CHEVRON LUBRICANTS LANKA PLC [LLUB.N0000]

MAINTAIN BUY

SLEEPING GIANT AT A DISCOUNT

Fair Value [2023E]: LKR 150.0 [+65%]
Total Return with DPS 77% [AER 113%]

Fair Value [2024E]: LKR 175.0 [+92%]
Total Return with DPS 110% [AER 52%]

LLUB is the market leader in an oligopoly lubricant market in Sri Lanka with a market share of c. 46%. Moreover, LLUB is also Sri Lanka's biggest lubricant exporter, catering to both Maldives (market leader) and Bangladesh. Operating in a relatively slow growth industry, LLUB's business model is built around offering the best quality products whilst focusing on margin expansion through pricing aided by its wide distribution network. Moreover, with a dividend payout of 60%-90% in the next few years, LLUB is also amongst the leading dividend yield companies listed on the bourse. Meanwhile, taking into consideration the dominant market position, resilient operating margins, positive outlook benefitted from the absence of high-quality imported products, recovery in tourism and agriculture and increased drainage cycles aided through possible relaxation of fuel quota system, we have arrived at a fair value of LKR 150.0 for 2023E and LKR 175.0 for 2024E. Thus, we rate the share MAINTAIN BUY.

YE Dec/LKR Mn	2018	2019	2020	2021	2022	2023E	2024E	2025E
Estimates (LKR 'Mn)								
Revenue	10,861	11,856	11,637	16,866	24,575	22,398	26,840	32,416
Gross profit	4,092	4,435	4,617	6,178	10,293	9,407	11,407	13,939
EBIT	2,743	2,917	3,036	4,363	7,502	6,616	7,660	8,927
Net Profit	**1,992**	**2,099**	**2,226**	**3,926**	**3,671**	**3,771**	**4,836**	**5,969**
Adjusted EPS (LKR)	8.3	8.7	9.3	16.4	15.3	15.7	20.1	24.9
YoY Growth (%)	-22%	5%	6%	76%	-7%	3%	28%	23%
Valuations								
PER (x)	10.9x	10.3x	9.7x	5.5x	5.9x	5.7x	4.5x	3.6x
PBV (x)	5.5x	5.2x	5.2x	4.3x	3.5x	2.5x	2.3x	2.1x
DPS	8.8	7.8	9.0	13.0	5.0	11.0	16.1	22.4
DY (%)	9.7%	8.6%	10.0%	14.4%	5.5%	12.2%	17.9%	24.8%
Dividend Payout (%)	105.4%	88.6%	97.0%	79.5%	32.7%	70.0%	80.0%	90.0%
NAVPS	16.3	17.2	17.4	20.8	25.7	35.8	39.9	42.4

LLUB topline to grow at 3Yr FWD CAGR of 9.7% to LKR 32.4Bn

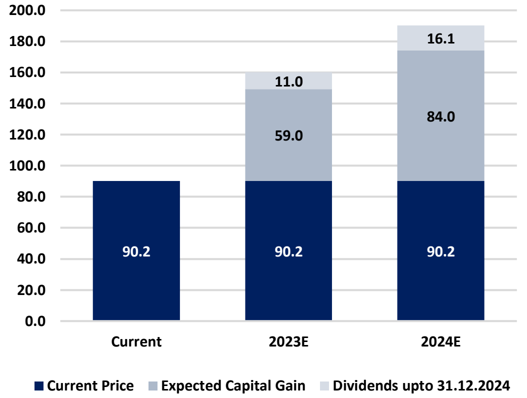
We expect LLUB topline to grow at a 3Yr FWD CAGR of 9.7% between 2022-2025E period aided predominantly by price increases and volume growth. Given the high-quality nature of the products offered together with the guarantee for extra mileage, LLUB products are superior in terms of quality compared to competitor products, which enables LLUB to adjust prices whilst remaining competitive in the industry. Meanwhile, we expect LLUB volumes to grow at a FWD CAGR of 4.8% between 2021-2025E and support topline performance backed by possible relaxation of fuel quota system (which is expected to lead towards higher drainage cycles), recovery in tourism and agriculture (which are highly lubricant intensive industries), recovery in business confidence and normalization of business activities. Moreover, expansion of market share from 46% to 54% between 2021-2025E is also expected to aid towards volume growth.

LLUB margins to remain intact given the proven track record for quality

Lubricant industry in Sri Lanka is facing serious competition as the shadow regulator PUCSL continuously grant licenses to new operators despite the limited growth in the industry. However, despite the intense competition in the industry, LLUB has continuously expanded margins (GP margins expected to improve to 43.0% in 2025E cf. 41.9% in 2022) due to its superior nature of the product and LLUB's wide dealer network, which surpasses +650 oil marts across the country.

Leading dividend player in the Colombo bourse

Given the ownership and backing of a global conglomerate, LLUB have consistently paid out +90% of their profits as dividends and is amongst the leading dividend players in the Colombo bourse. However, affected by the current economic context LLUB dividend payout has declined to 60% of its earnings, yet offers an attractive dividend yield of +10%. Going forward, as operating context improves, we expect dividend payout of LLUB to improve steadily and reach previous highs of +90% in 2025E, thus offering an excellent yield of 11.8%-24.1% in the coming years between 2023E-2025E.



FIRST CAPITAL RESEARCH

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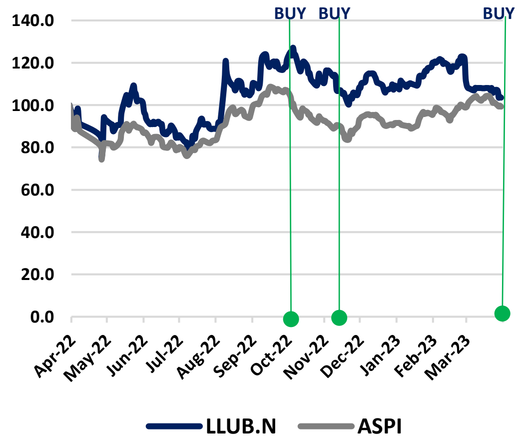
KEY DATA	
CSE Ticker	LLUB.N0000
Bloomberg Ticker	LLUB SL
Share Price (LKR)	90.20
52w High (LKR)	116.3
52w Low (LKR)	60.0
Avg. Daily Volume (Shares)	119,722
Issued Share Capital (Shares 'Mn)	240.0
Market Cap (LKR 'Mn)	21,648.0
Market Cap (USD 'Mn)	63.7
*1 USD = LKR 340	

Price movement of LLUB vs ASPI (indexed and rebased to 100)



Source: CSE

Minimum Return for BUY:

Buy Below 2024E - [AER of 41% with DPS]: LKR 120.0
LLUB categorized as 'Grade B' counter

Disclosure on Shareholding:

First Capital Group or the covering analyst did not hold 1% or more of the total outstanding share capital of LLUB during the five trading days prior to the issuance of this document.

Giant trading at a 5.7x and 4.5x 2023E and 2024E earnings

Having traded at a past 5-year average of 9.0x PER, LLUB currently trades at a 4Q trailing PER of 6.1x. The steep trading discount is partly attributable to the relatively lower dividend payout in 2022 whilst poor market sentiment also contributed towards the trading discount. However, driven by the above discussed factors, we expect LLUB 2023E and 2024E earnings to be at LKR 3.8Bn and LKR 4.8Bn, which further reduces the trading PER to 5.7x (discount of 34.4%) and 4.5x (discount of 48.9%), respectively.

