The Road Back: Post-Lockdown Assumptions for Sri Lankan Corporates

Most Rated Sri Lankan Corporates to Recoup Growth Momentum by Mid-2022

"The pandemic-related lockdown and its aftermath will erase almost LKR30 billion in revenue from rated Sri Lankan corporates in the financial year ending March 2021."

Nadika Ranasinghe, Fitch Ratings

Revenue across Fitch Ratings' Sri Lankan corporates portfolio could fall by almost LKR30 billion, or around 7% yoy, in the financial year ending March 2021 (FY21), based on the agency's baseline coronavirus pandemic scenario. This worsens to LKR40 billion, or around 15% yoy, if the two large telecom companies, which are likely to stay resilient during the pandemic, are excluded.

However, most corporates should recoup lost growth momentum by FY22 and generate higher revenue than in FY20. Our forecasts examine the effect of the March 2020 lockdown on revenue for the next 18-24 months. We also refine our expectation of recovery trajectories to reflect easing social-distancing requirements from May 2020 and a gradual recovery in economic activity.

Key risks to our assumptions include a second wave of infections that lead to further lockdowns and a prolonged weak global economic and travel environment, which could depress Sri Lanka's economy for longer than we expect.

Sri Lanka GDP to Contract in 2020

We expect Sri Lanka's real GDP to contract by 1.3% in 2020 due to the pandemic, worsening from our 24 April 2020 forecast of a 1.0% contraction. This follows mid- to low single-digit economic growth in the last five years. However, GDP growth should rebound to historical levels in 2021, with 4.0% growth.

The weakened operating environment will continue to dampen demand and challenge the near-term operating performance and liquidity profiles of most of our rated corporates.

Hotel Sector Most Affected

Sri Lankan hotels are among the hardest-hit sector by the pandemic and will see the largest drop in revenue in FY21. Hotels have been operating with minimal revenue for almost four months and Sri Lanka is yet to decide when to open its borders. However, exposure of Fitch-rated corporates to the hotel sector is limited and counterbalanced by exposure to more defensive cash flow.

Hotels have resumed operation for domestic visitors, but we do not expect a meaningful earning recovery until international travel is restored.

We expect revenue of consumer-durables retailers to weaken in FY21, with muted demand throughout FY21 amid the difficult economic conditions. This has resulted in high negative rating action for the sector.

Consumer durables demand has recovered since movement restrictions were relaxed in May, but this could be partly due to temporary pent-up demand. A further tightening of restrictions on consumer-durables imports could also diminish recovery prospects for the sector.

Related Research

Coronavirus Screener for Sri Lankan Corporates (April 2020)

The Road Back: Post-Lockdown Assumptions for Global Corporates (June 2020)

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More Downgrades if Recovery is Slow

Fitch has taken negative rating action on 30% of the corporates in its portfolio to reflect the impact of the pandemic, with the majority of these entities remaining on Negative Outlook or Rating Watch Negative. This implies the possibility of further downgrades should recovery prospects be delayed, although a faster recovery than we expect could lead Fitch to revise the Outlooks to Stable.

Fast moving consumer goods (FMCG) and food and beverage have seen some recovery in revenue since the re-opening of retail outlets. We expect the pace of recovery to be faster for these sectors than for most others, but FY21 revenue will remain modestly below FY20 levels amid lower personal income.

Telecoms, pharmaceutical trading and manufacturing should remain resilient, given inelastic demand and limited disruption to distribution channels. This will potentially see flat to positive revenue growth in FY21. However, private-sector hospitals may face pressure due to social-distancing measures, which have resulted in the postponement of elective procedures, as well as from declining affordability.

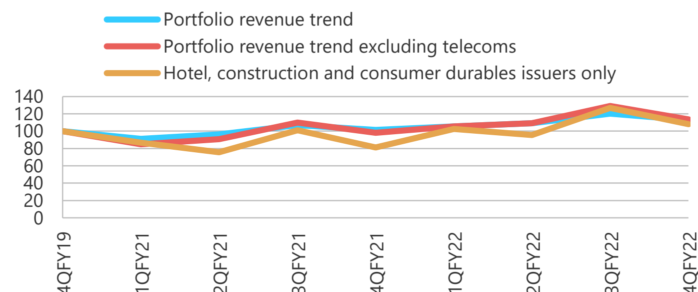
We also expect a limited impact on rated spirits and beer manufacturers, as demand for spirits is mostly inelastic and both spirits and beer are mainly consumed off-premise. This shields sales from weak tourist arrivals and restrictions on social gatherings.

