



WATAWALA PLANTATIONS PLC

CSE: WATA

Bloomberg: WATA SL

MAINTAIN STRONG BUY

Sep 2017 Current Price – LKR 33.0

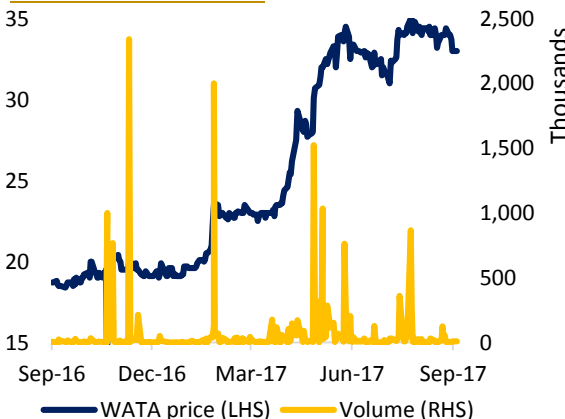
Fair value before spin off [FY19E] – LKR 47.0 (42.0 + 5.0)

1QFY18 Earnings ↑ 58%YoY

KEY DATA

Share Price (LKR)	33.0		
52w High/Low (LKR)	35 / 18.4		
Average Daily Volume (Shares)	71,217		
Average Daily Turnover (LKR)	1,860,177		
Issued Share Capital (Shares Mn)	237		
Market Capitalisation (LKR mn)	7,810		
Price Performance (%)	1 mth	3 mths	12mths
WATA	-4%	0%	76%
ASPI	-3%	-4%	-2%
Major Shareholders as at 31st Jun 2016			
Estate Management Services (Pvt) Ltd	75.65%		
Dr.T.Senthil Verl	10.10%		
K.C.Vignarajah	0.92%		
HSBC-SSBT-Deutsche Bank	0.71%		
J.B.Cocoshell (Pvt) Ltd	0.57%		
Estimated Free Float	24.4%		

Price – Volume Chart



ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 7.

“Reshaping the profit springs for better value creation”

P/e 31 March ¹	FY16	FY17	FY18E	FY19E	FY20E
Revenue (LKR Mn)	6,299	6,502	7,548	8,578	9,706
YoY % Growth	-8%	3%	16%	14%	13%
Net Profit (LKR Mn)	518	1,228	1,535	1,694	1,804
EPS	2.19	5.18	6.48	7.16	7.62
YoY % Growth	33%	137%	25%	10%	6%
Valuations					
PER (x)	15.1	6.4	5.1	4.6	4.3
PBV (x)	1.7	1.3	1.1	0.9	0.8
Dividend yield (%)	2.3%	4.5%	5.9%	6.5%	6.9%
NAVPS	20.0	25.6	30.1	35.1	40.4
DPS	0.8	1.5	1.9	2.1	2.3
Payout ratio	34%	29%	30%	30%	30%

1. Figures are before spinning off the tea segment

LKR (Mn)	1QFY17	1QFY18	YoY	FY16	FY17	YoY
Revenue	1,659	1,988	↑ 20%	6,299	6,502	↑ 3%
Gross profit	350	501	↑ 43%	853	1,673	↑ 96%
Operating profit	292	443	↑ 52%	669	1,494	↑ 123%
PBT	281	437	↑ 55%	590	1,446	↑ 145%
Net profit - equity	240	379	↑ 58%	518	1,228	↑ 137%

LKR (Mn)	2QFY17	3QFY17	4QFY17	1QFY18	QoQ
Revenue	1,648	1,430	1,764	1,988	↑ 13%
Gross profit	422	572	329	501	↑ 52%
Gross margin	26%	40%	19%	25%	↑ 7%
Operating profit	372	519	311	443	↑ 42%
Operating margin	23%	36%	18%	22%	↑ 5%
PBT	348	509	307	437	↑ 42%
Net profit	309	466	212	379	↑ 79%
Net margin	19%	33%	12%	19%	↑ 7%

Disclosure on Shareholding:

First Capital Group and its affiliates hold 445,000 shares of WATA and will not trade in this share for the three trading days following the issue of this document.

