MELSTACORP PLC

A Value-oriented Growth

BUY

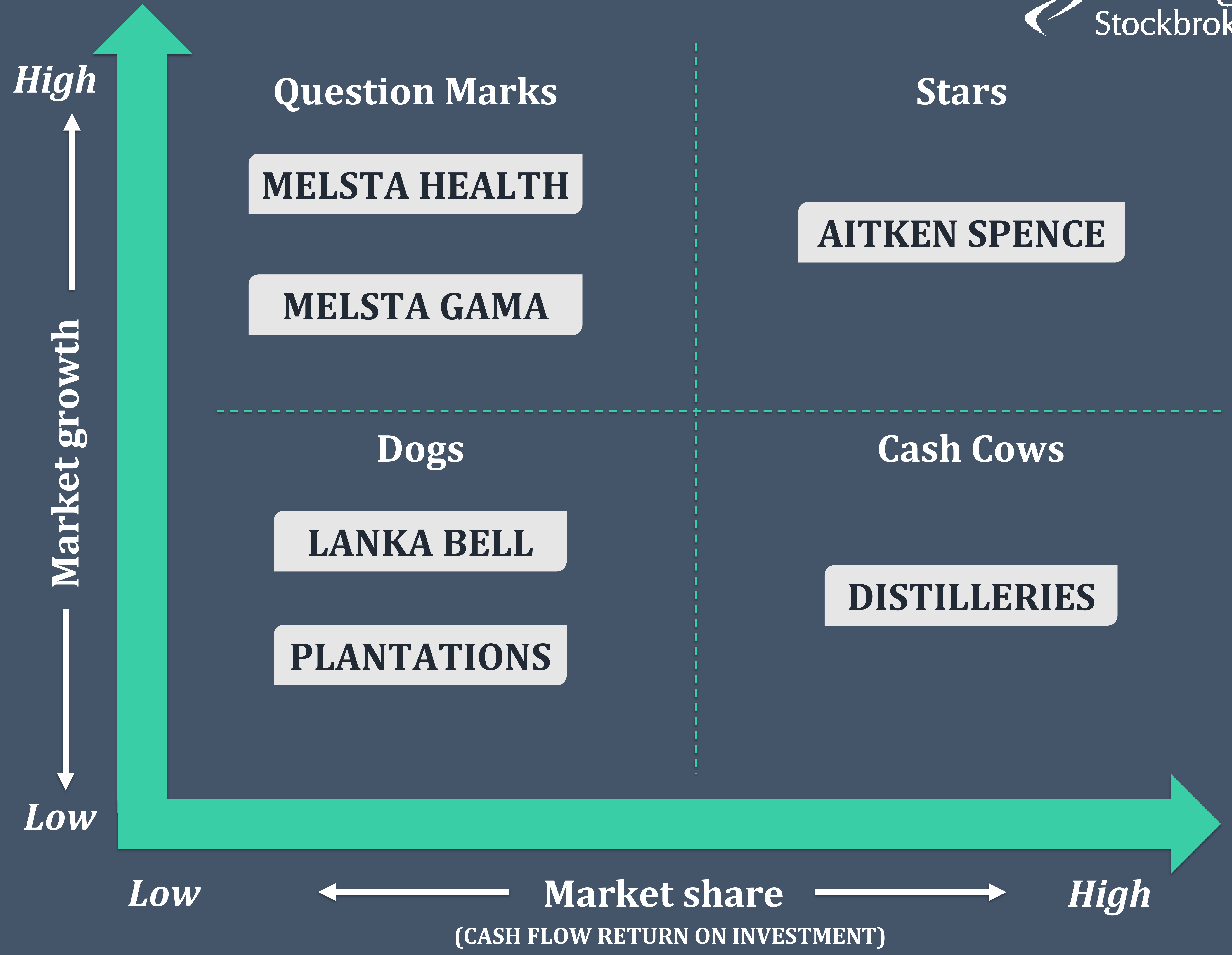
Bloomberg ticker – MELS.SL

Food Beverage & Tobacco
Price (LKR) – 42.3
Target Price (LKR) – 74.0
Total Return (%) – 75%

Share Data

Market Cap (USD mn)	264.8
Market Cap (LKR bn)	49.2
12M H/L (LKR)	43.0/16.0
Free Float (%)	42.7%

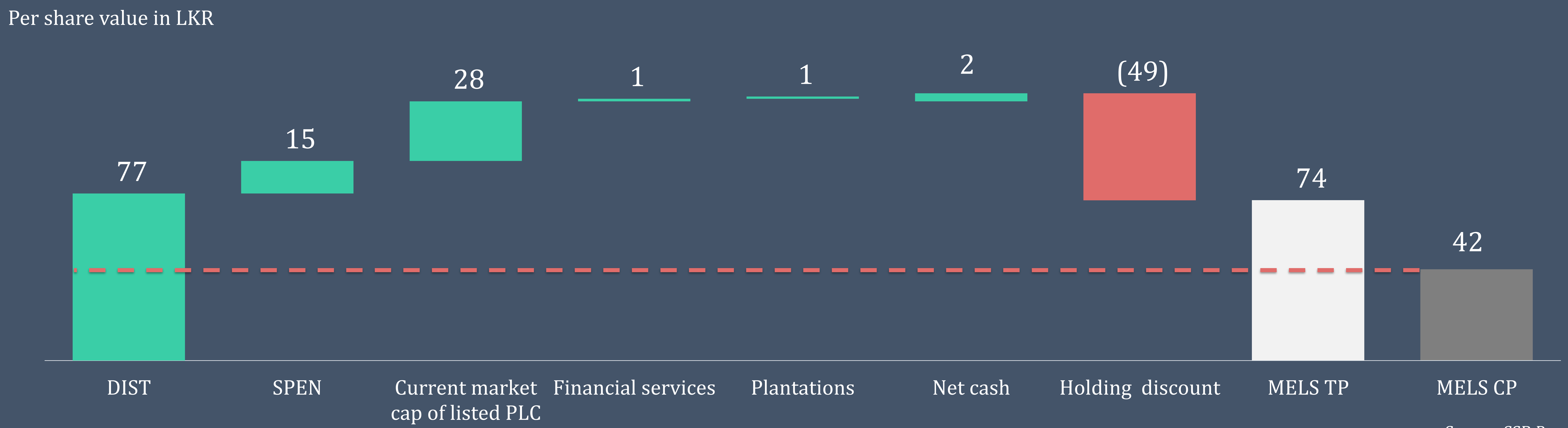
Analyst – Thuvarakan Senthilmani
10 December 2020



A Value-oriented Growth…

A Value Stock: SOTP valuation offers **75% upside**; Nevertheless, portfolio rationalization may shift the gear to be a **Growth Stock**

Assets other than DIST valued at zero by the current MELS share price



Source: SSB Research

A majority of Melstacorp's SOTP valuation is derived from DIST, which makes it understandable that investors prefer to take the direct exposure to DIST than the holding company MELS. However, we think given DIST's higher dividend payout (70-80%) and LKR 31bn liquid investments (in financial assets) puts MELS in a better position to acquire possible targets. We admit the market will only be comfortable with giving it more credit when MELS has a clear strategic focus by divesting its noncore businesses like Lankabell and Plantations while giving more emphasis to growth segments like Healthcare, Cement and Energy. However, the current 75% discount to the portfolio value is too steep even after applying a 40% holding discount. Our TP of LKR 74 is based on a sum-of-the-parts (SOTP) valuation with an upside of 75%, posing a BUY rating.