Stylised Curves

The sector curves in this report are stylised estimates, benchmarked against 4QFY20 and normalised where necessary, to convey the direction of top-line growth. The curves are not composites or aggregates of forecast sector revenue, but do contain an element of seasonality and economic cyclicality.

Overall, we expect revenue of our rated portfolio to fall by around 10% in 1HFY21 from pre-pandemic levels, but the drop will be more pronounced, at around 20%, if excluding the two resilient telecom companies. We expect revenue to recover to pre-pandemic levels by FYE21, but this is likely to take longer for some sectors, including hotels, construction and consumer durables.

Overall Portfolio Revenue Trend

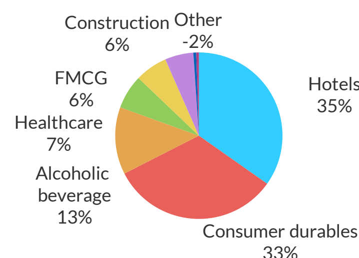


Source: Fitch Ratings, Fitch Solutions

Revenue Loss of LKR30 billion in 2021

We estimate total lost revenue of LKR30 billion across our rated corporates in FY21, compared with FY20 levels. Hotels lead revenue losses, followed by consumer durables retail. The two sectors represent just 25% of the portfolio revenue, but account for around 70% of lost revenue.

Revenue Loss by Sector, Excluding Telecoms



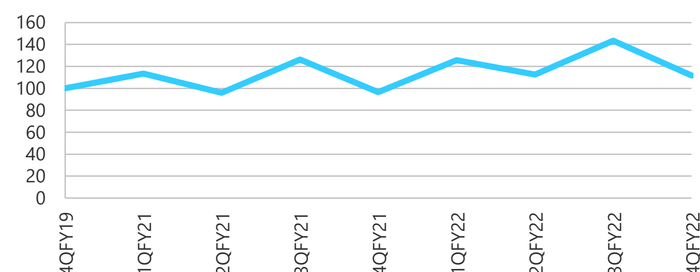
Source: Fitch Ratings, Fitch Solutions

Near-Term Liquidity Pressure in Some Sectors; Relief from Regulatory Measures

Our rated corporates had around LKR18 billion-19 billion of contractual debt maturities falling due in the next 12 months as of end-March 2020. Most corporates have negotiated payment extensions with banks by one to two quarters, while some sectors have benefited from sector-specific moratoriums stipulated by the government at least till the late 2020. However, lower-rated corporates or those with exposure to high-risk sectors may find it difficult to refinance contracted maturities should the pandemic stretch beyond 2020.

The rated corporates also have close to LKR35 billion in working-capital debt, which we expect banks to roll over due to the temporary nature of the economic disruption. In addition, the government has requested that banks provide working-capital relief to all sectors by refinancing loans at significantly lower interest rates and has provided credit guarantees on selected facilities. These measures should provide relief to several issuers in our portfolio, notably those in the hotel, construction and export-related manufacturing sectors.