Tea pours profits, overlaying the shortfall in palm oil

1QFY18 Earnings up by 58% YoY driven by tea: WATA recorded earnings of LKR 379Mn in 1QFY18, up 58% from LKR 240Mn in 1QFY17. The growth in profits was mainly driven by the turnaround in the tea segment into profitability from a loss in the previous quarter. Palm oils continued to be the largest contributor to total profit, occupying 71% of the profit pie while tea represented 24% of the total profits.

Tea profits up 213% sweetened by higher prices: Tea segment turned around to a profit of LKR 90Mn in 1QFY18, up 213% from a loss of LKR 79Mn in 1QFY17. The average tea prices in Colombo auctions saw an increase of ~30%YoY in June 2017 whereas during the Jan-July period the average prices were substantially up by ~43%. Higher tea prices reflect the increased demand as well as improved. WATA's tea revenues saw an increase of 30%YoY in 1QFY18. Further, due to productivity incentive introduced by the revised wage structure, the volumes have seen a growth.

Palm oil dips 9% due to lower prices: Palm oil profits dipped 9% to LKR 267Mn in 1QFY18 from LKR 294Mn in 1QFY17, however continued to dominate the total profit with a share of 71%. The reduction was mainly due to having to cut net sales average by LKR40/kg as a result of the import duty reduction. Segment's gross margins dipped to 57% in 1QFY18 from 67% in 1QFY17 while net margin also dropped to 47% in 1QFY18 from 58% in 1QFY17.



Investment case: Tea to spin off, palm oil to continue profit rally and dairy ready to gush volumes

Tea to spin off: WATA announced that it will be spinning off the tea business into a new company named “Hatton Plantations” which will eventually be listed on the CSE. Post spinning off, WATA will continue primarily with palm oil and dairy segments dominating its operations. The shareholding will be mirrored in a way that existing WATA shareholders will get an equivalent proportion in Hatton Plantations upon its introduction (i.e. 1 share held in WATA = receive 1 share in Hatton).



The benefits of the spinning off the tea business could be summed up as follows;

- Tea from time to time is affected with wage hikes and weather conditions compared to palm oil, therefore bears a higher risk profile
- Tea output is more seasonal compared to palm oil and used to cause fluctuations in profitability
- The separation of the operating and financial policies will help developing the two business lines (tea and palm oil) independently and separately
- Provides a better choice for the investor to invest in tea or palm oil according to their wish

Tea prices to stabilize while volumes to grow: current tea prices of LKR550/kg is expected to stabilize going forward due to improved quality while volume are expected to grow 5-10% per annum from the level of 7,400kg for FY17.

Palm oil prices dropped but yield to increase: Due to the reduction in the import duty, palm oil prices declined by LKR 40 per kilogram and the current net sales averages are ~LKR 180/kg. The global crude palm oil prices also saw a dip of 2% in 1QFY18 compared to 1QFY17 due to supply rebounding. We estimate palm oil prices to grow marginally at 0.4% between FY17-FY20E however be availed by rupee which depreciates ~4%YoY. Since 78% of WATA’s palm oil nurseries are mature, FC research estimate the yields to keep increasing going forward. The company plans to add ~100 hectares to the nurseries in each FY18E and FY19E. We have estimated gross margins of the palm oil segment to be ~55% between FY18E-FY20E (FY17: 60%)

Dairy farm is ~60% complete and ready to go full swing by FY19E: The Company has completed ~60% of the USD 12Mn investment in its Dairy Farm and ~USD 5Mn investment is pending in FY18E. Company has so far imported ~500 cows of which ~360 are milking in the farm’s automated milking parlor at Lonach Estate. The farm is expected to produce ~30,000 liters per day once it is in full operation, from its current level of ~10,000 liters per day. At the end of FY18E the herd is expected to grow to ~1,000 with 500 milking cows (by FY19E herd of 2,000 with 1,000 milking).