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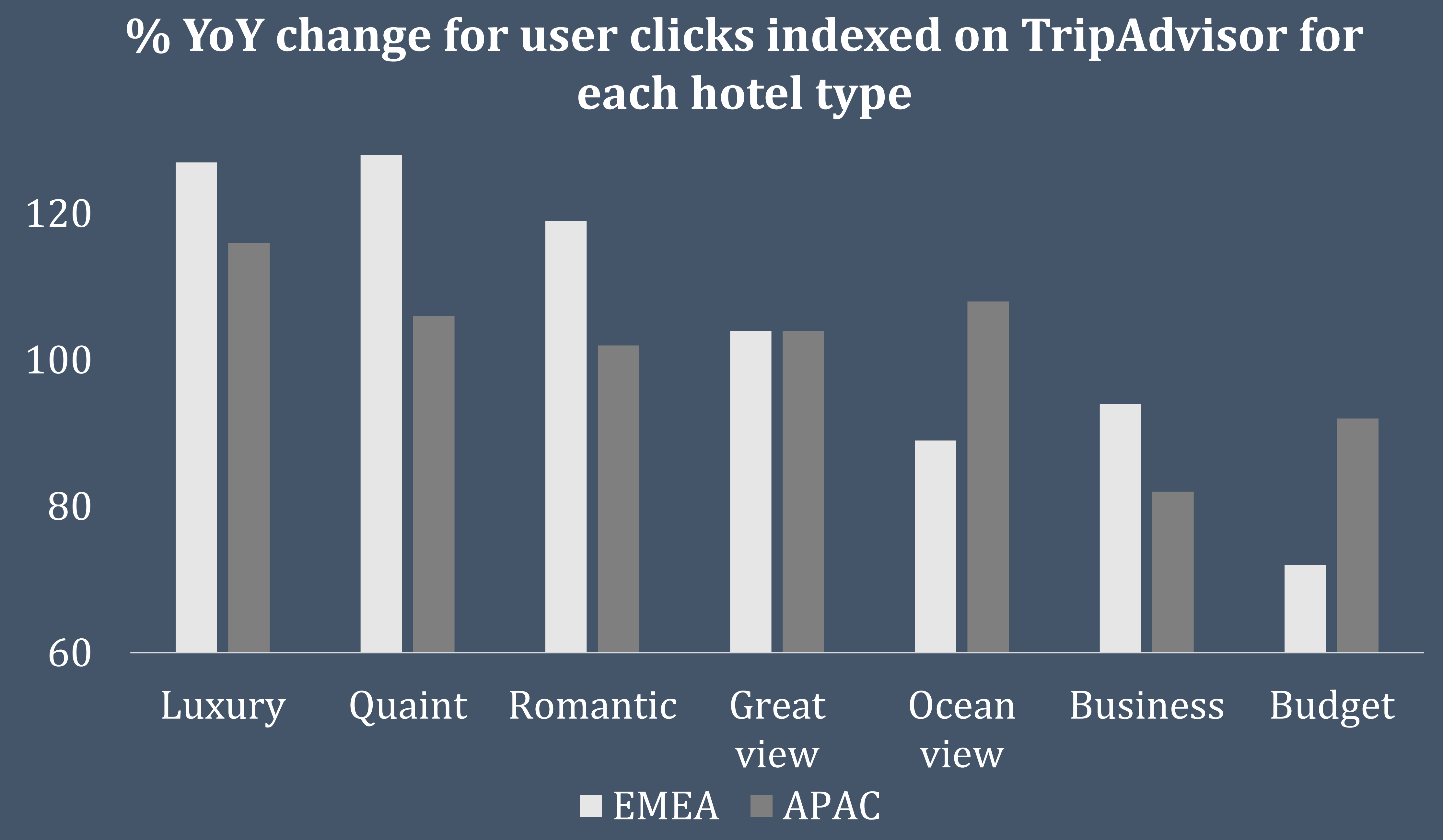
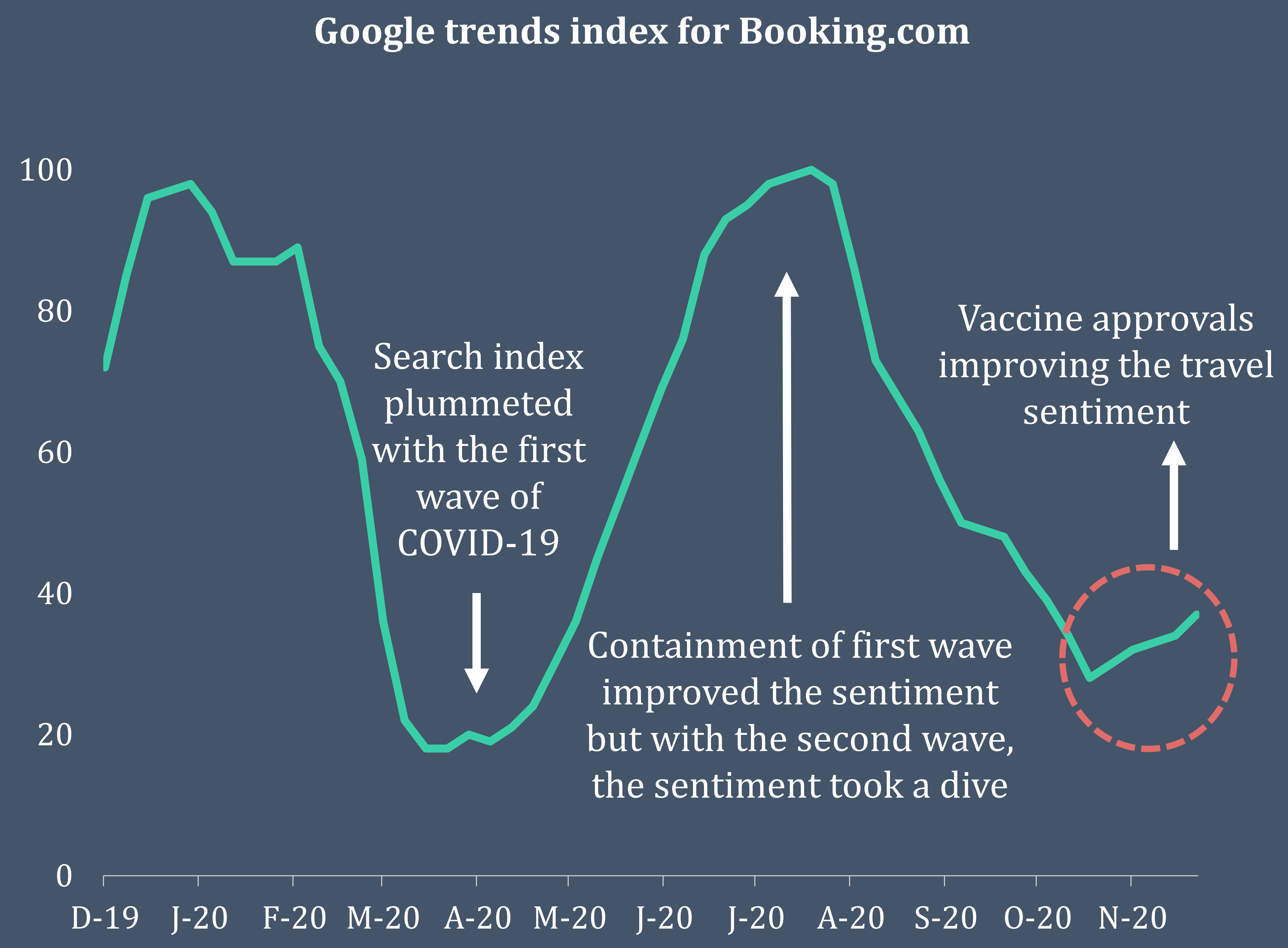
When the **Star** performs…

With the vaccination on the cards, **pent-up demand** would lead to a turnaround in the tourism sector of SPEN which wiped off LKR 5bn earnings in 1HFY21





Hotel searches on TripAdvisor under the categories romantic, great view and ocean view in Asia Pacific (APAC) and Europe, the Middle East and Africa (EMEA) recovered significantly on a YoY basis in Sep-20. Such a development is beneficial for SPEN as the company has significant exposure to these target segments in the region.