Consumer Durable Retail

How will revenues develop during the re-opening?	How will issuers respond during the re-opening?
• Overall sector revenue to decline by around 12% in FY21 amid a weak 1HFY21, largely due to store closures and lower disposable income. We expect a gradual pick-up from 4QFY21 and the sector should see a full recovery to pre-pandemic levels by mid-FY22. • Retail stores reopened in 19 districts on 20 April 2020, while the remaining four districts resumed operation on 11 May 2020. The lock downs had been imposed on 23 March 2020. • The lockdowns saw consumer durables retailers lose more than one month of sales in 1QFY21; the period included the mid-April peak sales period leading up to the Sinhala and Tamil New Year. Sales during the lockdown were mostly limited to online transactions, with restrictions on movement and Sri Lanka's under-penetration of online sales stifled revenue generation. • Sales spiked for certain products since re-opening due to pent-up demand, especially for IT and communications devices due to an increase in remote work and home schooling. However, we still expect weak growth in 1HFY21, at around 16% below pre-pandemic levels. • Sri Lanka's social-distancing requirements do not greatly affect store operation, as they do not limit operating hours or strictly regulate footfall. We expect further easing of requirements in the next few months. • Demand for consumer durables is likely to remain muted for the remainder of FY21 amid a drop in income levels. Job losses, pay cuts, lower foreign remittances – a key source of foreign-exchange income - and the need to preserve cash is likely to force most households to defer discretionary purchases. • Demand should start to recover towards the end of FY21 if the agricultural sector yields a better harvest, consumers react to the late FY20 cut in direct and indirect taxation and domestic interest rates continue to fall or at least remain stable. • EBITDA margins are likely to contract by around 250bp in FY21 owing to lower revenue and a high fixed-cost base. Retailers' plans to cut marketing and distributions costs, salaries and other discretionary spending should mitigate weakening profitability. • The sector exhibits high supply-chain risk due to import controls on consumer electronics, white goods and communication and IT devices. The controls, which were to be lifted at end-June 2020, have been extended indefinitely for some products, including televisions, due to the country's still-weak external financing position and currency pressure. • The import controls are somewhat mitigated by the two to three months of inventory held by retailers, which also have modest local manufacturing capabilities that could be used to cater for demand until the controls are eased. Retailers are able to import certain products, such as refrigerators, washing machines and communication and IT devices, if the required credit periods are made available by suppliers or if the imports are supported by sufficient foreign-currency deposits. However, a prolonged import ban beyond 2020 could significantly damage retailers' cash flow and liquidity positions. • Inability to collect hire-purchase receivables on time could lead to near-term liquidity pressure. However, consumer durables retailers indicate that hire-purchase collections had normalised by June.	• Cost-saving measures include rent negotiations, reducing marketing and distribution costs and pay cuts. However, store reopening will increase marketing and distribution costs to drive sales. • Retailers are likely to be more aggressive in discounting to drive sales, which will dilute margins. • We expect continued negotiations with suppliers for extended credit periods to sustain adequate inventory and manage cash flow and liquidity needs. • Expansion capex is likely to be cancelled or deferred, except for e-commerce initiatives to mitigate disruption to operations. • Retailers are likely to defer or reduce shareholder returns in FY21 amid impaired cash flow. • Retailers will continue to negotiate with banks to extend near-term maturities to address possible liquidity pressure amid weak operations. **Consumer Durables Retail** (Indicative revenue curve, 4QFY20 indexed as 100)  Source: Fitch Ratings, Fitch Solutions

Source: Fitch Ratings

Alcoholic Beverages

How will revenues develop during the re-opening?

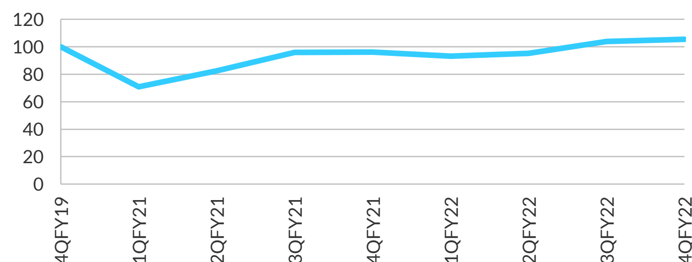
- We expect sector revenue to decline around 30% from pre-pandemic levels in 1QFY21 amid store closures. However, alcoholic beverage should recover faster than most other sectors, with sales reaching pre-pandemic levels by 3QFY21. This is supported by almost inelastic demand, mostly off-premise consumption as well as a recovery in personal income levels and a gradual recovery in tourism. Overall, we expect a yoy revenue decline of around 15% in FY21.
- Alcoholic beverage sales resumed in late May 2020, after an almost two-months hiatus owing to the lockdowns. Liquor shops were re-opened several weeks after the lockdown was lifted in a controlled manner to adhere to ongoing social-distancing requirements.
- Rated alcoholic beverage manufactures say sales had largely normalised by June, except for sales from the leisure sector, which remains severely affected by the pandemic.
- The lower sales in FY21 will be driven by lower demand for mild beer and foreign liquor, which mainly caters to the tourism and leisure sectors. However, these products account for a minority of rated-brewers' revenue. We expect revenue from these sub categories to remain muted until there is a pick-up in the tourism industry, which is at least nine to 12 months away.
- Locally produced spirit sales could fall due to lower personal income levels, as some consumers switch to the more affordable illicit market during economic hardship Daily wage earners, who largely contribute to the country's liquor consumption, have been severely affected by the slowdown in economic activity amid the pandemic.
- We expect the sector's EBITDA margin to contract by around 120bp in FY21, owing to weak revenue performance in 1HFY21. The sector's variable cost structure adds resilience against downturns.
- Spirit manufactures source most of their input costs locally, while beer manufactures import malt for production. The government has banned most imports, but we believe imports of malt and any shortfall of ethanol will be permitted in light of the importance of excise duties to government revenue. The sector has not seen any supply shortages.

