

## MELSTACORP LIMITED: MELS.N

### Base case price target appeals “BUY”

Inelastic nature of liquor products together with increasing trend of per capita alcohol consumption would lead MELS to mark topline based growth. We expect MELS to record c.14% gross income CAGR over FY17-21E driven by solid market positioning of beverage business and high growth trajectory of MRF & CNI. We believe BALA and LB to gradually recover from loss making status to support group EBT margins to sustain at c.9-10% levels. We believe unutilized debt capacity and large cash inflows of MELS would facilitate substantial CAPEX requirements elsewhere leaving overall dividend payout largely unchanged. In our opinion MELS is currently undervalued at LKR 63 per share price. Our base case SOTP evaluation estimates LKR 66 per share intrinsic value. This is further backed by our base case market based valuation which calculates LKR 70 per share value.

### MELS to record c.14% gross income CAGR

We believe MELS's beverage arm would continue its market leadership position in domestic hard liquor industry. Besides increasing ASP's, we assume price inelasticity would support volume growth of alcohol. Further, growing general insurance business of CNI and increasing loan book of MRF would overcome possible income contraction in Plantations and Telco arms.

### EBT Margins to sustain at 9-10% levels

Healthy growth potential of diversified segment with relatively high margins aided by rising contribution of SPEN profits would help MELS to post increased group EBT margins over FY17-21E.

### We establish LKR 66-73 valuation range for MELS

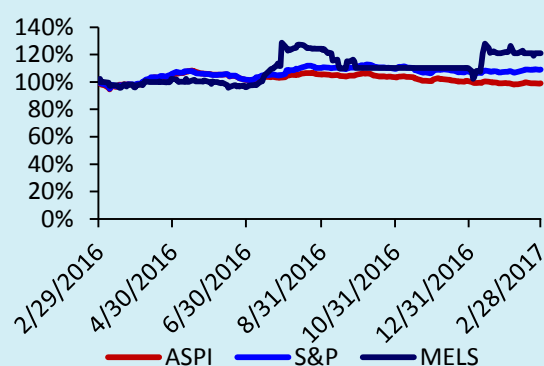
Our Base case SOTP valuation results in LKR 66 per share intrinsic value which is c.5% upside to the current market price. This is further backed by our market based valuation which estimates LKR 70 per share value reflecting c.11% upside.

### Key Statistics

CSE Ticker	MELS.N
Share Price(3-March-17)	LKR 63
No.of issued shares (m)	1,165
Market Cap. LKR m	75,751
Free Float	43%
52-week H/L	LKR 54.9/69.50
Avg.daily vol.(000' shares,1yr)	201.93
Avg.daily turnover(USD 000')	212.65

Source: MELS AR's, CSE

### Share Price Movement



Source: CSE/APSL estimates

### Share Price Performance

	3m	6m	12m
MELS	10%	-3%	21%
S&P	2%	-1%	9%
ASPI	-2%	-6%	-1%

Source: CSE/APSL estimates

### Summary Financials

LKR 000"	FY16	FY17E	FY18E	FY19E
Net Revenue	33,840	39,920	45,172	50,813
Gross Profit	15,452	18,868	21,305	23,890
EBITDA	10,824	13,286	14,681	15,988
EBIT	8,390	10,596	12,135	13,549
EBT	8,188	10,344	11,863	13,209
EAT	5,613	7,393	8,272	9,058
EPS	4.82	6.34	7.10	7.77

Source: MELS AR's, APSL estimates

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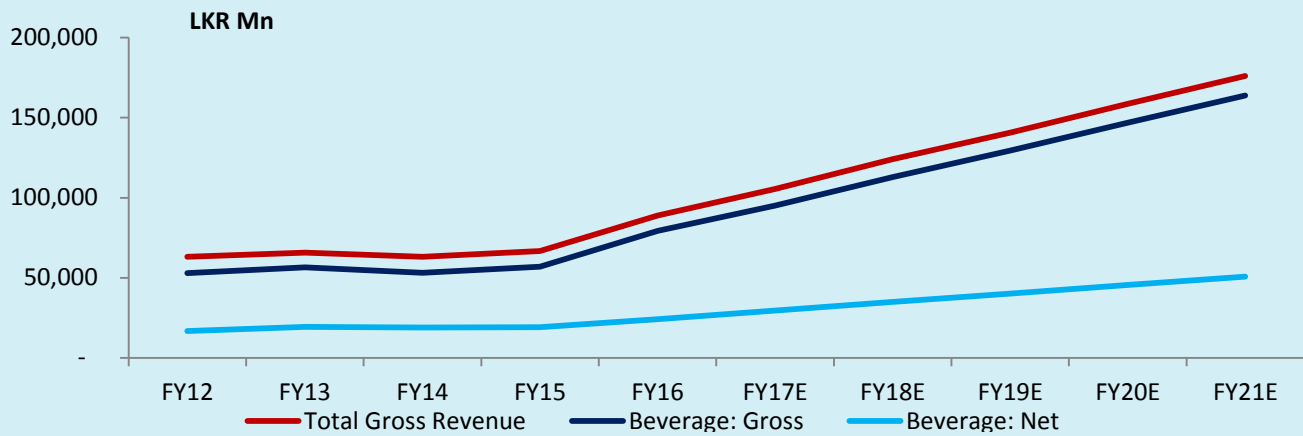
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**MELS to record 14% gross income CAGR over FY17-21E**

We expect MELS would record c.14% income CAGR over FY17-21E mainly backed by Beverage business which is expected to post a healthy 15% gross income CAGR over FY17-21E. Further, growing general insurance business of Continental Insurance and growth potential of Melsta Regal would collectively translate to c. 12% gross income CAGR over the same period. Besides sings of growth in Telecommunications, Plantations and Diversified segments, we conservatively assume zero growth in terms of income contribution.

