July 22, 2019

FAIR VALUE: 81

CURRENT PRICE: 69.0

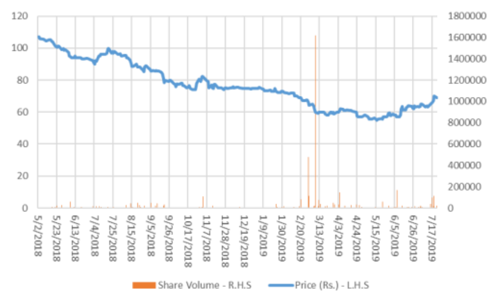
Royal Ceramic Lanka PLC (RCL)

Price target	LKR 81
Current Price	LKR 69.0
52-week range	LKR55.0-130.0
Market capitalization	LKR 7.6bn
Public float	c.20%
Average daily turnover	LKR 1.4m

YTD Performance	
ASPI	-6.6%
Sector	-10.3%
RCL	-7.5%

Year End 31-Mar	FY18	FY19	FY20e	FY21e
EPS (Rs)	25.6	21.7	22.8	34.1
DPS (Rs)	9.0	2.0	4.0	4.0
NAVPS (Rs)	263.8	291.1	313.1	346.4
P/E (x)	2.7	3.2	3.0	2.0
P/BV (x)	0.3	0.2	0.2	0.2
Div. Yield (%)	13.0	2.9	5.8	5.8
Div. Payout (%)	35.0	9.3	17.6	11.7
ROE (%)	9.7	7.4	7.3	9.8
EBITDA margin (%)	19.9	22.4	22.9	22.6

RCL: 52-week price/volume chart



Source: Bloomberg, Taprobane Research

A domestic growth story

Royal Ceramic Lanka PLC (RCL) is the largest manufacturer of tiles and bath/sanitaryware products in Sri Lanka. RCL also produces Aluminium fixtures for homes and offices. Through its subsidiary, Swisstek, RCL also operates in the packaging industry. On average, both tile and bath/sanitaryware prices have remained stagnant over the past 2-3 years, with volume growth being the key revenue driver. The tile and bath/sanitaryware segments account for c.75% of RCL's revenue and c.85% of EBIT. We expect tile segment volumes to grow at c.10-12% over the FY2020-23E period with the bath/sanitaryware segment expected to grow at c.15%. We have modelled Aluminium segment revenue growth in the mid-single digit levels in the FY2020-23E period. We also expect the Packaging segment to grow at a similar run rate. We expect tile segment EBIT margin to hover at c.15-20% range over the forecast period. We expect bath/sanitaryware segment EBIT margin to hover at c.12-15% over the same period. Aluminium and Packaging segment EBIT margin are expected to hover in the mid-single digit mark over our forecast period. RCL is also exposed to the plantation segment through its subsidiary, Horana Plantations PLC (HOPL). As HOPL is mainly exposed to tea and rubber, our outlook is neutral and we expect soft topline growth over the FY2020-23E period with EBIT margins expected to hover in the c.5-6% range. RCL's c.28% stake investment in LB Finance (LFIN) is a key valuation driver. LFIN is one of the more stable firms in the Sri Lankan finance and leasing company sector. We expect LFIN's NIMs to range between c.10-12%. We also expect tight credit monitoring to lessen any adverse impact from the anticipated asset quality issues facing the sector in the FY2020-21E period. Our SOTP based 12- month Target Price of Rs.81 is a c.17% upside to the current share price. RCL is currently trading at a FY2020E PE of c.3x which is well below the market. BUY.

Soft tile prices offset by volume growth: Tile prices have on average remained flat over the last 2-3 years and we conservatively estimate soft pricing going into our forecast period. Improving per capita income and awareness has enhanced the quality of the average Sri Lankan dwelling; houses with permanent floors and toilet facilities have increased from c.89% in 2009 to c.98% in 2016. This should translate into more demand for tiles and bath/sanitaryware. Moreover, expected increase in commercial real estate as well as urban housing projects are significant tailwinds.