How will issuers respond during the re-opening?

- Manufacturing resumed after movement restrictions were relaxed in May and liquor shops were fully operational. Manufacturing ceased while shops were closed as excise tax is imposed at the point of production, not sale, and would have affected cash flow.
- Companies have introduced temporary cost saving measures, such as pay cuts, a reduction of distribution and marketing expenses and other discretionary costs, to defend margins during the down turn.
- We do not expect companies to expand in the next nine to 12 months until economic conditions stabilise.
- Companies are likely to maintain or only slightly lower dividends in FY21 to support parents' cash flow requirements, in light of the stable cash flow generation from operation, even during a tough operating environment,
- We believe companies have sufficient liquidity on hand to meet near-term debt obligations without having to renegotiate terms with banks.

Alcoholic Beverage

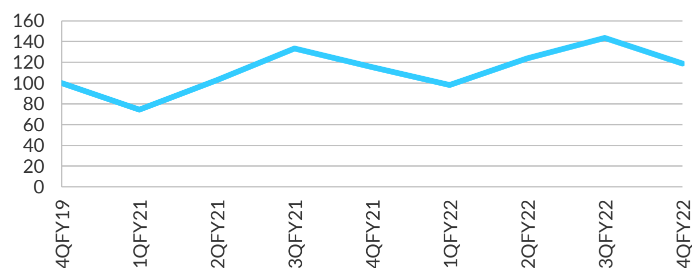
(Indicative revenue curve, 4QFY20 indexed as 100)



Source: Fitch Ratings, Fitch Solutions

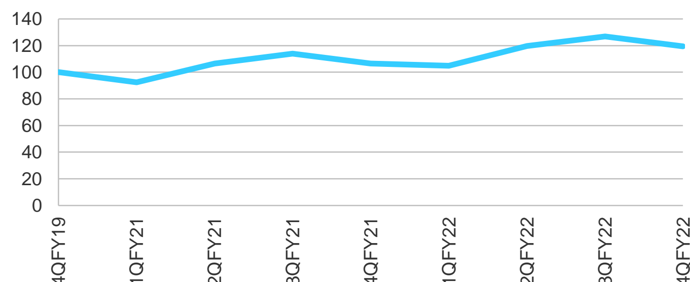
Source: Fitch Ratings

Fast Moving Consumer Goods

How will revenues develop during the re-opening?	How will issuers respond during the re-opening?
• We expect 1QFY21 revenue to be around 25% lower before the pandemic, but to recover to historical levels from 2QFY21 and surpass FY20 revenue in FY22, supported by easing social-distancing requirements, a gradual pick-up in economic activity and a recovery in demand. We forecast rated corporates within the sector to record a revenue decline of around 6%-7% in FY21. • FMCG products were made available to consumers during the lockdown, as they were categorised as essential services by the government. The products were distributed through online platforms and mobile delivery services amid store closures. • The country's low penetration of online sales saw much lower revenue generated than during pre-pandemic. However, most retail stores reopened in early May and companies say sales have now mostly normalised. • We expect consumers to increasingly look for value in their purchasing decisions amid lower income levels. Consequently, there may be a demand shift away from premium products within categories. Similarly, companies may offer higher discounts to drive demand in the difficult environment. • FMCG manufacturers closed factories during the lockdown, but gradually resumed operation from late April by adhering to social-distancing requirements. We do not believe production disruption will significantly affect revenue, in light of the lower demand in April and May. Manufacturers also tend to carry around one or two months of finished goods inventory. • A significant portion of inputs in FMCG production is imported, exposing companies to currency risk. We expect the cost of production for most manufactures to increase in FY21 amid a weakening domestic currency. The ability to pass on higher costs to end customers may be limited by the difficult environment. Overall, we expect the sector to see an EBITDA margin contraction of around 150bp in FY21. • We do not believe the ban on imports, including on certain raw materials, will be strictly applied to FMCG manufacturing, given the essential nature of the products they supply, such as packaged food, personal care and home care. The government would also want to encourage the domestic manufacturing sector to stimulate the economy and improve employment levels. • We expect mounting working-capital requirements in 1HFY21 due to inventory build-up and delays in collecting receivables. However, pressure should ease towards the latter part of the year with improved demand conditions. Strong access to banks and extended supplier credit should help manage near-term working capital needs.	• Increased focus on value categories to cater for lower income levels as well as on products catering to personal and public hygiene in the home and personal-care market. • We expect FMCG manufacturers to extend discounts mostly, in 1HFY21, to dispose of built-up inventory and stimulate demand. • Extensive cost saving measures, including pay-cuts as well as lower marketing and discretionary spending to improve profitability and preserve cash. • Expansion capex to be deferred till FY22, when demand conditions are more stable. • Reduced or deferred dividends in FY21 to preserve cash for debt obligations and working-capital needs. • Internally generated cash and extended payment periods from suppliers should help manage near-term debt obligations. However, most manufacturers have strong access to banks for near-term funding requirements. **Fast Moving Consumer Goods** Indicative revenue curve, 4QFY20 indexed as 100 FMCG  Source: Fitch Ratings, Fitch Solutions