LLUB maintained BUY

LLUB earnings are expected to grow at 3YR FWD CAGR of 17.6% between 2022-2025E backed by the (1) Turnaround in tourism and agriculture industries (2) Improvement in business environment (3) Increased drainage cycles with the possible relaxation of fuel quota system as country's FX situation improves (4) Possible relaxation of vehicle imports (5) Margin expansion through price adjustments and recapture of market share from existing players. Furthermore, significant trading discount to LLUB's past trading multiples, steadily increasing dividend payout and hence an impressive dividend yield is also amongst the key catalyst for the future performance of the share. Taking into consideration the fair value of LKR 150.0 for 2023E and LKR 175.0 for 2024E and the potential earnings growth of LLUB, First Capital rate the share **MAINTAIN BUY**.

1.0 ABOUT CHEVRON

Chevron Brands

- ***Chevron Lubricants Lanka is the 51.0% owned subsidiary of American multinational Chevron Corporation***, which is amongst the biggest petroleum corporations in the world. Chevron Corporation engages in all phases of petroleum operations, from exploration, production, and refining to marketing and research.

- ***Excellent track record of 30 years:*** Incorporated in 1992, through a privatization initiative by Sri Lankan government, 51% stake of Lanka Lubricants Limited was sold to Caltex International. Caltex International was listed in the Colombo Stock Exchange in 1996 and later in 2007 in-line with global branding initiative.

- ***Market leader in Lubricants in Sri Lanka:*** Operating in an oligopoly with 26 other players, Chevron Lubricants is the market leader of lubricants controlling c. 46% of the total lubricants sold in Sri Lanka.

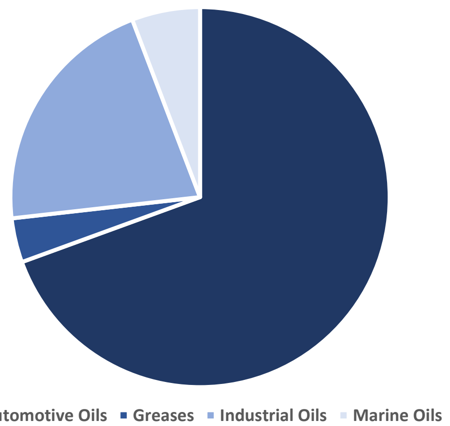
- ***LLUB the complete package:*** Chevron Lubricants engages in blending, manufacturing, importing, distributing, and marketing lubricants oils, greases, brake fluids, and specialty products in Sri Lanka. The Company offers its products for industrial, commercial, and consumer applications. Chevron Lubricants Lanka PLC markets its products under Chevron, Caltex, and Texaco brands.

- ***State of the art blending plant:*** 90% of Chevron's products are produced locally at its state-of-the-art blending plant at Lindel Estate, Sapugaskanda. Certified with BS EN ISO 9001:2008 certification from UK's most reputed standards body, the British Standards Institute (BSI). LLUB's facility is currently the only lubricant blending plant in the country to have received this certification from BSI, UK. The facility is built on a 4 ½ acreage of land with a floor area of 5,000 sq m, this semi-automated plant has the capacity to produce 45 MML per annum of finished lubricants in a single shift operation.

- ***Equipped for the future:*** Chevron's blending facility is also equipped with an in-house modern laboratory facility and on-site base oil and finished lubricants storage tank farm. The modern warehouse with an efficient racking system has 1.4Mn litre storage capacity for raw materials & finished products.

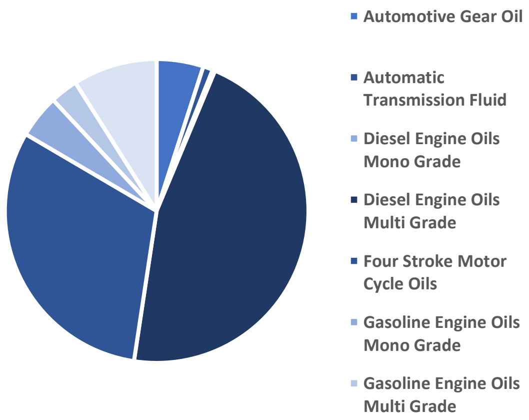
- ***Biggest lubricant exporter in Sri Lanka:*** Chevron exports lubricant products to Maldives and Bangladesh and generates c. 5% of its revenue from export operations. Chevron is the market leader in Maldives, selling its Caltex range of lubricants via Damas Company in Maldives. In-line with the change of strategy to Go-to-market model for Bangladesh, LLUB appointed Rock Energy as the new distribution partner for Caltex branded lubricants in Bangladesh with effective from January 2022.

Figure 1: LLUB- Lubricant sales by type



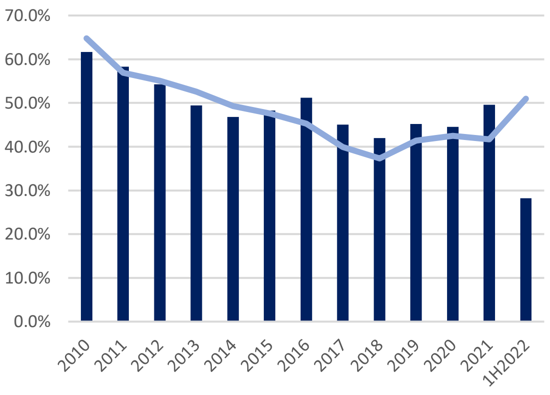
Source: PUCSL/First Capital Research

Figure 2: Automotive Lubricant Sales by Type



Source: PUCSL/First Capital Research

Figure 3: volumes sold & Market Share



Source: PUCSL/First Capital Research

2.0 SWOT Analysis

2.1 Strengths

- ***Unparalleled history of +30 years in the lubricant market:*** Chevron Lubricants is the longest serving lubricant blender in Sri Lanka, with a history and an experience of +30 years in the industry.

- ***Undisputed market leader in lubricants since inception:*** Having entered the Sri Lankan lubricant market in 1992 via acquisition of state-owned Lanka Lubricants Limited, Chevron Lubricants have been the undisputed market for lubricants in Sri Lanka with a market share of c. 46% as of 3Q 2022.

- ***Backing of a multinational energy corporation:*** Chevron Lubricants is a 51% owned subsidiary of American multinational Chevron Corporation. With a rich history of +150 years, Chevron Corporation is present in more than 180 countries and engages in every aspect of the oil and natural gas industries. Chevron Corporation is ranked 16th on the Fortune 500 in 2022 with revenues of USD 162.5Bn, which also ranked it 37th on the Fortune Global 500.

- ***Sri Lanka's biggest lubricants distribution network:*** Chevron Lubricants possess the largest distribution network with + 650 Caltex oil marts around the country. Further, Chevron Lubricants also goes the extra mile to conduct regular training programs for operating staff to ensure up-to-date product knowledge. Regular Health, Safety and Environmental audits are also carried out to ensure that the organization's standards are met within these outlets.

2.2 Weaknesses

- ***Heavy focus and reliance on the lubricant industry in Sri Lanka:*** Chevron lubricants currently engages in blending, manufacturing, importing, distributing, and marketing lubricants oils, greases, brake fluids, and specialty products in Sri Lanka. In an event where dynamics of operating environment changes as we witnessed during Covid-19 with the imposition of travel restrictions, LLUB may have an adverse impact due to reliance on lubricant industry.