Source: Company data, TripAdvisor, Google trends, SSB Research

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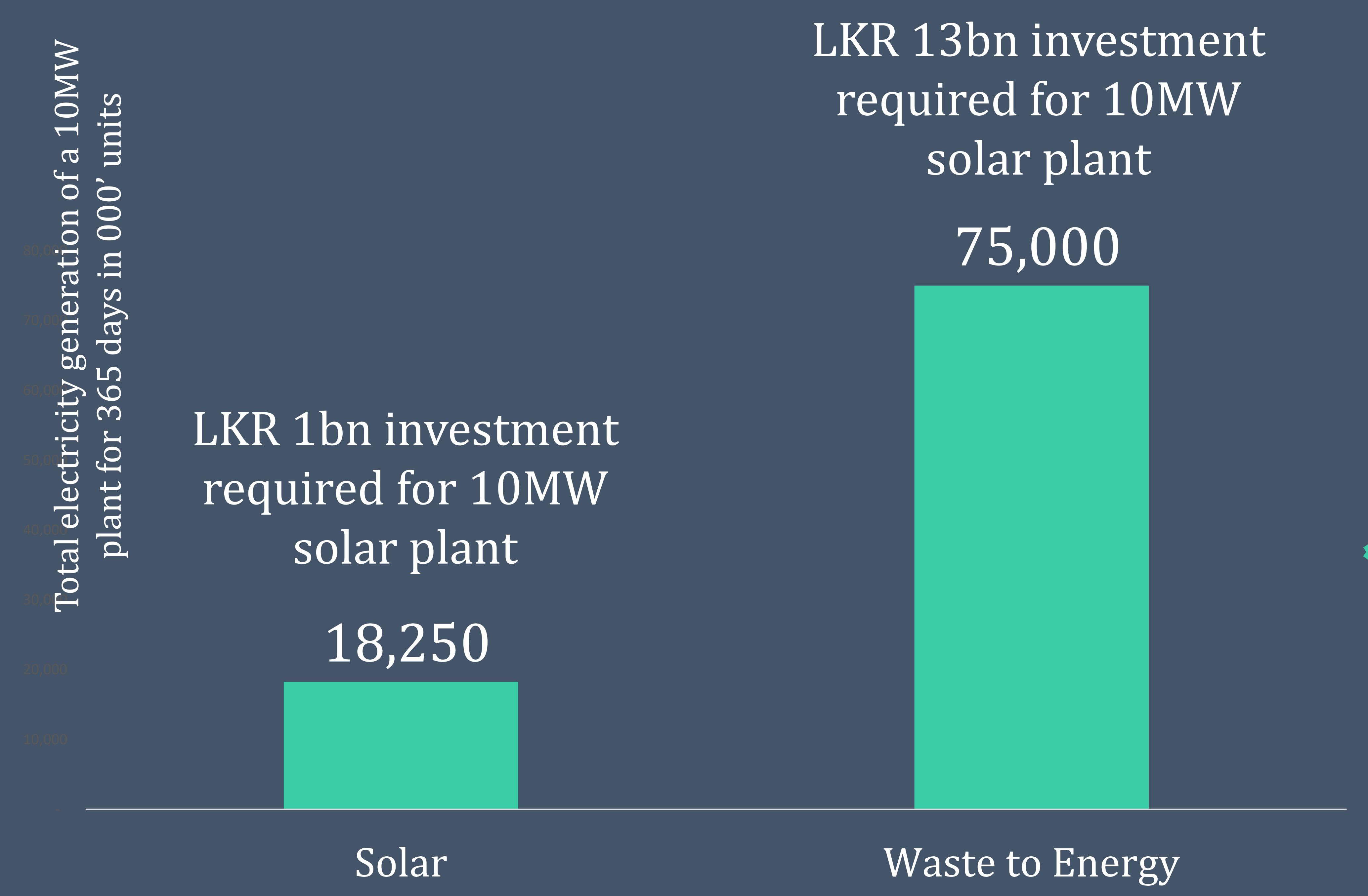
A Win-Win solution: LKR 13bn Waste to Energy plant to provide 10MW capacity to the grid while addressing the problem of solid waste (700 MT) disposal and landfilling

Read our highlights on SPEN: ***Things can only get better:*** We maintain a BUY on SPEN with a TP of LKR 75



Given that an LKR 13 Bn investment could otherwise go to the creation of over 100 MW of solar Capacity, this project would be financially viable only if a higher tariff could be charged for the project. Given that WTE could be almost 4 times more productive, the tariff (which may include a waste clearance payment) should be almost 3x the typical solar tariff for the company to see the project as a feasible opportunity.

The current WTE offers an opportunity to reduce 700MT of the Municipal waste and could yield ash as a by-product, which if reused claims 100% recovery from waste..

The waste to energy (WTE) plant can be operated closer to 21 hours per day by burning waste. As a result, electricity generation will be higher compared to solar which will have a direct sun exposure of 5 hours per day on average.

Source: Company data, SSB Research

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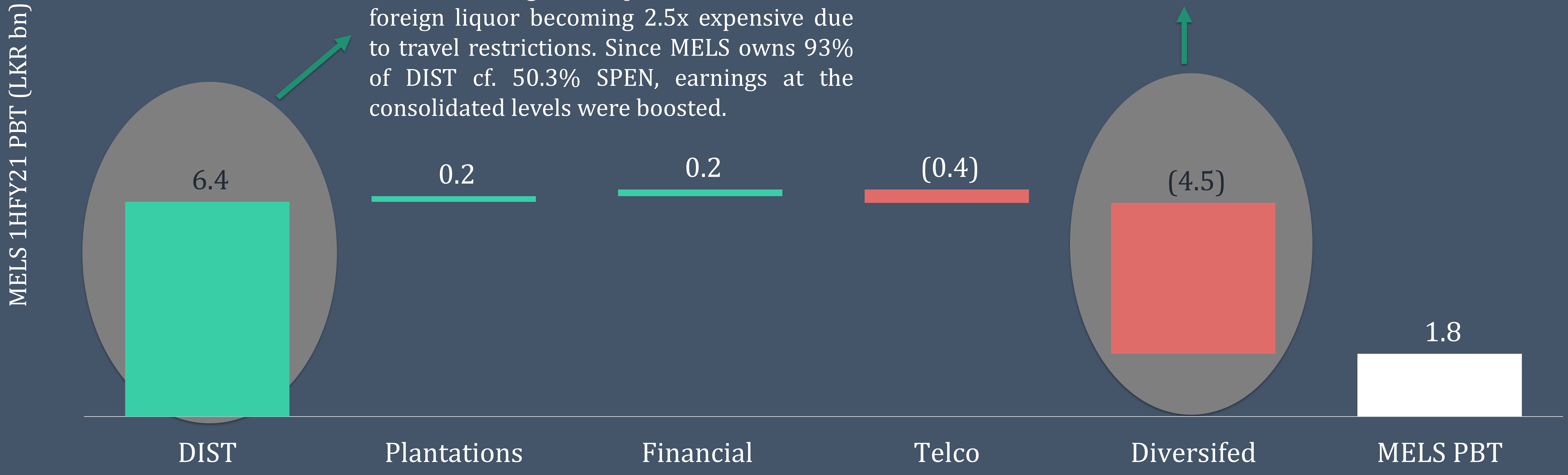
The **Cash Cow** to soften Group earnings volatility

DIST continues to be the Cash Cow, with a resilient dividend income, compensating for earnings volatility of the other sectors

Read our highlights on DIST: ***The light at the end of the Tunnel***: We maintain a BUY on DIST with a TP of LKR 24

SPEN reported an earnings of LKR 4bn in FY19. However, due to the closure of hotels in 1HFY21, the performance of SPEN took a beating, with a loss of LKR 2.3bn.

DIST reported LKR 3.6bn earnings in 1HFY21 due to sourcing of cheaper local ethanol and foreign liquor becoming 2.5x expensive due to travel restrictions. Since MELS owns 93% of DIST cf. 50.3% SPEN, earnings at the consolidated levels were boosted.