Recommendation

FC Research’s previous target price of LKR 32.0 for WATA has been already achieved. For FY19E, FC Research estimates WATA’s fair value (before spinning off the tea segment) at LKR 47.0. This comprises a post-spinning value of LKR 42.0 (DCF LKR 50.0, PER based LKR 34) which includes only palm oil, dairy and other segments, plus the tea segment valued at LKR 5.0 based on a discounted cash flow method. The shares of Hatton Plantations (which will carry the tea segment) will be offered to the shareholders upon introduction to CSE, however the company has not announced a listing price. The pre-spin value of LKR 47.0 gives a total return of 55% (capital gain 42%, dividend yield 12%) in FY19E with an annualized return of 32%.

STRONG BUY

Investment risks

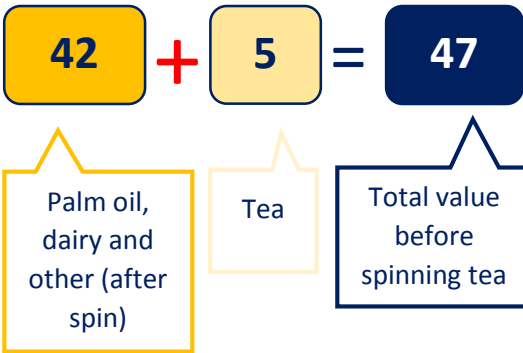
Limited land for palm oil expansion: The arable land for cultivation of palm oil is scare to find as most of the available land has been already used. This is limiting the potential to gain profits from palm oil after a certain point. WATA is already taking steps to improve the productivity in the existing land adopting sustainable practices. In addition, they have considered further diversifying into dairy farming with a long term view.

Commodity price risk: The commodity prices are affected by global events hence are unpredictable. The global palm oil prices saw a decline in 1QFY18 due to supply rebounds. European Union is phasing palm oil out of the biofuel production while United States is looking forward to impose anti-dumping duties on palm oil imports from Indonesia. On the plus side, India has increased levies on refined palm oil imports resulting crude palm oil cheaper and hence boosting demand for crude palm oil. At the same time Malaysia and Indonesia are in talks with China to supply for a B5 biodiesel program which may lead to increased prices due to higher demand.

Rising utility and labour costs: The rising electricity, water and labour costs increase the cost of production. Palm oil is least affected with labour. Tea business is more exposed to labour related cost increases where 70% of the direct cost represent labour. However the tea segment will soon be spun-off making WATA less prone to wage hikes.



Valuation summary



Expected WATA price	FY18E	FY19E
DCF based valuation	42	50
PER based target price	29	34
Average price (post spin)	36	42
Value of the tea segment	5	5
Average price (pre spin)	41	47

Return	FY18E	FY19E
Target price (pre spin)	41.0	47.0
Current price	33.0	33.0
Capital gain	8.0	14.0
Dividend	1.9	2.1
Capital gain %	24%	42%
Dividend yield %	10%	12%
Total return	35%	55%
Total return (annualised)¹	59%	32%

1. FY19E price annualised over 573 days

DCF valuation (excluding tea segment)

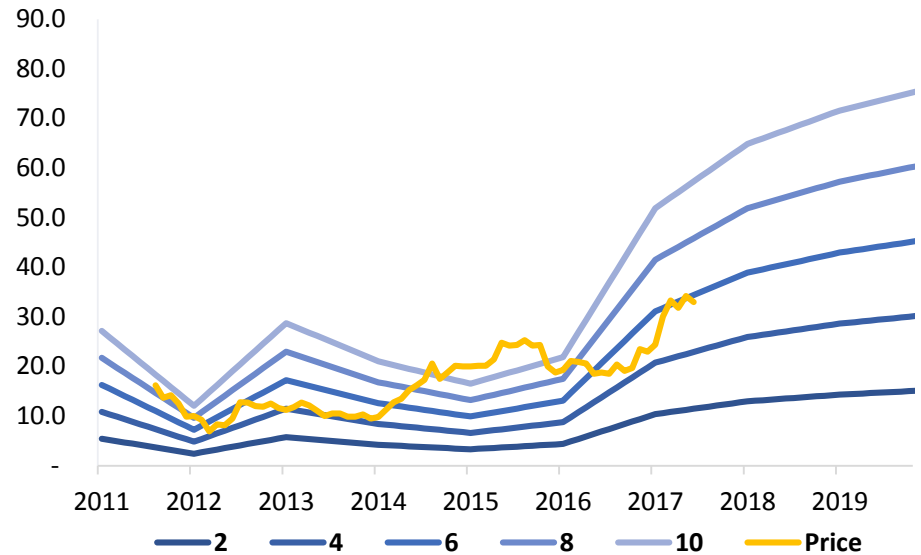
Valuations w/o tea (LKR Mn)	FY18E	FY19E
NPV	9,567	11,139
Less: debt	306	307
Add: cash and cash equivalents	651	924
Equity value	9,913	11,756
No. of Shares (Mn)	237	237
Value of Equity per share	42	50