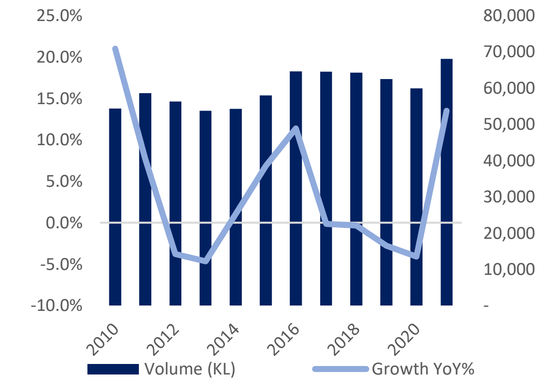
2.3 Opportunities

- ***More ways to diversify revenues:*** During the month of October 2022, in a move to open up the country's petroleum industry, Sri Lanka gazette and approved the legislation to let companies from oil-producing nations import and sell fuel. LLUB's parent, Chevron Corporation engages in both upstream and downstream operations in the petroleum industry. Benefitted from the parental expertise in downstream operations, Chevron Lubricants have the opportunity to commence downstream operations and diversify their revenue streams in Sri Lanka

2.4 Threats

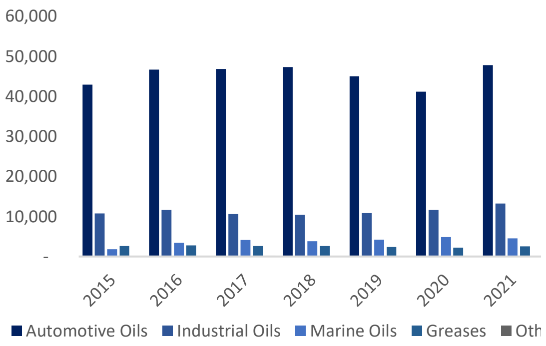
- ***Threat from cheaper imported lubricants:*** As Sri Lanka eyes a deal with IMF, Sri Lanka could see import restriction easing as country's reserves position improves, thus allowing cheaper, imported lubricant products to enter the market.

Figure 4: Total lubricants volumes 10 years



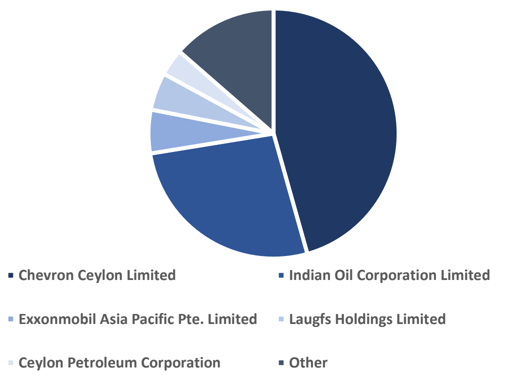
Source: PUCSL/First Capital Research

Figure 5: Lubricants use by type.



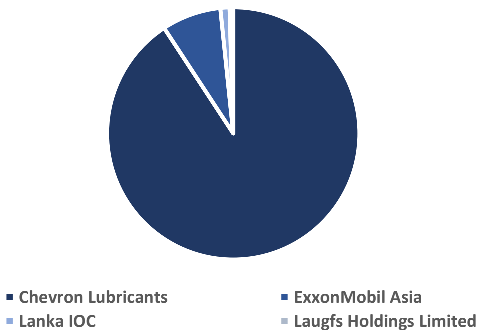
Source: PUCSL/First Capital Research

Figure 6: Market shares as of 2Q2022



Source: PUCSL/First Capital Research

Figure 7: Export Market shares as of 2Q2022



Source: PUCSL/First Capital Research

3.0 Lubricant Market Analysis

- ***PUCSL acts as a shadow regulator for lubricants:*** Sri Lankan lubricant market is regulated and governed under the provisions of the Petroleum Products (Special Provisions) Act No. 33 of 2002 and the Ceylon Petroleum Corporation Act No. 28 of 1961. The Government has appointed PUCSL as the shadow regulator for the Lubricants Market. Legislative enactments are currently pending, which would enable the PUCSL to fully regulate the downstream Petroleum Industry. As the shadow regulator of the lubricants market, the PUCSL advises the Ministry of Petroleum Industries on policy and regulatory matters with respect to liberalization of the lubricants industry.

- ***Sri Lankan lubricant market grew at a 10-year past CAGR of 1.9% to 68,018KL in 2021:*** Total lubricant market in Sri Lanka is mainly represented by 4 segments consisting of Automotive (contributes to 70% of total volume), Industrial (contributes c. 19% to total volume), Marine (c. 7% of total volume sold) and Greases (c. 4% of total volume sold).

- ***Automotive segment:*** which is used for the lubrication of automotive parts in vehicles grew at a 10-year CAGR of 2.0% in 2011-21 period. The growth in automotive lubricants usage was mainly driven by the increase in vehicle population, which grew at a 10-year past CAGR of 8.6% in 2011-21 period. Meanwhile, Industrial lubricant volumes grew at a 10-year CAGR of 3.5% backed by growth the use of industrial machines whilst Marine lubricants volume grew at a CAGR of 2.2% during 2011-21 period.

- ***Intense competition in the industry:*** Sri Lanka's total lubricant volumes consist of both locally manufactured and imported lubricants. According to the PUCSL 2021 lubricants report, major Sri Lankan players including Chevron, Lanka IOC, Laugfs Lubricants and Ceypetco own and blends c.75% of total lubricants used in Sri Lanka whilst c.25% of total volumes are imported by several small and medium players.

- ***Top 5 players control 87% market share:*** Sri Lankan lubricant industry is an oligopoly by nature with 26 players operating in the country. Chevron Lubricants is the Largest blender and operator in the country controlling 46% of the market, whilst Indian Oil Corporation (controls c. 27%), Laugfs Holdings Limited (controls c. 5%), ExxonMobil Asia Pacific Pte. Limited (controls c. 6%) and Ceylon Petroleum Corporation (controls c. 3%) are amongst the other notable players in the industry.

- ***Sri Lanka exports 4.5% of total manufactured lubricants:*** Sri Lanka also engages in exporting locally manufactured lubricants to regional peer countries. In 2021, Sri Lanka exported a total of 2,272KL of lubricants to regional countries, which consists of 4.5% of total manufactured lubricants in the country. Presently there are four players engaged in the lubricant export business including, Chevron Lubricants (contributed 90.8%), ExxonMobil Asia Pacific Pte. Limited (contributed 7.6%), Indian Oil Corporation Limited (contributed 1.2%) and Laugfs Holdings Limited (contributed 0.5%).

4.0 Porter's 5 force analysis

- **Threat of new entrants- Medium**

  Sri Lankan lubricants market is governed and regulated under the provisions of the Petroleum Products. Public Utilities Commission of Sri Lanka (PUCSL) acts as the shadow regulator for the industry and grants licenses for operators at their own discretion and charges an annual registration fee of LKR 2.5Mn or 0.75% of total invoiced sales (excluding any sales taxes) per annum, whichever is higher, which will be levied bi-annually. Moreover, PUCSL has also imposed entry barriers which includes minimum blending plant capacities (7,500MT for lubricants and 1,000MT for grease), minimum value of investment (USD 5Mn for an investment in blending plant and USD 1Mn investment for trade, distribute or sell automotive and marine lubricants and greases) and minimum number of experiences in lubricant market (minimum of 5-years' experience).

- **Bargaining power of suppliers- Low**

  The key ingredient in lubricant production is base oil and it remains a very generic product. Given that there are multiple suppliers of base oil globally, we believe the bargaining power of suppliers are low in the lubricant industry.

- **Bargaining power of customers- Low**

  Based on the primary research conducted by First Capital Research, +90% of oil drainage in automobiles takes place at service stations and preference of lubricant brand of the service center operator plays a key role. This is largely due to the availability of brands with service centers and discounts offered by lubricant suppliers. Meanwhile, switch between different lubricant brands also remains low due to the hassle of draining, cleaning and replacing of oil filters, and lack of knowledge with customers related to price discounts and offered products.