Source: Company data, SSB Research

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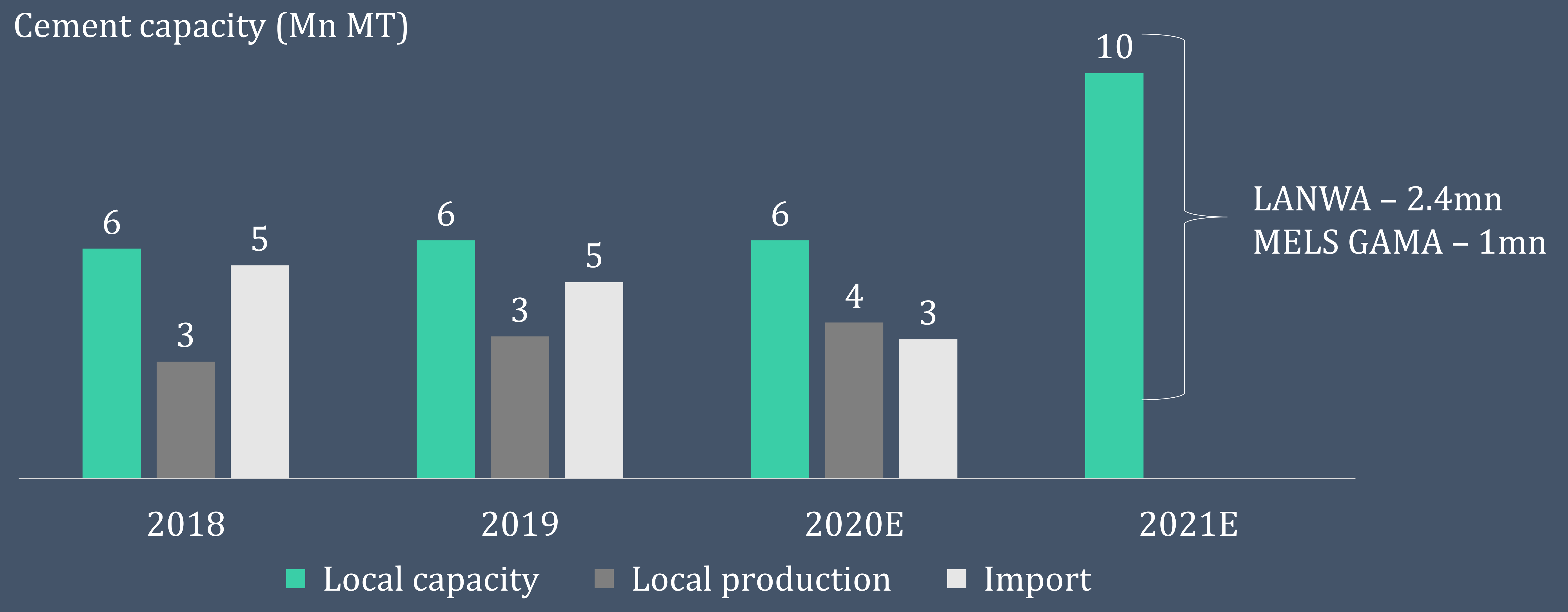
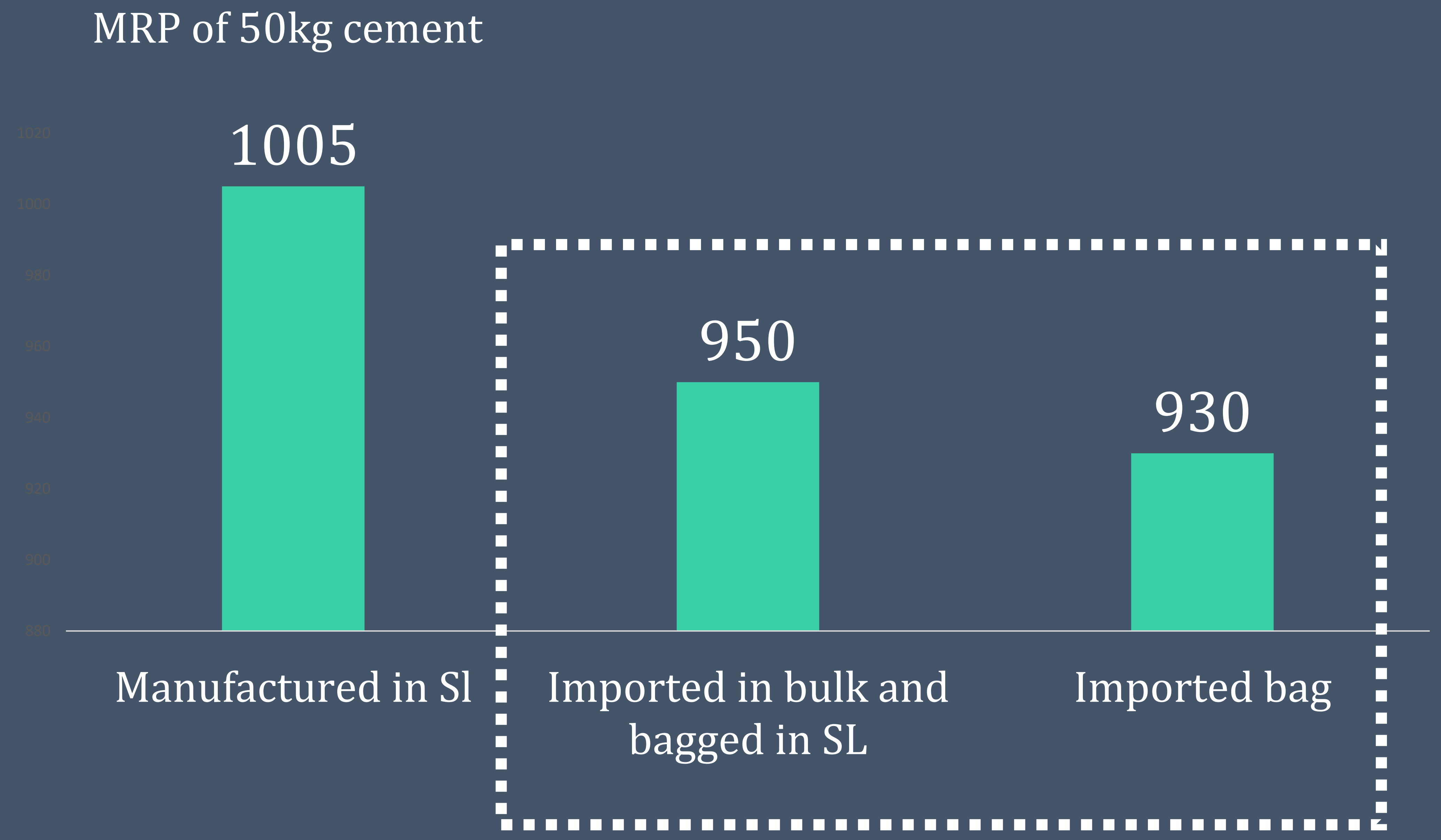
While limited information is available on **MELSTA-GAMA** plant, we remain positive on the cement industry due to the flourishing opportunities in the construction sector

We expect cement demand recovery to get stronger in the coming quarters considering resilient rural and retail demand, expected recovery in urban developments, and increased government spending on road and water related projects.



MELS entered a JV with Pyramid GAMA to import, bag and distribute cement in Sri Lanka. The company has invested LKR 1.1bn in this JV thus far. Industry source indicates that capacity could be in the range of 1mn MT



Our understanding is that MELS-GAMA JV will import bulk cement to bag it in SL. This set-up can exert pressure on margins for a start-up due to the CESS imposed on cement imports. Further, discounted pricing to capture market share can also erase margins in the short term. However, long term prospects remain intact.

Source: Company data, Industry sources, CBSL, SSB Research

Ample opportunity for **divestments** may allow expansion in lucrative segments…

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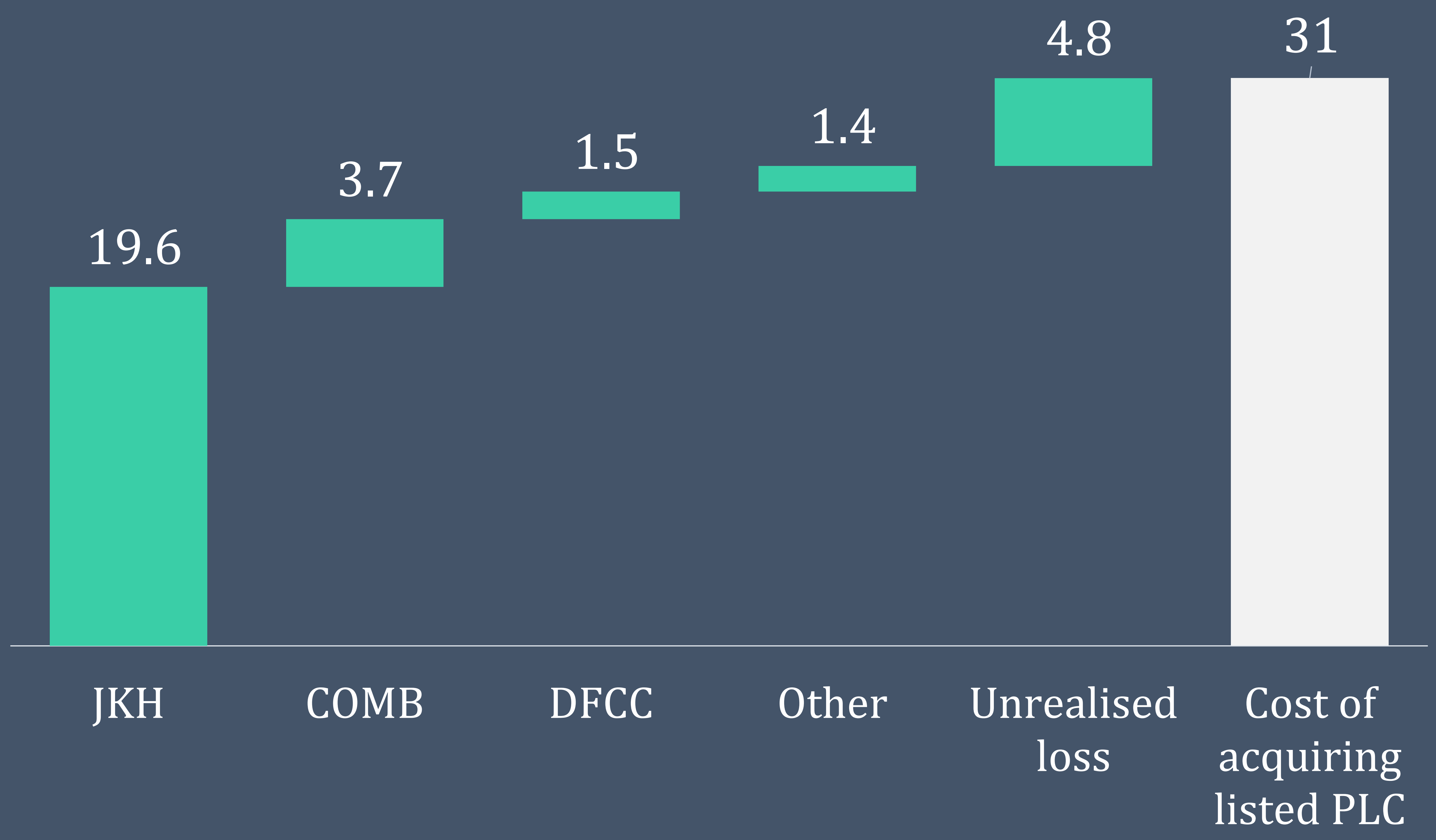
LKR 31bn being tied up in value stocks with low dividend yields dragged down earnings growth over the years