COE		WACC	
R _f	10%	K _e	22%
R _m	19%	K _d	11%
R _m - R _f	9%	D/ E	30 / 70
β	1.38	Terminal Growth rate	3%
K_e = R_f + β (R_m - R_f)	22%	WACC	19%

DCF valuation summary (tea segment)

Tea segment valuation (LKR Mn)	FY18E	FY19E
NPV	1,225	1,138
Less: debt	482	488
Add: cash and cash equivalents	434	616
Equity value	1,177	1,266
No. of Shares (Mn)	237	237
Value of Equity per share	5.0	5.3

WATA PE band



PER valuation (w/o tea)	FY18E	FY19E
Earningsw/o tea (LKR Mn)	1,156	1,342
No of shares (Mn)	237	237
EPS (w/o tea)	4.9	5.7
Expected PER	6x	6x
Price at 6x expected earnings	29	34

Recommendation criteria

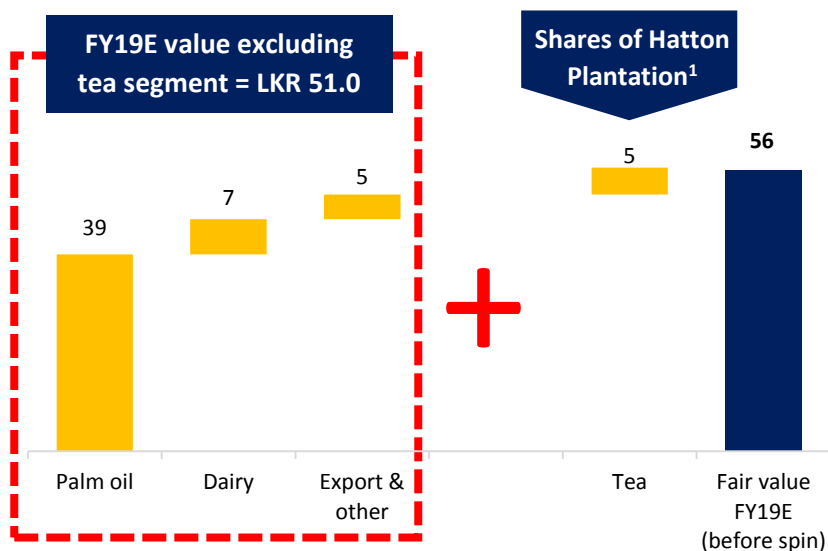
Categorization	Company Category	Strong Buy	Buy	Hold	Sell
Grade A	S&P SL20 Companies	T.Bill + 10% & Above	T.Bill + 5% & Above	T.Bill + 1% & Above	Below T.Bill + 1%
Grade B	Rest of the Companies	T.Bill + 13% & Above	T.Bill + 8% & Above	T.Bill + 3% & Above	Below T.Bill + 3%
Grade C	Companies less than LKR 1Bn Market Cap	T.Bill + 16% & Above	T.Bill + 11% & Above	T.Bill + 6% & Above	Below T.Bill + 6%



Annex I - Potential upside using Sum-of-the-Parts (SOTP) valuation

Segment	Method	Valuation assumptions				Value per share		% of total
		D/E	CoE	WACC	Growth	FY18E	FY19E	
Palm oil	FCFF	15/85	22%	20%	3%	36	39	70%
Dairy	NAV					6	7	13%
Export and other	NAV					4	5	9%
Fair value (post spin)						46	51	
Plus: Tea	FCFF	80/20	22%	12%	3%	5	5	10%
Fair value (before spin)						51	56	100%

Note: net debt adjustment are done for FCFF valuations



Note 1: The Company has not published a valuation for Hatton Plantation and LKR 5.0 is FC Research estimate of the tea segment for FY19E based on a discounted cash flow method. According to the announcement to CSE by the Company dated 28 Jul 2017, the excess of Hatton Plantation's assets over liabilities is LKR 1,845.87Mn which gives a net asset value of LKR 7.8 per share based on the current number of 236.6 Mn shares.