Margin protection from strong brand, stable input prices: We expect RCL's margins to remain healthy as its strong brand and premium positioning should enable it to pass down to a considerable extent any cost increases. Energy costs which account for c.60% of input costs have remained largely flat. LPG which is a key input, is a price-controlled commodity.

Valuation: We have valued RCL using a Sum-of-the-parts (SOTP) method. Our DCF based valuation of RCL and its various subsidiaries yield a fair value of Rs.19/share. We have conservatively valued LFIN using a justified PBV of 1.2x; LFIN's contribution to RCL's share price is Rs.62/share. This gives us a 12-month SOTP based target price of Rs.81 which is a c.17% upside to the current share price. RCL is currently at c.3x 2020E PE which is a discount to the market. BUY.

YE 31 March (Rs m)	FY18	FY19	FY20e	FY21e	FY22e	FY23e
Revenue	29,090	31,499	34,516	37,840	41,841	46,287
+/- YoY%	10.1	8.3	9.6	9.6	10.6	10.6
EBITDA	6,938	6,010	6,470	8,346	9,151	10,056
PAT	2,839	2,399	2,523	3,777	4,190	4,607
+/- YoY%	-19.3	-15.5	5.2	49.7	10.9	9.9
EPS (Rs)	25.6	21.7	22.8	34.1	37.8	41.6
NAVPS (Rs)	263.8	291.1	313.1	346.4	383.5	424.3
EBITDA margin (%)	19.9	22.4	22.9	22.6	22.3	22.0
EV/EBITDA (x)	3.6	4.2	3.9	3.0	2.7	2.5
PER (x)	2.7	3.2	3.0	2.0	1.8	1.7

Source: Company Data, Taprobane Research

Company Outlook

RCL is a diversified conglomerate with strong roots in the Tile industry

RCL is a holding company under the Vallibel One PLC umbrella, with significant exposure to the local construction sector through its tile, bath/sanitaryware and aluminium products segments. Following the acquisition of Lanka Tiles PLC (TILE) and Lanka Walltiles PLC (LWL), RCL is the dominant (c.90%) manufacturer of tiles in Sri Lanka. The only other company operating in this segment is Mack Tiles (Pvt) Ltd. The Aluminium extrusions and fittings segment mainly serves the commercial real estate segment. It also operates in the packaging industry. RCL also holds 51% of Horana Plantations PLC (HOPL), through its subsidiary, Vallibel Plantation Management Limited. The bulk (c.97%) of RCL's topline is from the domestic market with exports still in the nascent stage.

retailing is a competitive market

In addition to manufacturing tiles and bath/sanitaryware, RCL also markets them under the Rocell and Lanka Tile brands. Tile and bath/sanitaryware retailing is a highly fragmented industry with several players. With the relaxing of duties and levies on Tile imports, imported tiles have become cheaper cf. locally produced tiles. Though buyers are price conscious, product quality and availability are also key factors in customers' decision-making process.

Multi-tiered product positioning and branding

RCL markets and positions its range of tiles to create and serve specific niches in the market. For instance, Rocell is positioned as an exclusive, higher quality and priced above average product. It's mostly sold through Rocell branded showrooms, which also attempt to have a design studio concept. Rocell branded bath ware and sanitaryware products are also retailed in a similar fashion. Lanka Tiles branded products are also retailed through third party distributors and vendors. RCL sources designs for their premium range of tiles from Italy and Spain enabling it to compete with high quality imported tiles. On the price sensitive low-end segment, RCL faces intense competition from cheaper products which are imported mainly from India and China.

Local recycling industry has more room for improvement

RCL's exposure to the construction sector is further entrenched through its aluminium segment, supplying aluminium extrusions to the construction industry. The bulk of aluminium extrusions are used in commercial real estate projects. The Packaging segment accounts for c.9% of revenue and c.4% of EBIT. This segments the tea, rubber, garment exports and FMCG sectors. Decline in tea and rubber sectors was offset by growth in the garments and FMCG sectors which helped segment EBIT to grow c.65% in FY2019.