Source: Fitch Ratings

Healthcare

How will revenues develop during the re-opening?	How will issuers respond during the re-opening?
• The revenue of pharmaceutical trading and manufacturing companies is likely to remain flat in FY21, supported by defensive demand and little disruption to operations during the lockdown. We estimate the hospital sector will see 10%-15% top-line erosion due to lower footfall and falling personal incomes, especially in the first half. Hospital sector revenue should rebound and surpass pre-pandemic levels from FY22, once the economic conditions improve. • Online sales supplemented disruption to the pharmaceutical trading sector due to drug-store closures in the early part of the lockdown. • Pharmaceutical retail, which includes drug stores, was affected by store closures during the early part of the lockdown, but operations normalised by late April. Online and call-and-order facilities introduced during the lock down also supported sales. • The local drug-manufacturing industry was affected by factory closures during the early part of the lockdown, but factories reopened by mid-April in light of the essential nature of the services. This resulted in only modest disruption to operations. • We expect a delay in new drug manufacturing capacity coming online during the year due to construction delays of new facilities. • Hospitals have seen a drop in footfall due to social-distancing measures, resulting in fewer elective procedures. We expect a modest rebound in demand for elective procedures from 2HFY21 on account of a slowdown in COVID-19 cases and the consequent easing of social-distancing requirements. However, pressured consumer income levels could continue to dampen demand for paid in- and out-patient care through to FY21. • Pharmaceutical distributors have not seen a shortage of supplies – which are mainly imported - which has helped to sustain revenue. Distributors placed bulk orders in advance, which helped maintain adequate inventory. • Domestic drug manufactures saw a supply shortage of active pharmaceutical ingredients, which are mainly sourced from China, in March and April. However, supply normalised with the resumption of economic activity in China. • Pharmaceutical distributors import almost all the drugs they sell, exposing themselves to significant currency risk. However, distributors have been able to mitigate profit-margin pressure from a weakening currency owing to their contractual arrangements with global suppliers. • We expect pharmaceutical trading and manufacturing margins to remain flattish in FY21, while hospital-sector margins are likely to contract by around 150bp due to a higher fixed-cost base. Measures to cut costs across all operations should mitigate the margin impact for the sector.	• Companies have introduced temporary cost-saving measures, such as pay cuts and a reduction in distribution and marketing expenses, to defend margins, especially in 1HFY21, when the pandemic impact was felt the most. • Asset-heavy business models, such as hospitals and drug-store chains, will have limited ability to cut costs given their high operating leverage. Cost-saving measures will partly offset earnings losses, but will not be sufficient to avoid margin losses, especially in 1HFY21. • We expect companies to cut discretionary expansion and growth capex in FY21. However, capex related to expanding local manufacturing capabilities and improving online presence, is likely to be prioritised. • We believe cash flow from operation will be sufficient to meet the near-term debt obligations of rated health-care issuers without having to renegotiate terms with banks. **Healthcare** (Indicative revenue curve, 4QFY20 indexed as 100)  Source: Fitch Ratings, Fitch Solutions

Source: Fitch Ratings

Telecoms

How will revenues develop during the re-opening?

