FitchRatings

Fitch Downgrades Kotagala Plantations to 'CCC(lka)'

Fitch Ratings - Colombo/Singapore - 16 Oct 2024: Fitch Ratings has downgraded Kotagala Plantations PLC's National Long-Term Rating to 'CCC(lka)', from 'B+(lka)', and its listed unsecured debentures of LKR251 million due between the financial years ending March 2025 (FY25) and FY27 to 'CCC-(lka)', from 'B+(lka)'.

The downgrade follows a major weakening in liquidity. We expect the statutory increase in labour costs effective September 2024 to dampen free cash flow (FCF), leading to a high likelihood that Kotagala will amend or extend the terms of its debt facilities as they fall due over the next two years. We are likely to consider such transactions to be distressed debt-exchanges under our rating criteria, as they would significantly reduce the contract terms and allow the issuer to avoid a probable default. This would lead to a downgrade of the National Long-Term Rating to 'C(lka)' or 'RD(lka)' (restricted default).

Kotagala's senior unsecured notes are rated one-notch below the issuer's rating to reflect the subordination to Kotagala's secured bank debt, which comprises the large majority of its capital structure.

KEY RATING DRIVERS

Weak Liquidity, Default Risk: We expect Kotagala to generate thinner annual FCF of around LKR100 million over FY25 and FY26, significantly below the LKR130 million in 1QFY25 and an annual average of LKR300 million over FY23-FY24. This, together with cash and cash equivalents of LKR170 million as of end-June 2024, will be insufficient to repay debt of LKR540 million and LKR496 million due in FY25 and FY26, respectively.

Kotagala has weak access to banks, although it was able to borrow around LKR500 million from two banks backed by corporate guarantees from its immediate parent, Consolidated Tea Plantations Limited, and affiliate, Lankem Ceylon PLC, which are ultimately held by The Colombo Fort Land & Building PLC (CFLB, 41% effective stake in Kotagala). These loans were drawn specifically to fund statutory repayments of LKR972 million and it is unclear whether CFLB or its affiliates will provide timely support to prevent future payment defaults or amendments to borrowing terms.

No Uplift for Parental Support: The corporate guarantees from Kotagala's immediate parent and affiliate leads to our 'Medium' assessment of the legal incentive for the ultimate parent, CFLB, to provide support to Kotagala and could result in a one-notch rating uplift. However, we applied an analytical overlay to not include this uplift, given the limited visibility of receiving timely support to avoid future payment defaults or debt restructuring.

We also assess the operational and strategic incentives for CFLB to support Kotagala as 'Weak'. This is because the subsidiary contributes less than 10% to CFLB's EBIT. In addition, Kotagala's tea and rubber plantations, which drive most of its revenue, are structurally weakening amid Sri Lanka's high production costs and there is low avoidance cost of the subsidiary's operational benefits to the parent.

Volatile Demand and Prices: Global tea prices are sensitive to supply and demand, with bulk-tea sellers unable to pass on production cost increases. Most domestic tea producers are price takers, with the majority of revenue coming from bulk sales. About 45% of tea is exported in bulk, without value addition. This also raises the risk of substitution. Tea auction prices have fluctuated in the last four years, even though Sri Lanka's tea attracts better prices due to its quality. Exports are mainly to politically and economically volatile regions, like parts of the Middle East and Russia.

Narrowing EBITDA Margin: We forecast the EBITDA margin to narrow to 11.5% in FY25 and 10.0% by FY28 (FY23: 25%, FY24: 15%) amid structural industry weaknesses, including the higher LKR1,350/day wages from September 2024, a 35% hike yoy. The margin will be further affected by depressed plantation yields, due to labour shortages and ageing crops. Tea yields fell again in 1QFY25, after a recovery in FY24 following three consecutive years of declines. Replanting costs are also increasing. Sri Lanka already has the lowest productivity and the highest cost among major tea producing countries.

DERIVATION SUMMARY

Kotagala's rating reflects a high level of default risk relative to other Fitch-rated issuers in Sri Lanka, due to its weak liquidity and funding access, volatile operating cash flow and limited medium-term business prospects.

KEY ASSUMPTIONS

- Revenue to increase by 2.4% in FY25 and 0.7% in FY26, with better auction prices, however impacted by falling yields

- EBITDA margin to decline to around 11.5% in FY25-FY26, due to wage-hike driven costs

- Capex of around LKR230 million a year in FY25 and FY26 for field development work

- No dividend payments over FY25-FY26

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Further weakening in liquidity or funding access

- A payment delay or default or debt restructuring that Fitch classifies as a distressed debt exchange

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-A sustained improvement in liquidity and funding access

LIQUIDITY AND DEBT STRUCTURE

Kotagala's liquidity is weak with its cash on hand and our forecast for FCF unlikely to cover its debt repayments in the next two years. This could lead the company to restructure its debt terms.

ISSUER PROFILE

Kotagala is a domestic plantation company engaged in the cultivation and sale of tea, rubber and palm oil.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

Click here to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Kotagala Plantations PLC	Natl LT	CCC(lka)	Downgrade	B+(lka)
senior unsecured	Natl LT	CCC-(lka)	Downgrade	B+(lka)

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

- National Scale Rating Criteria (pub. 22 Dec 2020)
- Parent and Subsidiary Linkage Rating Criteria (pub. 17 Jun 2023)
- Corporate Rating Criteria (pub. 04 Nov 2023) (including rating assumption sensitivity)
- Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 22 Jun 2024)
- Corporate Recovery Ratings and Instrument Ratings Criteria (pub. 03 Aug 2024) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

- Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

- Solicitation Status
- Endorsement Policy
- Potential Conflicts Resulting from Revenue Concentrations

ENDORSEMENT STATUS

Kotagala Plantations PLC -

DISCLAIMER & DISCLOSURES

SOLICITATION STATUS

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