RCL's plantation segment underperformed due to decline in tea and rubber prices. Tea and rubber form the bulk of HOPL's revenue stream. HOPL's attempts at crop diversification are still continuing. Nevertheless, there has been limited traction in commencing large scale palm oil cultivation, despite the availability of land legally available for palm cultivation.

LFIN is a key investment

RCL has a c.28% stake in LFIN, which is one of the largest and better managed finance companies in Sri Lanka with NPL ratio of c.2.6%. LFIN's credit growth was c.11% in FY2019 while deposits have grown c.14%. NIMs have averaged at c.11-12% with ROE at c.30%. LFIN's core strength is in the leasing of automobiles (primarily cars and SUVs). It also has exposure to the SME sector. In a bid to diversify its exposure, LFIN has commenced a micro finance operation in Myanmar.

volume growth should offset soft prices

Sluggish prices offset by increased volumes in single unit dwellings segment: Improving per capita income levels, increased social awareness and sophistication are key factors which have increased the quality and condition of the average Sri Lankan dwelling. For instance, dwellings with permanent floors and walls have increased from 83% and 89% in 2009 to c.95% in 2016. Dwellings with toilet facilities have improved from c.89% in 2009 to c.92% in 2016. These indicate an increase in the potential market for tiles and bath/sanitary ware products. This coupled with increasing income levels and widespread availability of tiles and bath/sanitary ware products as well as availability of skilled labour in installing such products should contribute to strong volume growth in the domestic/individual housing unit segment. We believe this should buttress topline growth and compensate for weak pricing. An additional indicator of strong volume growth is that commercial banks' lending to personal housing construction has grown c.170% over the last five-year period.

Item	2009 / 10(a)				2012 / 13				2016			
	Urban	Rural	Estate	All Island	Urban	Rural	Estate	All Island	Urban	Rural	Estate	All Island
Wall Type(b)												
Permanent	94.1	91.5	89.1	91.7	96.0	92.8	95.0	93.5	97.30	95.1	96.2	95.5
Semi Permanent	5.9	8.5	10.9	8.3	4.0	7.2	5.0	6.5	2.7	4.9	3.8	4.5
Floor Type(c)												
Permanent	97.1	87.6	83.1	88.7	98.4	91.6	84.9	92.4	98.9	95.2	89.1	95.6
Semi Permanent	2.9	12.4	16.9	11.3	1.6	8.4	15.1	7.6	1.1	4.8	10.9	4.4
Toilet Facilities												
Exclusive for the Household	86.4	90.9	74.0	89.5	90.0	90.7	76.2	89.9	91.9	92.4	77.3	91.7
Sharing with another Household	7.1	6.2	13.1	6.6	7.3	7.8	21.1	8.4	6.6	7.0	19.8	7.5
Public Toilet Facilities	5.1	0.4	7.2	1.4	2.7	0.2	2.1	0.7	1.6	0.1	2.6	0.4
No Toilet Facilities	1.3	2.5	5.6	2.5	0.0	1.2	0.7	0.9	–	0.5	0.4	0.4

Source: CBSL, Taprobane Research

CRE demand should drive tile and bath ware demand

Increasing Commercial Real Estate (CRE) demand should also drive volumes: We expect substantial tailwind for RCL's topline from the expected growth in CRE, especially in Colombo and its key suburbs. The demand for office space is directly linked to growth in the service sector. Currently over 50% of the Sri Lankan economy is service oriented. With development of the Banking and Financial Services, IT, BPO and Logistics industries, demand for CRE should increase. Moreover, positioning Colombo as an attractive clean city should also attract MNCs to set up offices here. Key infrastructure Initiative such as the Western Region Megapolis Master Plan (WRMMP), Colombo International Financial City, the Port city project should also serve to make Colombo an attractive regional business hub.