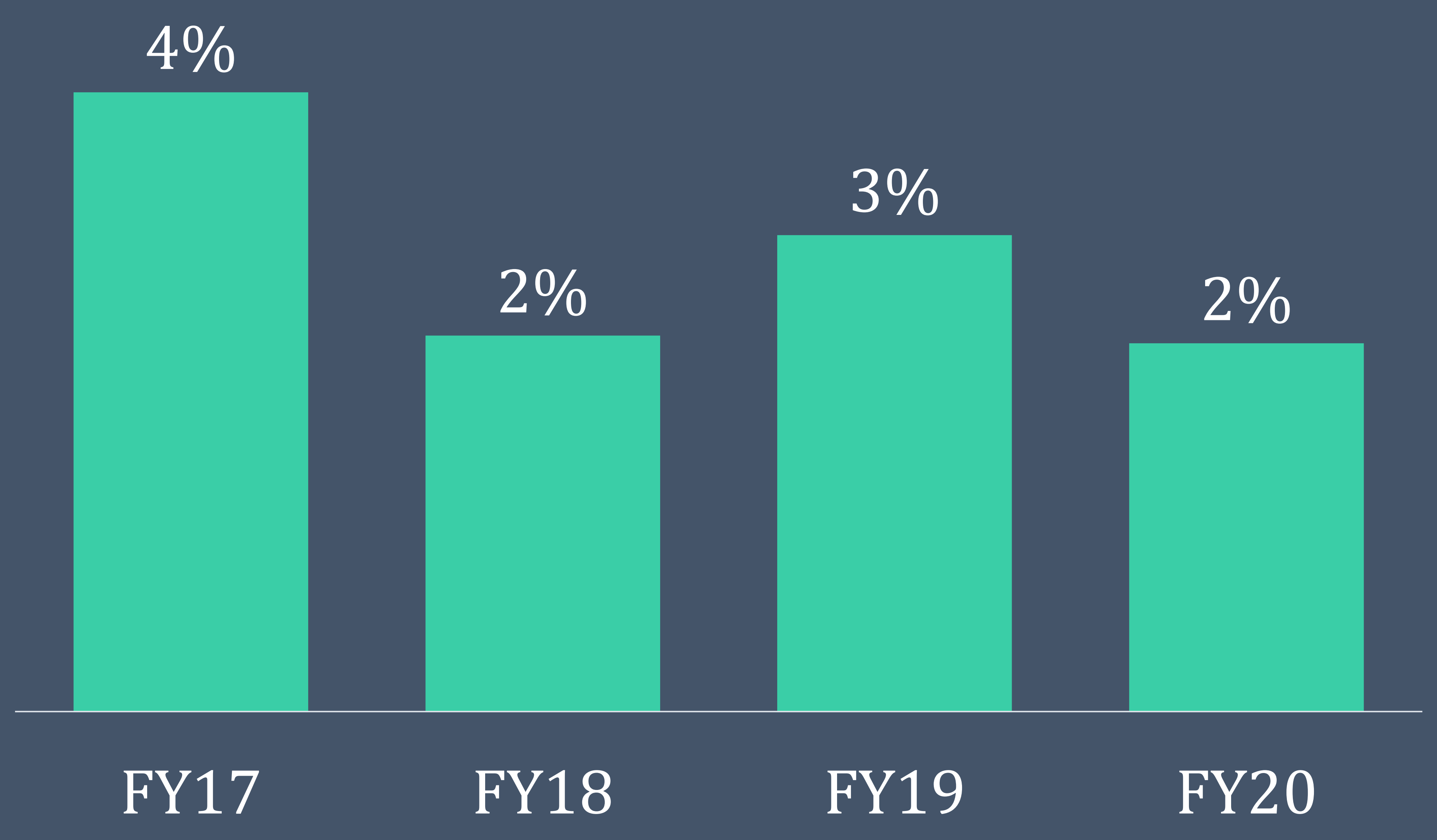
MELS has invested LKR 31bn in liquid counters while dividend income from these counters remained low over the period. With the ASPI crossing 6600 levels, MELS should be able to divest non-strategic counters with a capital gain, providing fresh capital to acquire hospitals in healthcare segment.

Scenario: MELS selling 200mn of DIST shares at LKR 25 per share to improve the free float will inject LKR 5bn capital to the company.