- **Threat of substitutes- Very Low**

  Threat of substitutes remain almost non-existent as lubricants play a major role in vehicle maintenance and substitutes for lubricants are unavailable.

- **Rivalry among existing players- Very High**

  Rivalry amongst existing players remains very high in the Sri Lanka lubricant market. Given the fact that top 4 players in the industry control +75% of the market and these players are backed by large multinationals or by the government, hence threat remains very high.

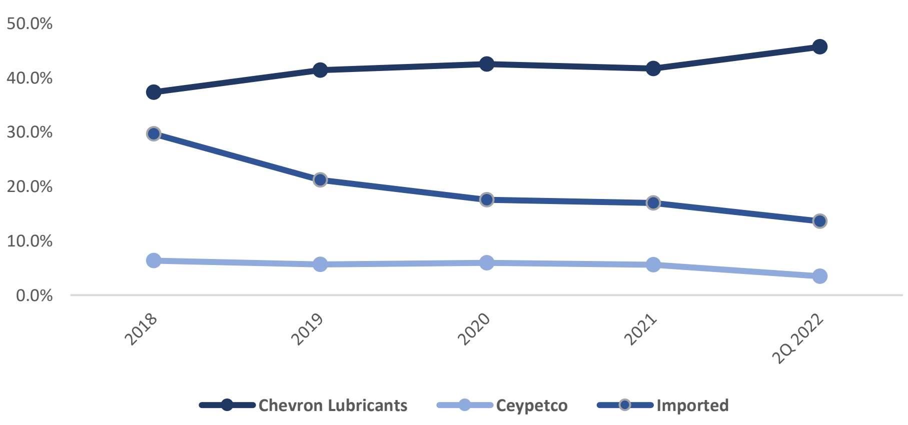
5.0 Revenue to grow at a CAGR of 9.7% between 2022-2025E

5.1 Leader in lubricants in Sri Lanka

Leader in lubricants in Sri Lanka: Since its inception, LLUB has consistently been the market leader for lubricants in Sri Lanka. Despite the heavy competition in the industry, with new licenses issued and new players entering the domestic market, LLUB has stood tall and maintained a market share of +45% throughout the history. Brand loyalty among customers, wide dealer network, consistent improvement in products offered, maintaining global industry standards have also enabled LLUB to stand out from competition.

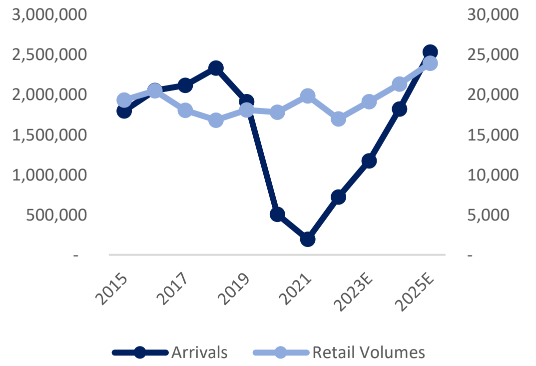
Market share to grow to 54% in 2025Ecf. 46% in 3Q2022: Going forward, we expect LLUB to continue dominate the lubricants market in Sri Lanka with the possibility of increasing its market share to c. 54% in the medium term from 43% recorded in 2021 (c. 46% in 3Q 2022). The growth in market share will be predominantly driven by the wide dealer network and brand loyalty of customers towards LLUB whilst non-availability of imported high quality lubricants due to forex crisis prevailing in the country is also expected to contribute towards a shift to LLUB products and thus the increase in market share. Furthermore, the performance of the state-owned lubricant manufacturer Ceypetco (who controlled c.6% of market share) have also been affected during the past few quarters due to temporary closure of Sapugaskanda blending plant due to unavailability of crude oil. However, operations have partly commenced at the Ceypetco blending plant, yet we do not expect blended volumes to regain its previous heights anytime soon due to limited production, limited availability of products and customer hassle to change the brand of lubricants again to Ceypetco brands from other substitute products.

Figure 8: Chevron Lubricants, Ceypetco & Imported products



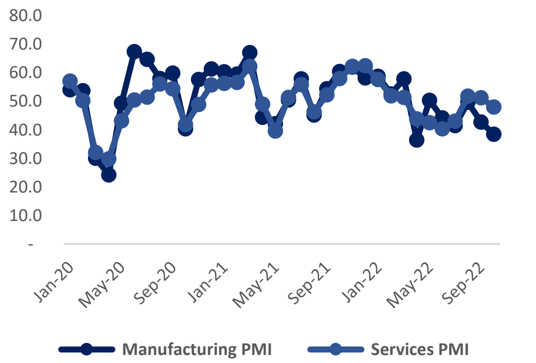
Source: PUCSL/First Capital Research

Figure 9: Tourist arrivals vs retail volumes



Source: SLTDA/PUCSL/First Capital Research

Figure 10: PMI Index and AWPLR



Source: CBSL/First Capital Research

5.2 Recovery in tourism to aid volume growth

Recovery in tourism to aid volume growth: Tourism was the 3rd largest source of foreign currency earner for Sri Lanka between 2014-2019 period and in 2019, tourism contributed 5.6% to the Sri Lankan GDP. However, dealt with double blows from Easter attacks in 2019 and Covid-19 pandemic, Earnings from tourism fell to USD 507.0Mn and contribution drastically reduced to 0.8%. Moreover, following the earnings drop, arrivals to Sri Lanka also reported a big drop to 194,495 in 2021 cf. a peak of 2,333,796 witnessed in 2018. Hence we believe lubricant consumption by retail has also impacted heavily with the slowdown of arrivals to the country.

Tourist arrivals to reach pre-pandemic by 2025E: Recovering from the blow to the industry from the severe economic crisis together with lifting of travel adversaries placed by key tourist destinations, we expect tourist arrivals to improve and touch a pre-pandemic arrivals of 2.3Mn arrivals by 2025E. Thus, we expect LLUB retail volumes to grow in tandem with arrivals and record a 4Yr FWD CAGR of 4.8% between 2021-25E.

5.3 Recovery in businesses to boost LLUB volumes

Recovery in businesses to boost LLUB volumes: Impacted from consecutive blows to the economy and record high interest rate environment (AWPLR 28.5% in Dec-22 cf. 9.7% in Jan-20), business confidence is at a historic low as Purchasing Managers Index (PMI) of 42.3 points in Feb 2023 (from 54.0 points recorded in Jan-20). Furthermore, business sentiment was also hampered by the impact of the current economic crisis as daily necessities including fuel and electricity was scarce.

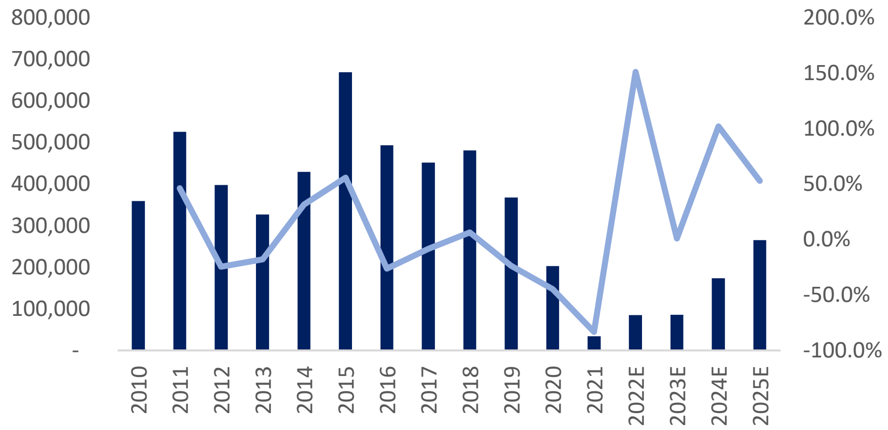
Business sentiment to improve as Sri Lanka enters IMF deal: However, given that Sri Lanka has signed the board level agreement with IMF for USD 2.9Bn Extended Fund Facility, on the back of consolidation in fiscal situation together with passing of key reforms including fuel formula and electricity pricing formula, crisis was partially mitigated and recovery in progress. Thus with the current development and improving political stability, we expect business confidence to improve momentarily, benefitting lubricant retail volumes growth in the coming months.

