in the local division. Therefore, the ability of the Company to successfully turnaround this operation in the medium term, will remain as a concern.

Key rating drivers

Credit strengths

Experience of the promoters and the group support: The assigned ratings consider favourably the experience of the management team and BTE's strong operational track record, which have enabled the Company to record healthy growth in revenues and profits over the past several years. ICRA Lanka also draws comfort from the experience of the promoters, who are actively engaged in the strategic decisions of Bogawantalawa Tea Estates PLC and the reputation in the industry, which have helped the Company to enjoy steady access to funding both from the capital markets as well as financial institutions that have supported its growth over the years. The Company's strong corporate governance structure adds further comfort for the reaffirmed ratings.

Attractive NSA levels; The Company's NSAs are among the top three plantations companies in Sri Lanka and further, the Company's estate level NSAs are well diversified. However, during 9MFY2019, the overall average tea prices (for high grown tea) have declined by 10% to LKR 575 from LKR 620/Kg in FY2018. This was largely attributable to tea import restrictions, imposed by Japanese authorities (due to higher MRL levels of MCPA chemicals, after banning widely used Weedicide-Glyphosate in Sri Lanka). Moreover, the political/economic instabilities of Ceylon tea importing key markets/regions (such as Middle Eastern and CIS countries) have also contributed to this reduction in average NSAs. However, the management is confident that the average NSAs (for their tea produce) would be further increased by ~ LKR 50/Kg in FY2020, after further enhancing the quality-standards of their tea productions (through the manufacturing/plucking processes). Further, the Company intends to market their quality standard as Bogawantalawa teas are produced from the globally famous-Golden Valley of Ceylon. Therefore, the ability of the management to successfully market their tea produce (through the quality enhancement exercise) and thereby increase the average NSAs as envisaged, remains to be reviewed in the future.

Strong revenue visibility amidst the diversification Strategy: the Company intends to further develop highly demanded specialty tea varieties (such as oolong and organic tea varieties) going forward although this market segment is still at initial stages. The proposed convertible debenture programme will help accelerate the Company's replanting exercises (for tea and other crops) and therefore, ICRA Lanka will

continue to monitor the progress of the Company's capital development programmes going forward. The Company also continues to invest in timber plantations in its low country estates; these biological assets are valued on annual basis and the fair value of these trees were valued at LKR 839 Mn as at 31st March, 2018. Going forward, this segment will be a major income generator of the Company, as certain regulations preventing the harvesting of timber trees, have now been resolved by the Company. Given, the Company's tea plant-age profile, which represents relatively older tea plants in the tea plantation estates, ICRA Lanka envisages that the Company's ongoing replantation/infilling exercises should be further accelerated, post the proposed convertible debenture programme, besides the Company's increased long term capital commitments towards new oil palm projects.

Credit challenges

Cyclical nature of the plantation industry, leading to risk of volatile cash flows: Plantation industry is cyclical in nature and the exposure to adverse weather conditions, impacts the net realizations (due to quality variations) as well as tea production. During past two years, Sri Lanka's tea production has declined by 10-13% (from the normal production levels during CY2010-CY2016) due to adverse weather conditions that prevailed during these periods. Moreover, during 9MFY2019, the adverse weather conditions have further continued and therefore, again, the country's tea production levels have been negatively affected. However, Company's yield levels are relatively higher than the national average due to ongoing replantation exercises.

The Company's operations are also exposed to regulatory risks, including changes in interest rates, changes in agricultural practices & policies etc. However, ICRA Lanka notes Sri Lankan tea plantation industry's position as a major foreign exchange earner and employer in the country and therefore, the government's policy towards this industry will tend to be supportive, as in the past. Moreover, given the tea plantation industry in Sri Lanka is an export oriented industry, the Company's net realizations (NSAs) are indirectly benefited by the Sri Lankan Rupee depreciation.

Increased cost of Production due to periodic wage hikes: the increased labour costs and lower productivity levels have negatively affected the performance of the tea plantation industry over the past several years. The labour cost represents around 60-70% of the Company's production cost. The collective labour agreement (between the plantations workers' unions and the Regional Plantation Companies (RPCs)) was renewed in early CY2019. The plantations unions have agreed for a total wage of LKR 855/day. According to the new wage agreement, the productivity based incentive scheme, which was introduced in Oct 2016, has been excluded. However, according to the management, this is unlikely to negatively affect their productivity levels as most estates of the Company have lower norm levels (average tea plucking-targets per day per worker). Notwithstanding, the Company's recent efficiency improvement measures, the risk of margin erosion due to periodical wage hikes is high and is accentuated by BTE's volatile operating profit margins. Therefore, the ability of the management to manage the increased labour costs without affecting the Company's tea productions is key towards improving the overall profitability indicators and therefore, this is a rating sensitivity to the reaffirmed ratings.

Moderation in Financial Profile: BTE's revenues have increased at a compounded annual growth of 1.2% over the last five years (FY2012-FY2018) driven by the sharp Increase (9.3% annual growth) in average NSAs. The Company has recorded a PAT of LKR 94 Mn in FY 2017 and LKR 163 Mn in FY2018, as against LKR 36 Mn in 9MFY2019. The Company's capital structure has moderated on account of declining profitability margins and relatively high debt level. The debt profile of the Company is largely skewed towards long term loans, with the same contributing to over 65% of the debt outstanding in 9MFY2019. BTE's cash flows and coverage metrics have also moderated in 9MFY2019, stemming from reduced

profitability, and consequently, the moderation in debt levels. However, the Company is likely to further increase its capital expenditure plan on replantation and revenue diversifications projects through the proposed convertible debenture programme. This would exert some pressure on the debt coverage metrics to an extent in the short to medium term.