Current Market cap of listed securities excluding LMF in LKR bn



Historical dividend yield of the stocks based on investment cost



Source: Company data, SSB Research

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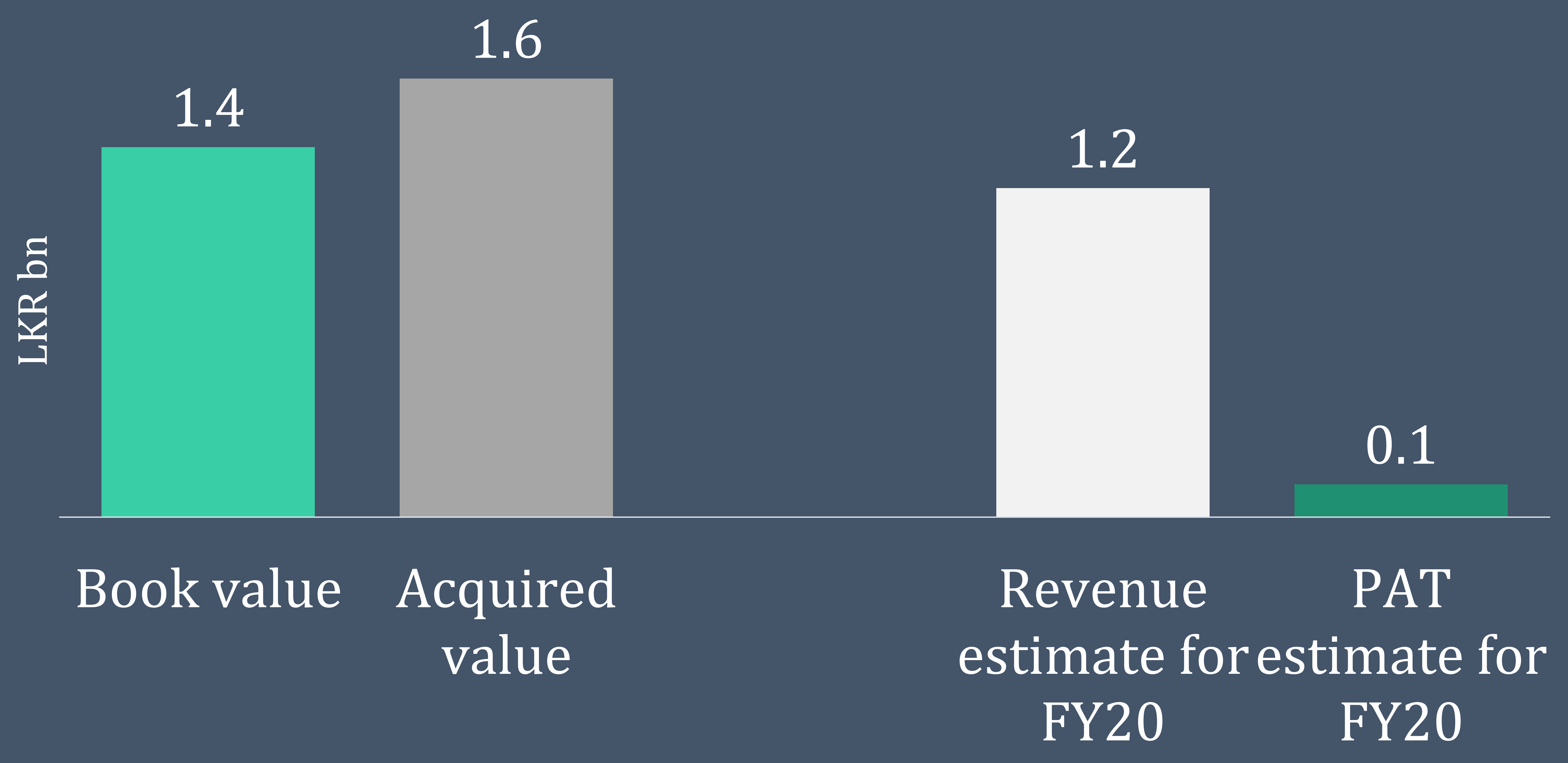
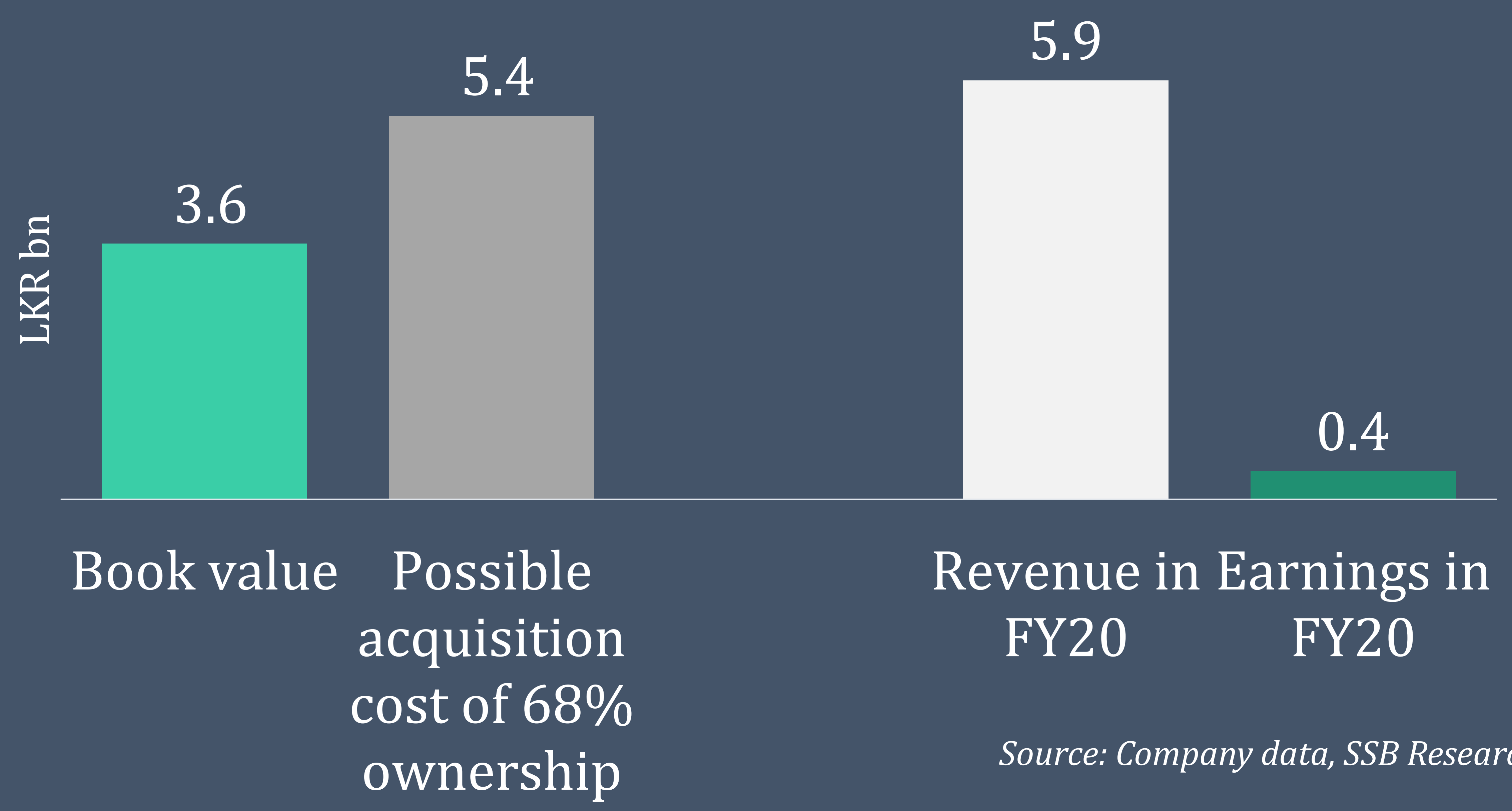
A probable disposal of highly liquid financial assets may inject fresh capital to **acquire larger hospitals** which may facilitate significant earnings growth in healthcare sector

MELS acquired Browns Healthcare (70 bed capacity) for LKR 1.6bn in 2020. Melsta Health has 4 medical labs, with plans to enter pharma business. We believe MELS has sufficient fire power (LKR 2bn net cash + LKR 31bn equity investments) to acquire larger players in healthcare segment to facilitate faster growth.

Scenario: If MELS acquires 68% stake of Durdans hospital, the healthcare segment should be able to post a consolidated earnings of LKR 500mn per annuum while expanding its lab presence to 102 locations from present 4.





Source: Company data, SSB Research

Health care spending is projected to increase driven by the aging of the population, technological and therapeutic advances, and increased medical insurance coverage.