5.4 Possible relaxation of imports to allow new volume growth

Vehicle population stagnant as Sri Lanka ban vehicle imports: Amidst a severe foreign currency crisis in 2020, Sri Lanka banned importation of motor vehicles in 2020. Thus, new registration of motor vehicles declined by 83.3%YoY to 33,850 in 2021 cf. an average growth of 4.4%YoY during 2010-2019.

Ban to be lifted as Sri Lanka's reserves rise: Amidst a stringent fiscal measures and controlled imports regime, Sri Lankan reserves have strengthened over the past few months and reached USD 2.2Bn in Feb 2022. As the Sri Lankan reserve position improves further, we expect government to gradually relax vehicle imports. However, due to the severe fiscal consolidation measures, high taxes are possibly placed on the vehicle import business and thus we expect new registrations to grow at a marginal CAGR of 1.7% between 2021-2025E period.

Figure 11: New vehicle registrations in Sri Lanka



Source: DMV/First Capital Research

5.5 Possible lifting of fuel quota in 2024E to boost volumes

Fuel quota introduced to curtail fuel queues: With the acute FX shortages in the country amidst the worst economic crisis faced during the last 7 decades, Ministry of power and Energy introduced the fuel quota (LKR 9,000/week) system in Aug-21 to deal with the long queues seen throughout the island.

Fuel quota system expected to be relaxed in 2024E: Aided by the decline in global crude oil prices and strengthening of the reserves position in Sri Lanka, Ministry of finance have signaled a possible reduction of fuel prices in April-23. However, as the country's reserve position stabilizes further, with possible inflows from multi-lateral funding lines, revamp in tourist arrivals and increase in remittances, we expect GoSL to relax the fuel quota system in the coming years. Which we believe will enable free movement, which is expected to enable LLUB through increased vehicle mileage and thus higher drainage cycles.

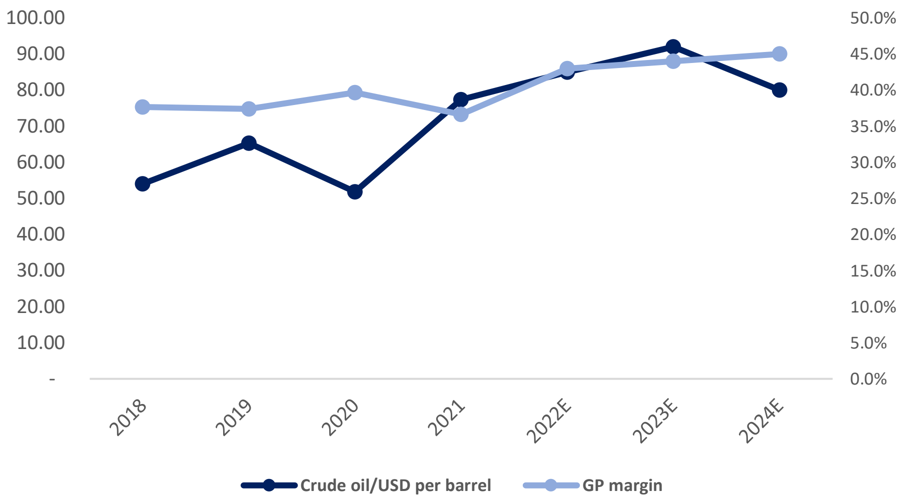
6.0 Margins to grow benefitted by slowdown in prices amidst sharp price increases

6.1 Crude oil prices forecasted to remain at record low prices

Crude oil prices tumble as Russia attack Ukraine: Price of a crude oil touched a record high price of USD 113/barrel in Mar-22 with Russia's invasion of Ukraine, which resulted in sanctions placed on Russian oil exports. Prior to Mar-22, Russia was the single largest gas exporter, and it is a major supplier of crude, refined products, and other resources, including to the U.S. However trading currently around USD 75.5/barrel, crude oil prices have taken a severe blow impacted by global recessionary fears due to rising energy costs and projected low growth in global economy.

Crude to remain at record low levels: Going forward, we expect global crude oil prices to stay inline with World Bank projections of USD 92.0/barrel in 2023E and USD 80.0/barrel in 2024E as slowdown in global growth and concerns about global recession outweighs worries about insufficient oil supply. Furthermore, prices are expected to be volatile in the coming years affected by various factors including EU sanctions on Russia, the G7 oil price cap, OPEC+ production capacity, the outlook for U.S. shale oil, and the use and refilling of strategic oil inventories. Moreover, potential global recession and the easing of COVID-19 restrictions in China are expected to be major factors towards oil demand and recovery in crude oil prices.

Figure 12: Crude oil price/barrel Vs LLUB GP Margin



Source: First Capital Research

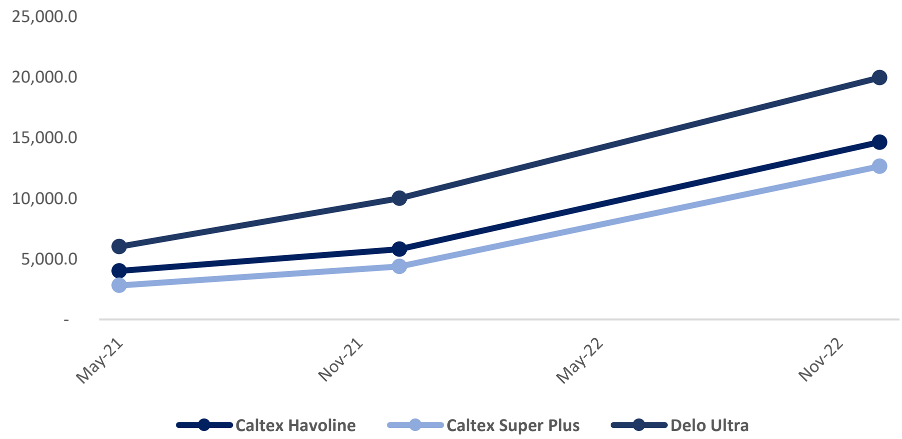
6.2 Multiple price increases to aid margin expansion

Taxes and inflation pose challenges for lubricants: Covid-19 pandemic brought multiple challenges to both the local and global operating climate. Supply chain disruptions due to scarcity of vessels, shortage of containers, record high freight rates, rising distribution costs and increased loyalty fees amid near 100% depreciation of LKR against USD resulted towards increased production costs to the company. Furthermore, recent fiscal measures introduced by the Government of Sri Lanka including, raising of Value Added Tax (VAT) rate from 8% to 15% and increase in corporate taxes from 18% to 30% have also caused incremental costs for the company, further impacting the operational cost of LLUB.

LLUB revise up prices by 250%: To minimize the margin impact due to above mentioned cost escalations, LLUB passed over multiple price increases during 2021 and 2022. Taking into consideration LLUB's three main products which includes Havoline, Super Plus and Delo and based on primary research, LLUB have revised up prices by more than 250% which we believe is higher than costs increase as GP margin expanded by an average of 525bps to 41.9% in 2022 cf. 36.6% observed in 2021.