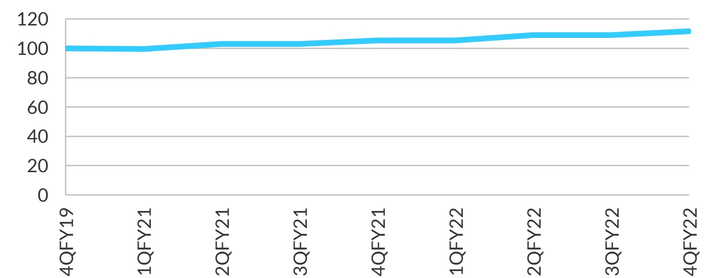
- Notwithstanding our lower expectations of national GDP growth, we believe demand for 4G data and fixed-broadband will remain strong, as the need for online connectivity and remote access will be boosted by the pandemic
- We forecast 2020 revenue to rise by a high-single-digit percentage following a cut in telecommunication levies and taxes in early 2020.
- We expect competitive intensity to remain subdued in 2020 as telecoms focus on profitable growth and managing network capacity.
- Roaming revenue is likely to be significantly affected in 2020, although the segment accounts for a small portion of total revenue.
- The re-opening of retail stores should increase gross subscriber additions and prepaid reloads from 2H20.
- The average operating EBITDA margin should stay stable, at 34%-36%, driven by improving economies of scale in the data and home-broadband segments.

How will issuers respond during the re-opening?

- We expect companies to upsell data services and bundles to increase average revenue per user and accelerate cost-cutting efforts to manage EBITDA margins.
- The extension of credit payments to post-paid customers and SMEs may temporarily increase working-capital needs.
- We forecast capex/revenue to increase in 2020 from 2019 levels to address rising demand for 4G network and broadband connectivity due to higher data demand, which was a trend even before the pandemic.
- Companies may not significantly reduce dividends from 2019 levels.

Telecoms

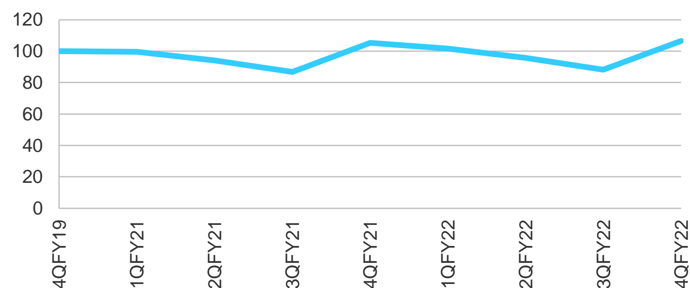
(Indicative revenue curve, 4QFY20 indexed as 100)