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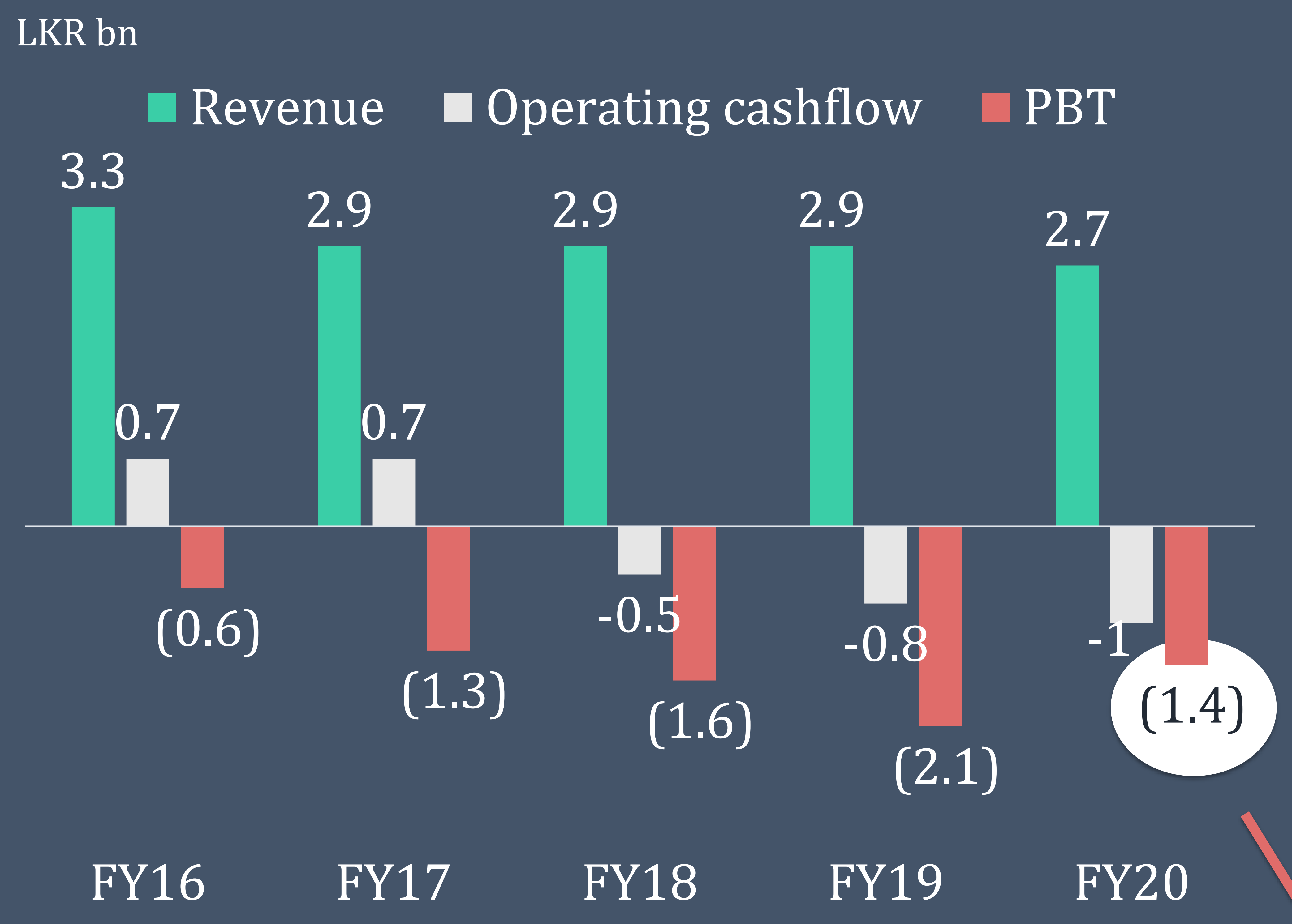
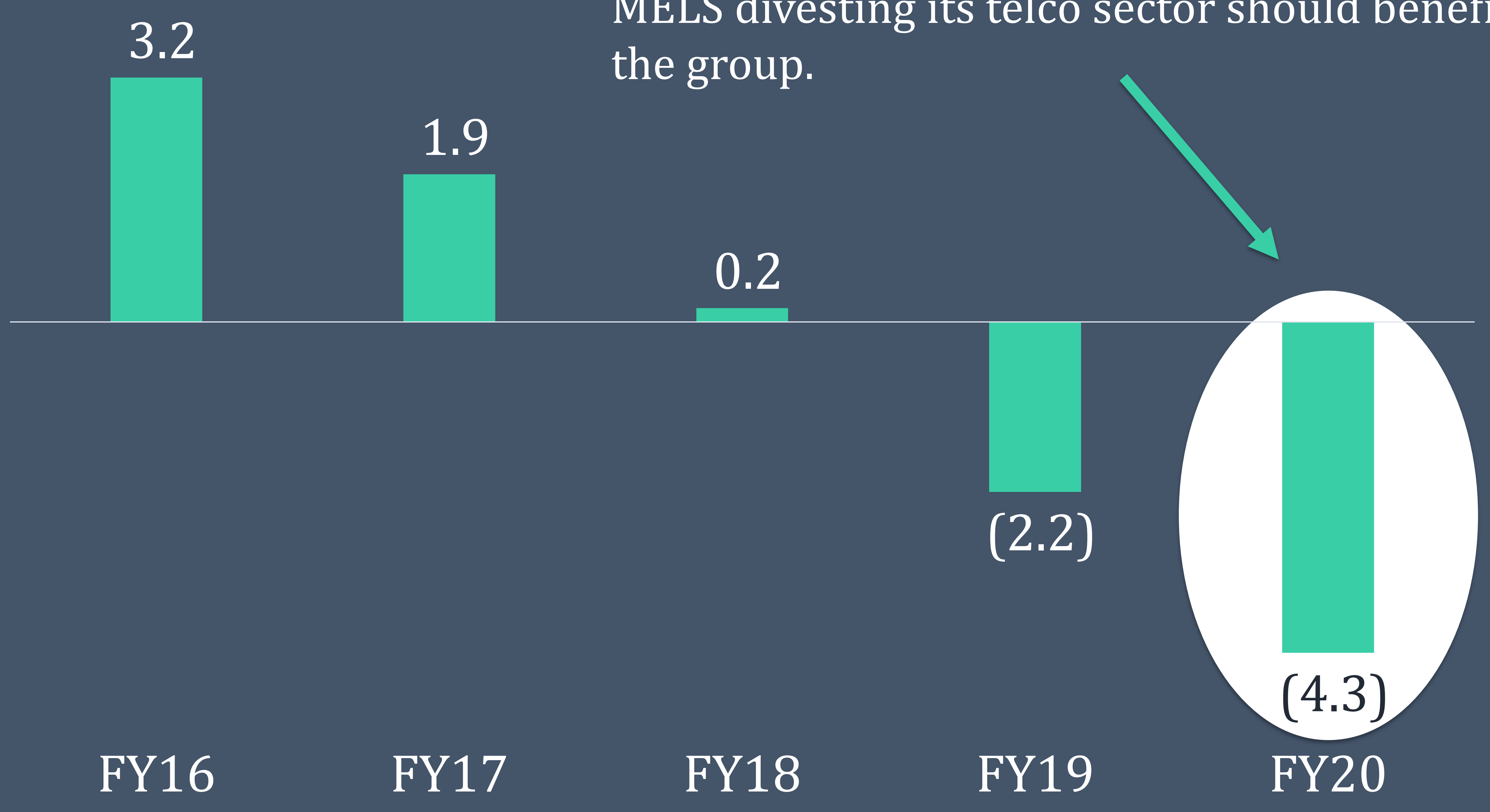
We believe Lankabell is a problem child for MELS. Thus, divestment of Telco sector should reduce earnings volatility at the group level

Telco sector Revenue, Operating cashflow and PBT



MELS owns 99.73% ownership of Lanka Bell Ltd, hence significant portion of the loss will be consolidated to the group P&L wiping off profit contribution from other sectors.

Telco sector NAV (LKR bn)



Since FY16, the company had invested LKR 5.4bn in capex while EBIT expanded its negative territory. Due to intense competition from DIAL and SLT, we believe MELS divesting its telco sector should benefit the group.

Source: Company data, SSB Research

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Appendix

AITKEN SPENCE (SPEN): BUY

Things can only get better

CMP LKR 61 + Gain: 23% DY: N/A = TP: LKR 75

- **SPEN reported a loss of LKR 2.3bn in 1HFY21** mainly on the back of Tourism sector reporting a loss of LKR 5bn. Excluding the Tourism sector, the group would have generated a profit of LKR 1.3bn (translating into an EPS of LKR 3).

- **Tourism sector to witness a turnaround in FY22.** While the next few months could be choppy for the tourism sector given the rising Covid-19 cases locally, AHUN's business offerings are well positioned for the anticipated acceleration in leisure travel that appears likely to begin in 1HFY22E given the rollout of Covid-19 vaccines.

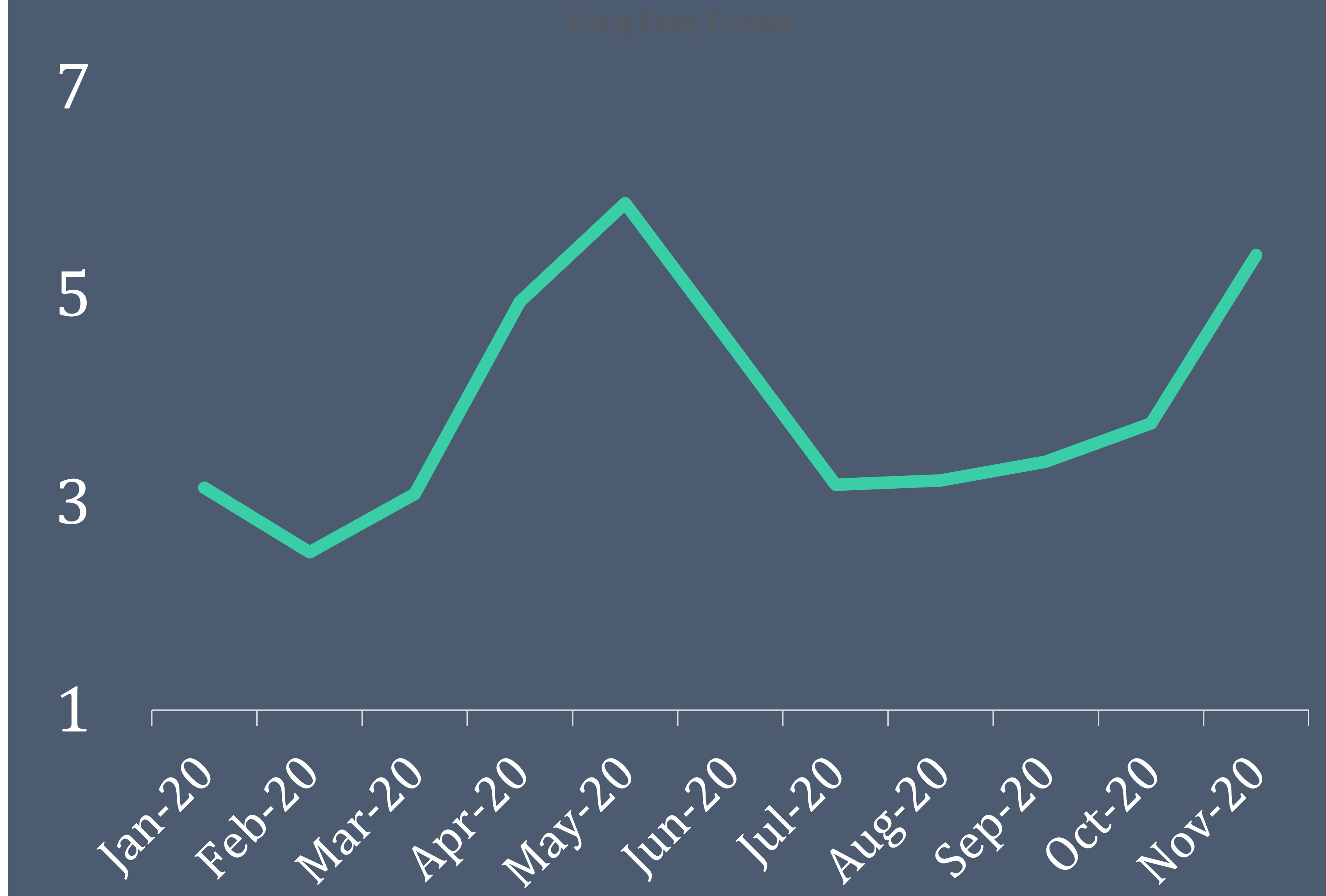
- **The commencement of the waste to energy plant is expected to yield positive to earnings for the group.** An additional revenue stream can be generated with the recycling of ash. While we wait for more information on the operational capex and capital structure of the project, our scenario analysis by looking at global players indicates that WTE plant may generate a *c.*LKR 700mn profit.