Negative financial performance of the Subsidiary: Financial performance of Bogawantalawa Tea Ceylon (Pvt) Ltd (BTC) has been negative over the past several years largely due to operational losses in the local division, which is approximately 25-30% of the Company's revenue. The losses in the local operation is attributable to the increased competitive landscape in Sri Lankan market. Moreover, BTC has been strategically investing in the distribution system during past two years. Over the past few years, BTE has not provided any direct capital support for Tea Ceylon (Pvt) Ltd. However, during 9MFY2019, the financial losses at BTC has been further contained and therefore, BTC is expected to turnaround in FY2020. This will also help the Company to limit its financial support towards the marketing operation going forward. Therefore, the ability of the Company to successfully manage and turnaround the marketing operation in the medium term remains to be reviewed.

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%20Methodology.pdf

About the Company:

Bogawantalawa Tea Estates has been producing predominantly high grown tea since 1869 from the Golden Valley located in the central hills of Sri Lanka and manages over 6,000 hectares of land (with 11 estates). After the privatization of the plantation estates in 1992 by the Sri Lankan Government, Metrocorp group, through Metropolitan Resource Holdings Plc (MRH) acquired the Bogawantalawa tea estates (along with some rubber estates). However, during 2002/03, the management decided to fully focus on the tea plantation business and therefore, 17 rubber estates were subleased to Lalan Rubber (Pvt) Ltd. Therefore, currently, the Company's operation is largely limited to the production of high grown tea (the Company has only one low grown tea estate, and the low grown tea production of this estates is about 5-7% of the total tea production). BTE was incorporated in 1992, and is today a public quoted Company listed on the Colombo Stock Exchange. Metropolitan Resource Holdings PLC (MRH) is the plantation agent of Bogawantalawa Tea Estates PLC and currently MRH owns a 79% stake in Bogawantalawa Tea Estates PLC.

Bogawantalawa Tea Ceylon Pvt Ltd (BTM) is the marketing arm and a fully owned subsidiary of Bogawantalawa Tea Estates PLC. BTC markets a wide range of black and green tea in packets and tea bags. The Company's product range includes flavoured, herbal and bulk forms. BTC is one of the largest and preferred suppliers of tea and herbs from Sri Lanka to many prestigious global supermarket chains and large scale food & beverage distributors.

About the Group:

Metrocorp (Pvt) Ltd, formerly known as Metropolitan Investment (Pvt.) Ltd, was established in 1994 and has diversified interests in Agro Industries, Plantations, Hydro power, Water and Environment, Office Automation and Leisure Sectors. The mini-hydropower segment (through Eco Power (Pvt) Ltd), is the largest revenue contributor of Metrocorp Group. Eco Power (Pvt) Ltd is now expanding rapidly in the overseas market, particularly in the African and East Asian regions. Eco Power has a total installed capacity of 75MW of which 37 MW installed capacity (12% of Sri Lanka's installed mini hydro power capacity) is based in Sri Lanka, while the balance is in overseas projects. Currently, under the leisure sector, Metrocorp group manages 40 tourism related bungalows based in their tea estates. The group has continuously

expanded its businesses through an organic as well as inorganic growth. Metrocorp Group along with BTE currently has an asset base of US\$ 120.8 Mn and consolidated revenues of US\$ 26.5 Mn in FY18.

Key Consolidated financial indicators (audited)

Revenue and profitability indicators-Figs are in LKR Mn	FY14	FY15	FY16	FY17	FY18	9MFY19*
Operating Income	4,109.5	4,464.9	4,327.7	4,368.2	4,933.0	3,404.3
OPBDITA	115.2	209.5	178.9	308.5	435.5	246.0
PAT	-28.7	131.5	-1.3	61.8	41.7	-4.0
ROCE (%)	9.7%	12.3%	5.4%	9.5%	14.3%	5.6%
NWC / OI(%)	-27.7%	-26.7%	-25.0%	-26.6%	-15.7%	-20.8%
Total Debt	1,231.1	1,261.6	1,420.0	1,340.6	1,399.5	1,786.6
Networth	1,007.0	1,096.7	1,204.0	1,383.0	1,482.3	1,478.4
Gearing (x)	1.2	1.2	1.2	1.0	1.0	1.2
OPBDITA/Interest & Finance Charges(x)	1.2	1.9	1.5	1.9	2.3	1.9
Total Debt/OPBDITA (x)	10.7	6.0	7.9	4.3	3.2	5.4

Note;-* Unaudited Financials

Rating history for last three years:

Instrument	Amount Rated	Current Rating (FY19) Date & Rating in April 2019	Chronology of Rating History for the past 3 years				
			Date & Rating in FY2018 July 2018	Date & Rating in FY 2018 March2018	Date & Rating in FY 2017 April 2017	Date & Rating in FY 2016 July 2016	Date & Rating in FY 2015
sIssuer rating	N/A	[SL]BBB+ (Negative)	[SL]BBB+ (Stable)	[SL]BBB+ (Stable)	NA	NA	NA
Proposed Senior Convertible Unsecured Redeemable Debentures	LKR 850 Mn	[SL]BBB+ (Negative)	[SL]BBB+ (Stable)	NA	NA	NA	NA

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