Urban housing is also another volume driver

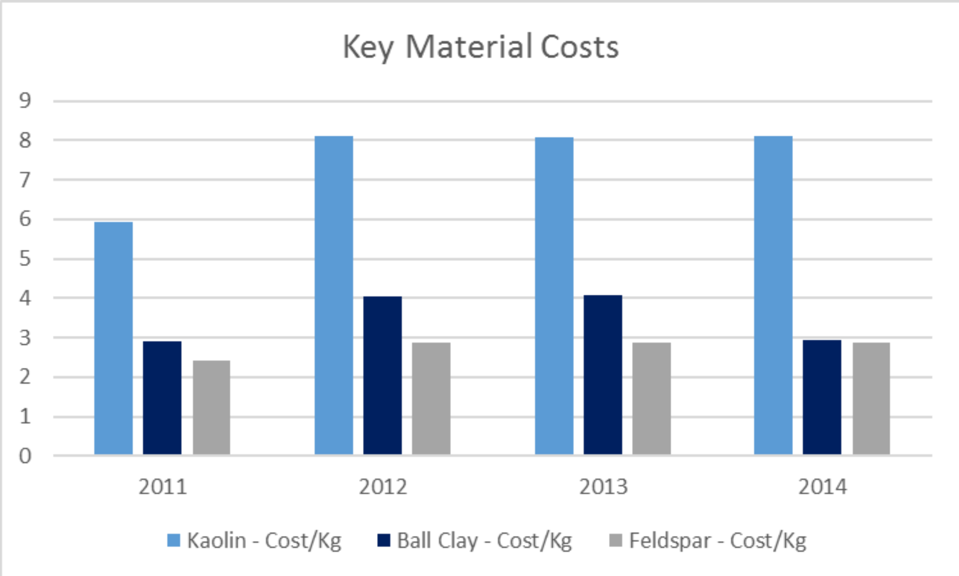
Tailwind from public housing projects: We also expect Tile and Bath/Sanitaryware volumes to growth due to demand from the Government's housing development projects. The provision of housing for low and middle income families located in Colombo has been a major priority for the Government. The Urban Development Authority (UDA) has launched housing projects aimed at the low and middle income segments. Under the urban regeneration program, the UDA has completed c.10,000-11,000 housing units with c.7000-8000 units under construction. The UDA plans to launch c.16,500 housing schemes in the 2019-2020 period.

LFIN is a valuation driver

Investment LFIN is a key valuation driver: RCL's c.28% stake in LFIN is a key value driver as it contributes to almost two thirds of RCL's fair value. LFIN is one of the largest and strongest finance companies in Sri Lanka. RCL's loan book grew c.11% in FY2019 with total assets growing at c.12%. Deposit growth in FY2019 was c.14%, with most of such deposits in medium (2+ year) term fixed deposits. LFIN has consistently managed good ROE on its portfolio, while keeping asset quality in check. Deterioration of asset quality has been a concern for the sector. While the finance company sector's gross NPL ratio has increased to 7.7% in 2018 cf. 5.9% in 2017, LFIN has bucked the trend by managing its loan book with NPL ratio to 2.69%, which is well below the industry average. This was achieved with regular monitoring of the loan book and adoption of stringent recovery protocols.

Stable input prices cushion margin

Sustainable margins from stable input prices and branding: RCL enjoys a strong brand portfolio through its Rocell and Lanka Tiles brands. We believe that RCL's strong brand and premium positioning should enable it to pass down to a considerable extent any increase in raw material and energy cost. Energy costs which account for c.60% of input costs have remained largely flat. LPG which is a key input, is a price-controlled commodity. In addition, most of RCL's raw materials such as Koalin, Ball Clay and Feldspar are sourced locally and are not affected by FX fluctuations. According to the latest available data (2015) from the Geological Survey and Mines Bureau (GSMB), prices of these key raw materials have not fluctuated significantly.