- Maritime & logistic sector EBIT margin expanded to 24% in 1HFY21 cf. 19% in 1HFY20. The expansion was achieved despite a 17% YoY decline in revenue to LKR 3.9bn. We believe the profit expansion could be due to rise in air freight rates due to limited air cargo capacity. We expect this trend to continue in 3QFY21E.

- Strategic Investments' earnings for 1HFY21 declined to LKR 149mn cf. 617mn in 1HFY20. The decline in performance could be due to lower utilization rate at the printing and apparel factory.

- In our scenario for SPEN, we believe all other segments may continue to perform the same while Tourism sector may witness a turnaround in 1HFY22E along with the launch of WTE plant. We value SPEN at LKR 75/share based on a FY22E EPS of LKR 9.4 implying a PE of 8x.

TAC Index monthly airfreight rates for Hong Kong - Europe



Source: TAC

DISTILLERIES PLC (DIST): BUY

SGST – light at the end of tunnel?

CMP
LKR 21

Gain: 14%

DY: 9%

TP: LKR 24

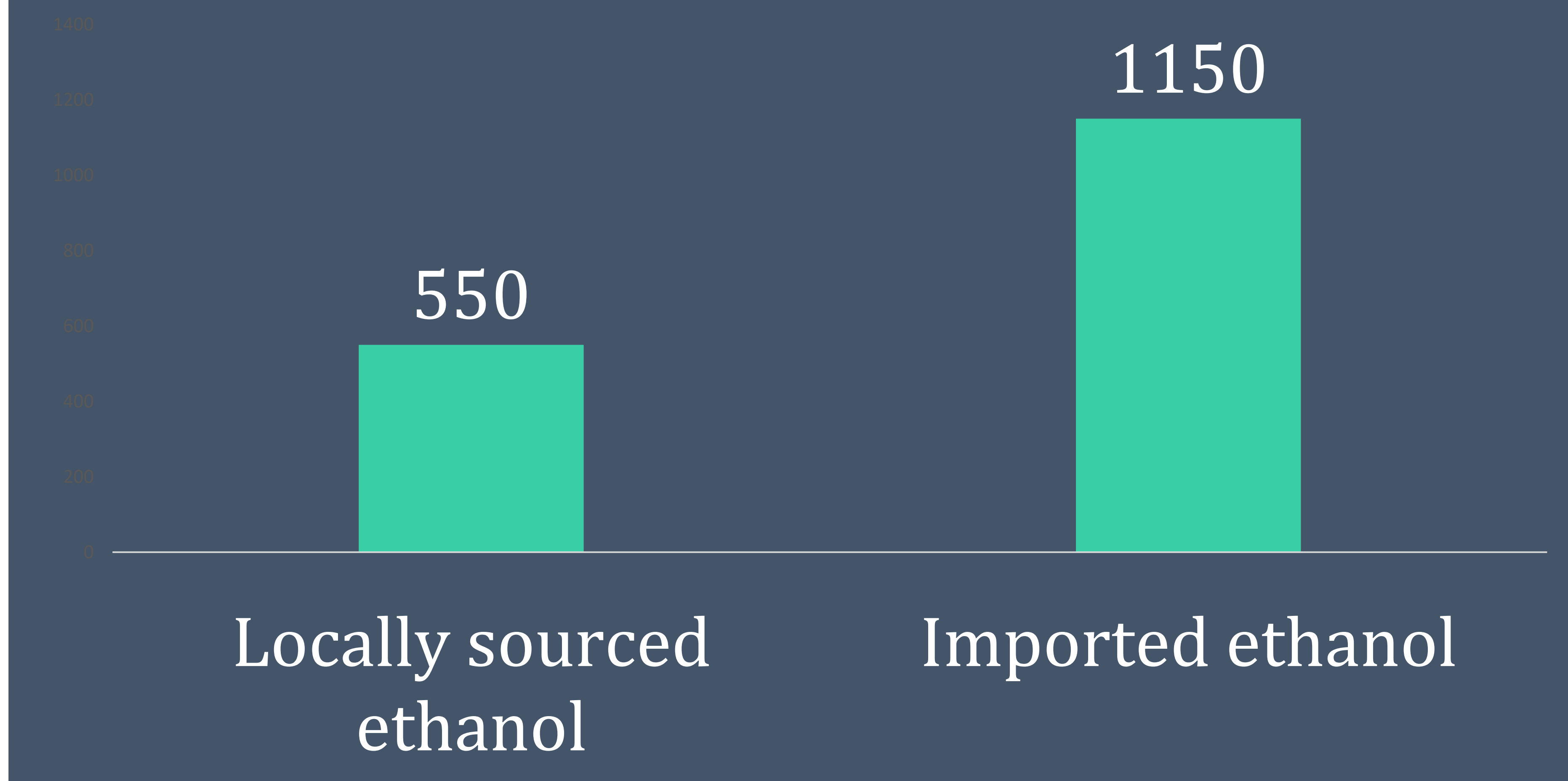
- **The Special Goods and Services Tax bill (SGST) proposed in 2021 budget,** with online management could be a game changing reform as effective tax collection can lead to cracking illicit alcohol market. According to industry sources, illicit market represents 35% of the total market size, a 10% share from the illicit market means an incremental 3mn liters alcohol volume for licit players and additional LKR 8bn excise revenue for the government.

- **On the other hand, we believe without the relaxation of wine store licenses it will be very difficult to crack the moonshine market.** At present, wine stores generate the highest revenue for the alcohol sector cf. bars or hotels. But when it come to its presence almost 40% of the outlets are scattered in Colombo, Gampaha and Nuwaraeliya. One way to boost the legal channel is to reduce the liquor license fee of retail outlets which have wider presence in the country.

- **Margin outlook – tailwinds emerging:** Improvement in earnings in 1HFY21 was also due to sourcing of local ethanol which is 50% cheaper than imported ethanol. The Capacity expansion of 70k MT at Lanka Sugar Company along with a possible launch of sugarcane cultivation in Kantale would aid margin expansion of DIST in the long run. In the short run, with the COVID-19 out break limiting duty-free alcohol to the local market, DIST is expected experience volume growth.

- **Downside risk:** It remains a key concern for us that the government may raise the excise duty to compensate any funding constraints faced. Present excise duty structure currently stands at LKR 4,050 for coconut arrack vs. beer LKR 3,200 per proof liter.

Ethanol price per liter in LKR



Source: Industry sources, SSB Research

- Our 10x P/E multiple derived NTM earnings target price for DIST stands at LKR 24, which in our view makes it reasonably attractive given the company's higher dividend payout. Total return 23% including a dividend yield of 9%.

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