LLUB selling prices to grow at an average of 8% between 2023E-2025E: Taking into consideration the prevailing high double-digit inflation, escalated distribution costs and energy costs, we have forecasted LLUB selling prices to increase at a CAGR of c. 8% in the next 3 years in tandem with the forecasted headline inflation in the country.

Figure 13: Price increase chart



Source: First Capital Research

6.3 Switch from low margin to high margin products aid margin expansion

Competition eases as FX shortages curtail imports: In the backdrop of continuous money printing and ballooned state expenditure, Sri Lanka is currently undergoing a severe FX crisis, pushing the government to impose a ban on all imported products. As of 2021, Sri Lankan lubricant industry had 14 players who had licenses to import and distribute products. With the unfolding of the present crisis, we believe that the operations of few major players in the lubricants industry were affected, thus a switch was observed to premiere LLUB brands from non-available imported products.

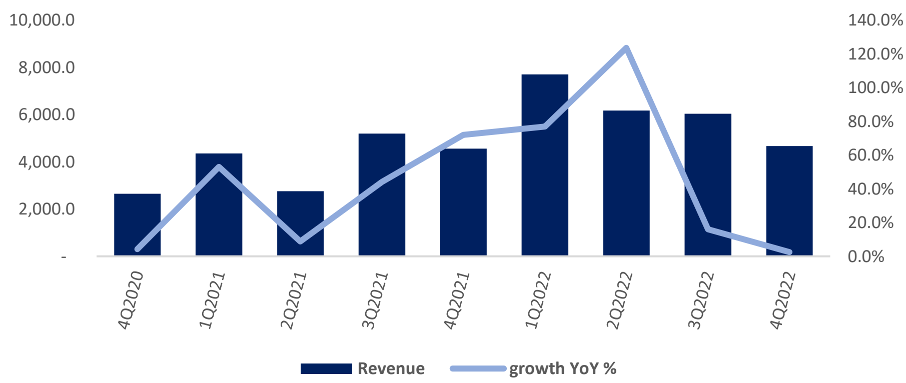
Demand for high margin/high performance products improve: Furthermore, with the prevailing import ban on vehicles, circulation of used vehicles in Sri Lanka have increased significantly and this have resulted towards increased drainage cycles. Given the lackluster availability of imported products together with increased shift to high margin products from substitutes in-order to maintain the performance of used vehicles. We believe LLUB will witness a shift in demand to high margin products such as Havoline from Super Plus product category as well as other low margin products available in the market. Thus enabling LLUB margins to grow in the near future.

7.0 Recent Quarterly Performance

7.1 Revenue Performance

LLUB posted a revenue growth of 2.5%YoY (-22.6%QoQ) to LKR 4.7Bn aided by multiple price increases (prices increased by an average of 280%) that took place during 2H2022. Multiple price increases carried out during the period was largely attributable to the increase in cost structure mainly coming due to the steep depreciation of the LKR against USD which resulted in a dual blow to increase in global base oil prices, relatively high freight rates, increases in indirect taxes and distribution expenses. During 3Q2022, LLUB expanded its market share to 46.8% from 45.6% in 2Q2022, which we believe is led by the wholesale business, aided by LLUB's wide dealer network in the country. Meanwhile, despite the expansion of market share in 3Q2022, LLUB volumes declined by 12.2%QoQ and 47.7%YoY as total lubricant market shrunk by 14.3%QoQ and 46.9%YoY affected by fuel quota and hampered disposable incomes. The steepest decline in LLUB volumes for 3Q2022 came from the automotive lubricant volumes (-13.2%QoQ and -44.6%YoY) whilst Industrial lubricant volumes declined by 12.7QoQ and 56.6%YoY.

Figure 14: Revenue & Revenue Growth



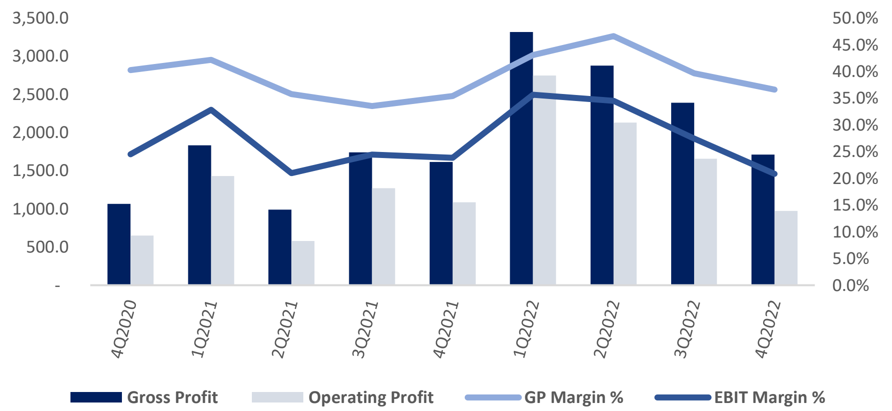
Source: First Capital Research

7.2 Gross profit and Operating profit performance

GP margins under pressure as product mix shifts: Gross profit increased by 5.9%YoY (-28.5%QoQ) to LKR 1.7Bn aided by the relatively higher price increases compared to the increase in costs. Cost of sales for 4Q2022 grew by 0.6%YoY (-18.7%QoQ) largely due to the increase in base oil prices, which makes up around 80% of the costs. Meanwhile, GP margin for the quarter improved by 118bpsYoY to 36.6% whilst on a quarterly basis GP margin declined by 303bps. Furthermore, LLUB's attempt to capture market share by sale of wholesale products or loose oil at a greater discount to competition, also added woes to the LLUB GP margin during the quarter.

Local currency depreciation hurts EBIT margins: Operating profit declined by 10.4%YoY (-41.2%QoQ) to LKR 972.9Mn due to escalation of operating costs. Operating costs for the quarter increased by 39.4%YoY to LKR 736.0Mn backed by increase in both Administrative and Selling and distribution expenses which inclined by 81.0%YoY and 8.9%YoY respectively. Growth in administrative costs for the concerned quarter was possibly as a result of the depreciation of the local currency which drove licensing fees costs which is directly linked to the revenue.

Figure 15: Gross profit & EBIT performance

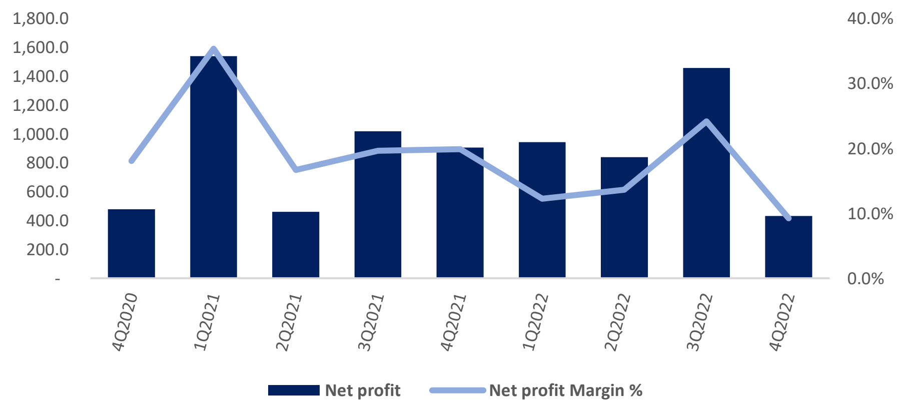


Source: First Capital Research

7.3 Net profit performance

Tax and interest rates take a toll on bottom line performance: Net profit declined by 52.4%YoY (-70.4%QoQ) to LKR 431.0Mn driven by contraction in EBIT margins, increase in finance costs and adjustments to the corporate tax structure. Finance cost for 4Q2022 inclined by 971.0%YoY and 92.7%QoQ to LKR108.8Mn as lease liabilities grew by 15.3%YoY to LKR 393.1Mn. Meanwhile, due to the changes in the manufacturing sector corporate tax structure from 18% to 30%, LLUB tax charge for 4Q2022 inclined by 184.1%YoY to LKR 594.3Mn. Net profit margin contracted by 1,066bpsYoY to 9.2% in 4Q2022 whilst 2022 margin contracted by 834bpsYoY to 14.9% largely due to the poor performance in the 4Q2022 period.