Source: Fitch Ratings, Fitch Solutions

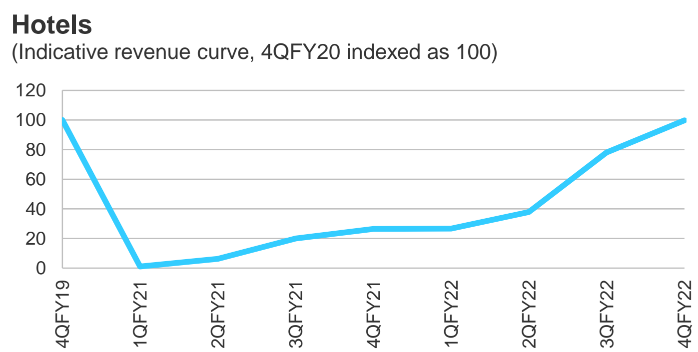
Source: Fitch Ratings

Agriculture

How will revenues develop during the re-opening?	How will issuers respond during the re-opening?
• We expect tea volume to remain robust in FY21, helped by better yields and increased global demand. • Sri Lankan tea prices surged by almost 20% since March, owing to rising demand for tea as an immunity booster as well as supply disruption in major tea exporting countries. • We believe supply from India, which is the world's second-largest tea exporter, will remain weak for the remainder of FY21 owing to the pandemic. This will help to maintain prices at current levels. Sri Lankan tea plantations resumed full operation in mid-April, despite disruption during the early part of the lockdown, which normalised tea auction volume to pre-pandemics levels by early June. • We expect domestic demand for rubber to remain subdued due to a drop in demand from the tire industry, which has been affected by the pandemic and ensuing economic downturn. Some volume has been absorbed by rising demand for rubber gloves and personal protection equipment, but we expect an oversupply globally. • Rubber prices are likely to remain muted in FY21 owing to lower oil prices and potential oversupply. • We expect the domestic palm oil sector to remain resilient against the downturn, benefiting from restrictions on imports and price protection for local manufacturers. Local palm-oil prices have been strong, supported by rising import tariffs and a weakening local exchange rate, which offsets our expectation of a decline in global palm-oil prices. • Sri Lanka imports around 80% of its palm-oil requirements and the ongoing import restrictions should bolster demand for domestic production. The import restrictions may be further extended due to Sri Lanka's still weak external financing position. • We expect agriculture sector revenue to remain stable over the next 12-18 months sans any weather-related impact on yields. • Palm oil sector profitability should improve in FY21, helped by rising prices amid higher tariffs and a weaker currency. The tea sector should turn profitable in FY21, benefiting from better prices and higher yields, but cost escalations could be a drag. We expect the rubber sector to remain loss making.	• Companies will focus on improving yields to cater to increasing demand, especially for tea and palm oil. • We believe plantations will further delay wage increases, which were due early this year, to preserve cash during the downturn. Companies will also cut other discretionary spending to stay afloat. • We believe companies will only spend on replanting capex and will not engage in expansions in the next 12-18 months. • Minimal dividend payments. • Liquidity should be manageable for large plantations, but smaller companies may have to negotiate extended payment terms to manage near-term maturities. **Agriculture** (Indicative revenue curve, 4QFY20 indexed as 100)  Source: Fitch Ratings, Fitch Solutions

Source: Fitch Ratings

Hotels

How will revenues develop during the re-opening?	How will issuers respond during the re-opening?
• We expect the hotel sector to generate minimal revenue in 1HFY20, gradually increasing to around 30% of pre-pandemic levels towards the end of FY20, benefiting from the peak tourist season. We do not expect revenue to normalise to pre-pandemic levels until at least the tail end of FY22. • Some Sri Lankan hotels have operations in the Maldives and we expect the trend in FY21 to be similar to that in Sri Lanka. The Maldives' government plans to open borders from 15 July, but we believe it will take another 12-18 months for demand to normalise. • The tourism sector has come to a complete standstill since late March after the government closed the country's borders to prevent the spread of COVID-19. • Hotels have been permitted to gradually resume operations since early June to cater for locals, while adhering to social-distancing requirements. • The government expects to welcome tourists from 1 August 2020, but this may be postponed due to impending elections and the ongoing process of repatriating Sri Lankan workers stuck overseas, delaying recovery prospects for the sector. • Despite the uncertainty, the tourism authority is gearing up international promotional campaigns to revive the industry. • The government will not require tourists to undergo mandatory quarantine once borders are open unless they show symptoms. However, they will need to undergo multiple tests before and after arriving in Sri Lanka. Visas will be issued to all nationalities. • We do not expect a large influx of tourists in the next six months, despite the re-opening, given Sri Lanka's top sourcing markets, such as India, the UK and Europe, including Russia, are still affected by the pandemic. • Hotels are offering large discounts to locals to at least cover running costs. We believe the sector will continue to offer discounts for the remainder of the year to drive local and international demand. • We expect the sector to generate significant operating losses in FY21 owing to the large fixed-cost base. Hotels have cut costs by laying off staff and saving on utilities, but these measures are insufficient to overcome the significant revenue loss. Operating losses should taper off by mid-FY22 with a gradual pick up in visitors. • The hotel sector is bound to face cash flow pressure in the next six to 12 months; as such, the government has extended the sector-wide debt moratorium till end-September 2020. There is a possibility of a further extension given the industry's slow recovery prospects. • We do not expect new room capacity to come online in the next six to 12 months amid construction delays and a sector-wide capex freeze.	• We expect the sector to offer significant discounts throughout FY21 to attract visitors. • Most hotels will try to operate with minimal cost structures to address weak revenue. This includes hiring staff on a casual basis, operating only parts of a hotel depending on occupancy and maintaining minimal advertising and marketing budgets. • Hotels may incur higher costs to adhere to safety protocols to prevent the spread of COVID-19. • Deferring expansion and refurbishment until at least 2HFY22 amid low demand and funding pressure. • Zero or minimal dividends for the next two years due to weak operations and cash flow pressure. • Near-term debt maturities to be manged through government-extended debt moratoriums and by negotiating with banks for payment extensions. We expect hotels to utilise low-rate working-capital facilities provided by banks to manage daily operations. **Hotels** (Indicative revenue curve, 4QFY20 indexed as 100)  Source: Fitch Ratings, Fitch Solutions

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