Source: CSE, Company reports, FC Research Estimates

Annex II – Sensitivity analysis

DCF value post spin FY18E (base case = LKR 42)

Terminal growth rate	WACC				
	17%	18%	19%	20%	21%
	1%	43	41	38	36
2%	46	43	40	38	36
3%	48	45	42	39	37
4%	51	47	44	41	39
5%	55	50	47	43	41

DCF value post spin FY19E (base case = LKR 50)

Terminal growth rate	WACC				
	17%	18%	19%	20%	21%
	1%	50	48	45	43
2%	53	50	47	45	43
3%	56	53	50	47	45
4%	60	56	52	49	47
5%	64	59	55	52	49



Annex III – Income Statement (prior to spinning off the tea segment)

LKR (Mn)	FY16	FY17	FY18E	FY19E	FY20E
Revenue	6,299	6,502	7,548	8,578	9,706
Cost of sales	(5,445)	(4,829)	(5,455)	(6,070)	(6,977)
Gross profit	853	1,673	2,092	2,509	2,729
Other operating income	134	147	168	153	140
Administrative expenses	(319)	(326)	(452)	(531)	(622)
Operating profit	669	1,494	1,807	2,131	2,247
Finance income	17	71	98	28	40
Finance cost	(96)	(119)	(132)	(169)	(170)
Net finance cost	(79)	(48)	(34)	(140)	(130)
Profit before income tax	590	1,446	1,773	1,991	2,117
Income tax expense	(72)	(220)	(241)	(300)	(316)
Profit for the year	518	1,226	1,532	1,691	1,801
Equityholders	518	1,228	1,535	1,694	1,804
EPS (reported)	2.19	5.18	6.48	7.16	7.62
Segmental revenue					
Tea	4,118	3,909	4,549	4,869	5,000
Rubber	73	-	-	-	-
Palm oil	1,504	2,162	2,326	2,797	3,272
Export	605	429	521	574	633
Dairy farm	-	33	152	339	802
Other	-	-	-	-	-
Inter segmental adjustmer	-	(31)	-	-	-
Total	6,299	6,502	7,548	8,578	9,706
Segmental net income					
Tea	(314)	6	377	349	149
Rubber	(48)	-	-	-	-
Palm oil	682	1,025	948	1,112	1,318
Export	65	48	100	108	119
Dairy farm	-	11	(13)	12	114
Other	134	134	121	110	101
Inter segmental adjustmer	(2)	2	-	-	-
Total	518	1,226	1,532	1,691	1,801

Source: CSE, Company reports, FC Research Estimates

Annex IV – Balance Sheet (prior to spinning off the tea segment)

LKR (Mn)	FY16	FY17	FY18E	FY19E	FY19E
Assets					
Non current assets					
PPE	1,835	2,424	2,996	3,277	3,159
Biological assets	3,431	3,629	4,097	4,461	4,617
Other non current assets	586	586	562	538	514
	5,853	6,639	7,655	8,276	8,290
Current Assets					
Inventories	638	733	796	904	1,023
Trade and other receivables	561	537	545	559	576
Other current assets	-	315	317	319	321
Cash and cash equivalents	695	888	1,086	1,540	2,870
	1,894	2,474	2,743	3,323	4,790
Total assets	7,746	9,113	10,398	11,598	13,080
Equity and liabilities					
Capital and reserves					
Stated capital	460	460	460	460	460
Retained Earnings	4,320	5,299	6,373	7,559	8,822
Non controlling interest	-	291	289	286	283
Total equity - equityholders	4,780	5,759	6,833	8,019	9,282
Non current Liabilities					
Borrowings	389	325	521	601	501
Other non current liabilities	1,784	1,761	1,746	1,731	1,716
	2,172	2,086	2,267	2,332	2,217
Current liabilities					
Trade and other payables	611	688	671	696	732
Other current liabilities	183	288	338	266	567
	794	976	1,009	962	1,299
Total equity and liabilities	7,746	9,113	10,398	11,598	13,080
NAVPS	20	26	30	35	40