Figure 16: Net profit and NP Margin



Source: First Capital Research

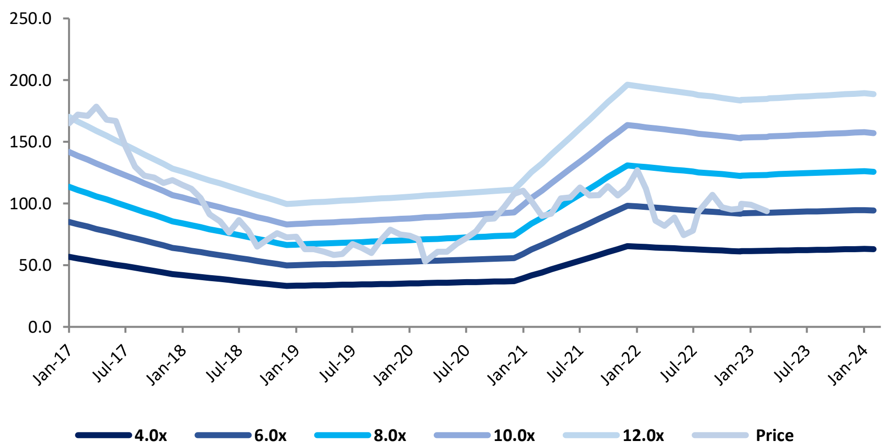
8.0 Valuations

8.1 PER Valuation

Historically LLUB traded at a PER multiple of 9x due to the market leadership position LLUB holds in the lubricant industry, the premium dividend payout company offers and multinational ownership of the company which offers greater transparency to company performance and management. However, given the depressed macro environment and poor performance of the Colombo Stock Market and buying sentiment, LLUB currently trades at a 4Q trailing PE of 6.1x.

Brighter outlook warrants for a premium PER: Given that Sri Lanka is on the path to recovery with economic degrowth decelerating to 3.3% (based on the ADB projections) from 2022 degrowth of 7.8%, coupled with decelerating inflation (expected to decline to 10.5% in Dec-23 from 50.6% recorded in Feb-23) and with the signing of the IMF board level agreement for USD 2.9Bn and strengthening reserve position, Sri Lanka's macro outlook is on track for recovery in 2024. Furthermore, with the company's outlook intact with availability of fuel across the island and normalcy getting back, tourism on recovery path and the restart of lubricant intensive agricultural sector, we believe that LLUB should trade at par with the historic average PE multiple of 9.0x 2023E and 2024E earnings. Thus, we arrive at a PER based target price of LKR 141.4 for 2023E and LKR 181.3 for 2024E.

Figure 17: PE Band



Source: First Capital Research

PER based Valuation	2023E	2024E
Earnings (LKR 'Mn)	3,771	4,836
No. of Shares ('Mn)	240	240
EPS	15.7	20.1
Expected PER	9x	9x
Price at 9x Earnings	141.4	181.3

8.2 DCF Valuation

DCF target prices 2023E and 2024E: We have derived a 2023E target price of LKR 152.8/share and 2024E target price of LKR 168.8/share for LLUB based on the discounted cash flow valuation.

WACC of 26.8% for 2023E and 2024E: Given that LLUB is operating in over-crowded industry with a marginal growth in volumes over the next few years, we have assigned LLUB a terminal growth rate of 3% for the next 2 years. Furthermore, taking into consideration the higher risk-free rate currently prevailing in the country, we have assigned 18.0% as the targeted risk-free rate for 2023E and 2024E, whilst assigning a beta of 1.3x and a market return of 26.0%, we have arrived at a WACC of 26.8% for LLUB.

Return	2023E	2024E
Target Price	150.0	175.0
Current Price	91.0	91.0
Capital Gain (LKR)	59.0	84.0
Dividends upto 31 Dec (LKR)	11.0	16.1
Capital Gain %	65%	92%
Dividend Yield %	12%	18%
Total Return %	77%	110%
Annualized Return %	113%	52%

DCF based Valuation	2023E	2024E
Enterprise Value	30,664	32,330
Debt (-)	(393)	(393)
Cash (+)	6,408	8,578
Total Value of Equity	36,679	40,515
No. of Shares (Mn)	240	240
Target Price	152.8	168.8

COE	2023E	2024E
Rf	18%	18%
Rm	26%	26%
Growth %	3%	3%
β	1.30	1.30
Ke = Rf + β(Rm-Rf)	28%	28%

WACC	2023E	2024E
Ke	28%	28%
Kd	18%	18%
D/E Assumption	10/90	10/90
Terminal Growth (%)	5%	5%
WACC	27%	27%

9.0 Environmental, Social and Governance

9.1 Environmental

Lubricants direct play for carbon emission: LLUB operates in the lubricant industry in Sri Lanka, which is directly linked to carbon emission in Sri Lanka. Despite the lack of governance by PUCSL on availability of quality lubricant products in Sri Lanka, LLUB have continuously focused on offering exceptional products to its customers.

Green in mind for LLUB: LLUB introduced several new products in 2021, targeting improved drainage cycles and lower emission, in an effort to mitigate the impact to the environment. Thus, LLUB discontinued their Diesel engine oil DEO monograde product range under Lanka Super DS 10W, 30,40 and 50 grades, and upgraded its products to Lanka Super DS 15W-40 and 20W-50.

9.2 Social

LLUB not just lubricants: Operating in the lubricant industry, Chevron works closely with the National Transportation Commission to provide relief for the private bus owners and families. Affected by Covid-19, private bus owners were struggling to make ends meet due to lack of passenger travel and various travel restrictions placed by the authorities. Working closely with the private owners, LLUB provided relief to 18,000 bus owners island-wide, enabling them to better maintain their vehicles despite financial difficulties.

9.3 Governance

1. Company is headed by an effective Board	✓
2. Role of the CEO and Chairman are two different individuals	✓
3. Chairman is an independent director	✓
4. Firm has an audit committee	✓
5. Firm has a remuneration committee	✓
6. Firm has at least an additional specialized committee other than nomination, remuneration and audit committees. Ex: risk committee and/or governance committee	✓
7. Firm discloses individual director's performance appraisal	✓
8. Has an equity-based compensation plan (ESOPs)	✗
9. No adverse opinion by the auditor in the past year	✓
10. Classes of stocks with different voting rights	✗
11. Diversity in the Board	✓
12. Firm discloses the total and breakdown of remuneration as fixed and variable	✗
13. Announcements to the CSE when required	✓

10.0 Investment Risks

Sri Lankan lubricant market is a mature market, with almost stagnant or negative market growth. Despite the saturated market condition, lubricant market in Sri Lanka is occupied by 26 players, the competition in the local lubricant market is very intense and during 2021 nine new licenses were issued by the shadow regulator (PUCSL). Furthermore, lubricant market volumes are also affected by the unlicensed operators in the market who sells adulterated products. We believe the loss of market share due to intense competition and granting of licenses could potentially affect LLUB's market share and could result in decline in volumes over the medium term. This will affect LLUB earnings in the medium term, yet the impact can be partly offset through LLUB's high operating margins.