Source: GSMB, Taprobane Research

c.17% upside - BUY

Valuation: We have valued RCL using a SOTP method. As the tile and bath/sanitaryware segments are the principal business lines of RCL with other segments contributing only a minor share, we have discounted group FCFF using a WACC of c.20%, instead of disaggregating and valuing each segment individually. This yields a potential segment fair value of Rs.19/share. We have valued LFIN conservatively at 1.2x PBV and LFIN's contribution to RCL's fair value is Rs.62/share. This yields an estimated 12-month target price of Rs.81/share which is an c.17% upside. Moreover, RCL is trading at a 2020E PE of c.3x, which is well below the estimated market PE of c.9-10x. While the numbers look apetising, we believe that RCL can unlock further value by divesting its stake in LFIN and redeploying proceeds in its core or related business lines or choose to distribute them to shareholders. BUY

Income statement

YE 31 March (Rs m)	FY18	FY19	FY20e	FY21e	FY22e	FY23e
Revenue	29,090	31,499	34,516	37,840	41,841	46,287
Operating Profit	5,409	4,312	4,419	6,195	6,885	7,654
Net finance cost etc.	-1,229	-1,869	-1,809	-1,935	-2,081	-2,303
Associate Income	1,107	1,304	1,304	1,304	1,304	1,304
PBT	5,287	3,747	3,914	5,564	6,107	6,656
Net Profit	2,839	2,399	2,523	3,777	4,190	4,607
EPS (Rs)	25.6	21.7	22.8	34.1	37.8	41.6

Balance Sheet

YE 31 March (Rs m)	FY18	FY19	FY20e	FY21e	FY22e	FY23e
Property, Plant & Equipment	26,323	29,068	30,485	32,135	34,070	36,314
Goodwill & Intangibles	1,201	1,196	1,180	1,163	1,146	1,129
Other non current assets	7,821	9,469	10,449	11,429	12,409	13,389
Non Current Assets	35,345	39,734	42,114	44,727	47,625	50,832
Inventories	11,396	14,622	15,032	16,479	18,222	20,158
Trade and Other Receivables	3,535	4,030	4,487	4,919	5,439	6,017
Other current assets	1,886	1,869	1,869	1,869	1,869	1,869
Cash and cash equivalents	996	946	935	1,109	1,456	1,815
Current Assets	17,813	21,467	22,322	24,377	26,986	29,859
Long Term Borrowings	6,068	6,661	9,782	10,513	11,621	12,852
Other Long term liabilities	4,290	4,806	4,806	4,806	4,806	4,806
Long term liabilities	10,358	11,467	14,588	15,319	16,427	17,658
Trade and other payables	3,649	4,136	4,305	4,550	4,845	5,173
Loans and borrowings	8,995	12,214	9,722	9,722	9,722	9,722
Other current liabilities	949	1,133	1,133	1,133	1,133	1,133
Current Liabilities	13,593	17,484	15,161	15,406	15,701	16,028
Share Capital	1,369	1,369	1,369	1,369	1,369	1,369
Retained Earnings	16,291	18,688	20,767	24,102	27,849	32,012
Others, MI etc.	11,547	12,194	12,551	12,908	13,266	13,623
Equity and Reserves	29,207	32,250	34,687	38,379	42,483	47,004
NAVPS	263.8	291.1	313.1	346.4	383.5	424.3

Cash Flow Statement

YE 31 March (Rs m)	FY18	FY19	FY20e	FY21e	FY22e	FY23e
PBT	5,287	3,747	3,914	5,564	6,107	6,656
Depreciation & Amortisation	1,530	1,698	2,052	2,151	2,266	2,402
Changes in working capital	-2,728	-3,276	-698	-1,635	-1,968	-2,187
taxes paid	-1,359	-725	-939	-1,335	-1,466	-1,597
interest paid	-1,343	-1,879	-1,809	-1,935	-2,081	-2,303
other adjustments	684	821	829	955	1,101	1,323
Operating Cash Flow	2,070	385	3,348	3,765	3,960	4,293
Capex	-3,659	-4,062	-3,452	-3,784	-4,184	-4,629
FCFF	**-1,589**	**-3,677**	**-104**	**-19**	**-224**	**-336**
net debt issued/(repaid)	2,220	2,210	629	731	1,107	1,231
FCFE	**631**	**-1,467**	**526**	**712**	**884**	**896**
Dividends paid	-994	-223	-443	-443	-443	-443
other adjustments	-832	60	-94	-94	-94	-94
Net Cash Flow	-1,195	-1,630	-12	175	347	359

Source: Bloomberg, Company Data, Taprobane Research

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