Annex V – Cash Flow Statement (prior to spinning off the tea segment)

(LKR Mn)	FY16	FY17	FY18E	FY19E	FY20E
Profit/Loss before tax	590	1,446	1,773	1,991	2,117
Adjustments for:					
Depreciation	310	313	349	350	363
Profit from sale of PPE	(14)	(10)	(31)	(25)	(20)
Profit from sale of bio assets	(16)	(20)	(19)	(20)	(21)
Movement in live stock	13	(4)	(256)	(212)	(64)
Timber fair value (gain)/loss	(29)	(6)	(20)	(20)	(20)
Amortization of leasehold properties	7	7	7	7	7
Amortization of capital grants	(10)	(10)	(10)	(10)	(10)
Interest Income	(17)	(71)	(98)	(28)	(40)
Interest Expense	96	119	132	169	170
Changes in working capital	-	-	-	-	-
(Increase)/ decrease in inventories	55	(95)	(63)	(109)	(119)
(Increase)/ decrease in Receivable	(70)	(51)	(8)	(15)	(16)
Increase/ (decrease) Trade and Other Payables	(75)	78	(17)	24	36
Defined benefit obligations	172	(205)	-	-	-
Cash generated from operations	1,012	1,595	1,740	2,103	2,383
Interest paid	(96)	(119)	(132)	(169)	(170)
Tax paid	(0)	(31)	(241)	(300)	(316)
Defined benefit obligations paid	(98)	(140)	-	-	-
Interest received	17	71	98	28	40
Net Cash from operating activities	835	1,377	1,465	1,663	1,937
Cash Flow from Investing Activities	-	-	-	-	-
Field development expenditure	(209)	-	-	-	-
Purchase of property, plant and equipment	(80)	(1,106)	(1,123)	(771)	(325)
Proceeds from sale of property, plant and equipment	20	11	42	33	26
Proceeds from sale of consumable biological assets	29	40	33	35	36
Re-investment in gratuity/ other	(14)	578	-	-	-
Purchase/ issue of shares	-	292	-	-	-
Net cash used in investing activities	(254)	(185)	(1,048)	(703)	(262)
Cash Flow from Financing Activities	-	-	-	-	-
Dividends paid	(118)	(331)	(460)	(508)	(541)
Proceeds from borrowings	341	71	440	200	600
Repayment of borrowings	(78)	(128)	(194)	(192)	(399)
Repayment of lease principal	(6)	(8)	(5)	(5)	(5)
Net Cash Flow from Investing Activities	139	(396)	(220)	(505)	(345)
Increase/ decrease in cash and cash equivalents	720	795	197	454	1,330
Movement in Cash and Cash Equivalents					
At the beginning of the year	(62)	93	888	1,086	1,540
Increase/ decrease in cash and cash equivalents	720	795	197	454	1,330
Cash and cash equivalents at the end of the Year	658	888	1,086	1,540	2,870

Source: CSE, Company reports, FC Research Estimates

Annex VI – Key ratios (prior to spinning off the tea segment)

P/e 31st Mar	FY16	FY17	FY18E	FY19E	FY20E	
Growth	Revenue	-8%	3%	16%	14%	13%
	Cost of Sales	-10%	-11%	13%	11%	15%
	Gross Profit	7%	96%	25%	20%	9%
	EBIT	22%	123%	21%	18%	5%
	Net Profit	33%	137%	25%	10%	6%
Margins	GP Margin	14%	26%	28%	29%	28%
	EBIT Margin	11%	23%	24%	25%	23%
	NP Margin	8%	19%	20%	20%	19%
Gearing	Debt/Equity	11%	7%	10%	8%	9%
	Debt/Debt+Equity	10%	7%	9%	8%	9%
	Debt/Total assets	11%	7%	10%	8%	9%

Research Disclosure

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