Politics a concern for the recovery: Sri Lanka is currently on a very delicate position in terms of operational and economical environment. In an event where the current political stability is disrupted, operational performance may yet again impact, affecting the ease of doing business. In a situation like this, we expect LLUB performance to get impacted by increased expenditure for operations and distribution. Thus, impacting the margins and earnings of the business.

Risk of cheaper substitutes due to lenient oversight: With Sri Lanka gradually opening up its borders for imported products, the threat of the return of cheaper imported lubricant products remains high. In an event the current import ban on lubricants is lifted, LLUB earnings may have a sizeable impact as customers opt for a cheaper imported lubricant, thus impacting volumes and market share of the company.

Energy costs on the a concern: Energy costs are increasing around the world due to geo-political issues as well as lockdowns in China (biggest energy consumer) affecting energy sector outlook in the coming years. Thus, Sri Lanka will also face a challenging times as a result of high energy prices due to electricity generation from conventional, non-renewable energy sources, which will possibly increase costs and push up inflation. In an event, we expect vehicle movement and per capita lubricant consumption to affect negatively, thus trickling down to LLUB earnings negatively.

Appendix I: Statement of Income and Expenses

Profit & Loss Statement Y/E 31 December	2017	2018	2019	2020	2021	2022	2023E	2024E	2025E
Revenue	11,052	10,861	11,856	11,637	16,866	24,575	22,398	26,840	32,416
Cost of sales	(6,312)	(6,769)	(7,421)	(7,020)	(10,688)	(14,282)	(12,991)	(15,433)	(18,477)
Gross profit	**4,741**	**4,092**	**4,435**	**4,617**	**6,178**	**10,293**	**9,407**	**11,407**	**13,939**
Other operating income	5	8	2	2	8	2	9	10	13
Selling and distribution	(659)	(637)	(789)	(778)	(945)	(1,310)	(1,232)	(1,610)	(2,107)
Admin expenses	(681)	(720)	(730)	(808)	(878)	(1,484)	(1,568)	(2,147)	(2,917)
EBIT	**3,406**	**2,743**	**2,917**	**3,033**	**4,363**	**7,502**	**6,616**	**7,660**	**8,927**
Finance Income	90	17	26	63	(31)	(2,496)	(1,229)	(751)	(400)
PBT	3,496	2,760	2,943	3,097	4,333	5,006	5,387	6,908	8,527
Taxation	(931)	(768)	(844)	(874)	(407)	(1,335)	(1,616)	(2,072)	(2,558)
Net Profit for the Period	**2,565**	**1,992**	**2,099**	**2,223**	**3,926**	**3,671**	**3,771**	**4,836**	**5,969**
Adjusted EPS	***10.7***	***8.3***	***8.7***	***9.3***	***16.4***	***15.3***	***15.7***	***20.2***	***24.9***

Appendix II: Statement of Financial Position

Balance Sheet As at 31 December	2017	2018	2019	2020	2021	2022	2023E	2024E	2025E
Assets									
Non current assets									
Property plant and equipment	2,067	1,963	1,883	1,758	1,661	1,589	1,537	1,511	1,514
Right-of-use assets	-	-	389	343	302	342	342	342	342
Non current receivables	77	76	74	79	64	70	70	70	70
	2,144	**2,040**	**2,347**	**2,180**	**2,028**	**2,001**	**1,949**	**1,923**	**1,926**
Current Assets									
Inventories	2,046	2,756	1,939	2,691	3,760	5,178	4,157	4,630	5,174
Receivables and prepayment	1,266	1,014	1,080	1,082	1,181	1,956	2,464	2,684	3,242
Short term investments	-	-	-	-	-	-	-	-	-
Cash and cash equivalents	140	259	870	1,899	4,025	3,876	6,408	8,578	9,593
	3,452	**4,028**	**3,889**	**5,671**	**8,966**	**11,011**	**13,029**	**15,892**	**18,008**
Total Assets	**5,596**	**6,068**	**6,236**	**7,852**	**10,993**	**13,011**	**14,977**	**17,815**	**19,934**
Equity and Liabilties									
Capital and reserves									
Ordinary shares	600	600	600	600	600	600	600	600	600
Retained Earnings	3,407	3,314	3,536	3,580	4,399	5,564	6,695	7,662	8,259
	4,007	**3,914**	**4,136**	**4,180**	**4,999**	**6,164**	**7,295**	**8,262**	**8,859**
Non - current liabilties									
Deferred tax liabilities	162	140	147	192	205	283	283	283	283
Defined benefit obligation	246	258	266	247	157	234	234	234	234
Lease liabilities	-	-	359	332	310	358	358	358	358
	408	**397**	**772**	**771**	**672**	**875**	**875**	**875**	**875**
Current liabilities									
Trade and other payables	661	1,423	789	2,167	4,739	5,011	5,846	7,716	9,239
Current tax liabilities	405	333	502	699	552	926	926	926	926
Lease liabilities	-	-	36	34	31	35	35	35	35
Borrowings	115	-	-	-	-	-	-	-	-
	1,181	**1,756**	**1,327**	**2,900**	**5,322**	**5,972**	**6,807**	**8,677**	**10,200**
Total liabilities	**1,589**	**2,153**	**2,099**	**3,671**	**5,995**	**6,848**	**7,682**	**9,553**	**11,075**
Total equity & liabilties	**5,596**	**6,068**	**6,236**	**7,852**	**10,993**	**13,011**	**14,977**	**17,815**	**19,934**
Adjusted BVPS	***16.70***	***16.31***	***17.23***	***17.42***	***20.83***	***25.68***	***30.40***	***34.43***	***36.91***

Appendix III: Shareholder structure changes

Top 20 shareholders	4Q2022	3Q2022	QoQ
CHEVRON CEYLON LIMITED	122,400,000	122,400,000	-
BNYM RE-BARCA GLOBAL MASTER FUND LP	12,931,372	12,931,372	-
RENUKA HOTELS PLC	5,201,918	5,201,918	-
SSBT-CHANGE GLOBAL FRONTIER MARKETS,LP	4,930,007	4,930,007	-
CARGO BOAT DEVELOPMENT COMPANY PLC	3,417,818	3,417,818	-
SRI LANKA INSURANCE CORPORATION LTD-LIFE FUND	3,400,000	3,400,000	-
MR. W.G.D.C. RANAWEERA	2,473,700	1,682,027	791,673
COMMERCIAL BANK OF CEYLON PLC/METROCORP (PVT) LTD	2,000,009	2,000,009	-
CRESCENT LAUNDERERS AND DRY CLEANERS PVT LIMITED	2,000,000	2,000,000	-
NUWARA ELIYA PROPERTY DEVELOPERS (PVT) LTD	1,954,055	2,340,816	(386,761)
BNYM RE- PIONEER MULTI-ASSET INCOME FUND	1,752,813	1,752,813	-
MRS. A. SELLIAH	1,600,000	1,600,000	-
HATTON NATIONAL BANK PLC/ELAYATHAMBY THAVAGNANASUNDARAM	1,461,371	1,869,789	(408,418)
BANK OF CEYLON NO. 1 ACCOUNT	1,272,121	1,272,121	-
BANK OF CEYLON-NO2 A/C (BOC PTF)	1,216,941	1,216,941	-
MR. M.M.C. COORAY	1,210,000	1,265,002	(55,002)
MR. L.E. BADER	1,185,772		1,185,772
MR. A.P. SOMASIRI	1,110,000	1,110,000	-
MRS. A. KAILASAPILLAI	1,100,000	1,100,000	-
EMPLOYEE'S PROVIDENT FUND	1,015,916	1,015,916	-

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