*Besides beverage business being the major revenue generator, financial arm continues to grow at healthy levels.*

**MELS’s gross revenue to grow at 14% CAGR over FY17-21E supported by its solid Beverage Business**

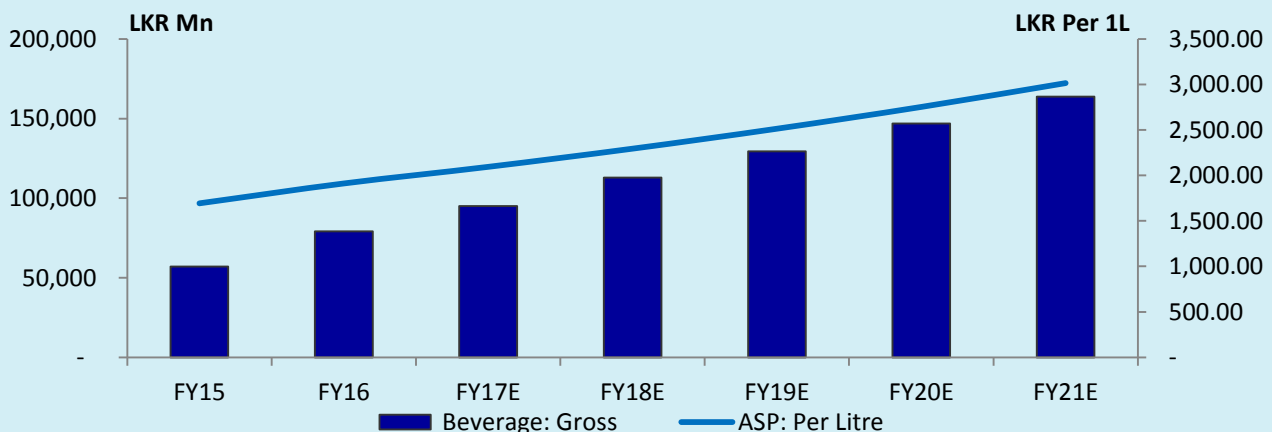


Source: DIST AR’s, APSL estimates

**DIST: Beverage arm continues to dominate income generation**

We believe Beverage segment would continue to dominate income contribution by marking c.15% gross income CAGR over FY17-21E. Beverage business currently accounts for c.89% of group gross revenue and 72% of group net revenue. Further we expect a steady demand growth for Alcoholic products and gradually increasing Average Selling Prices (ASP)

**Beverage Business to post a solid 15% CAGR over FY17-21E driven by both volume and ASP growth**



Source: DIST AR’s, APSL estimates

**Inelastic nature of demand to stabilize volumes despite increasing prices**

Despite predicted 10% increase in ASP’s over the explicit forecasting period, we believe hard alcohol industry as a whole would continue to grow at a healthy CAGR of c.8% during FY17-21E cf.13% CAGR over FY13-16. Price inelasticity of products due to addictive nature of alcohol would ensure both industry growth and MELS’s market share driving overall revenue up.

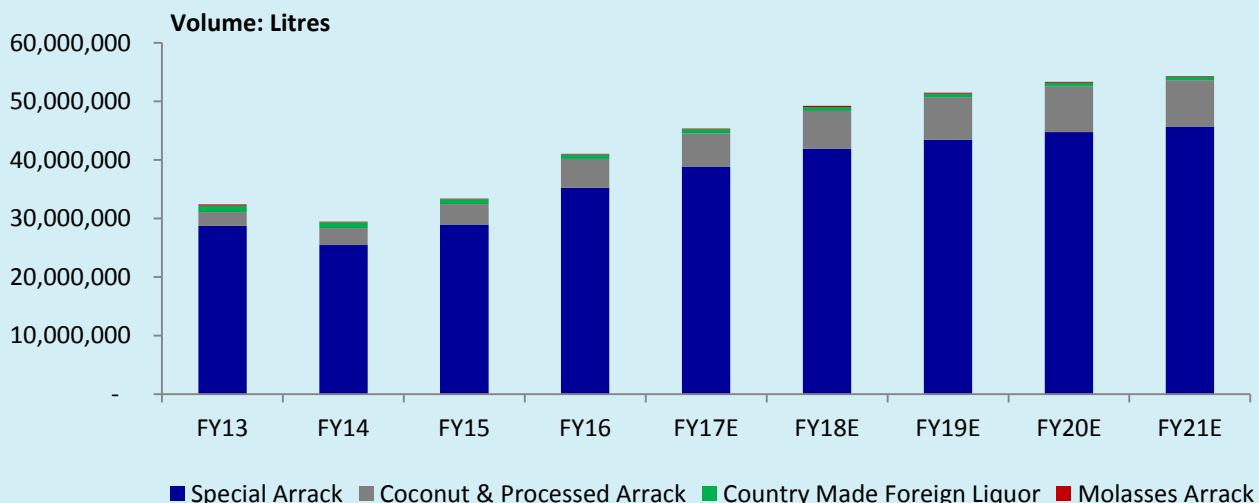
Special Arrack continued to score the highest contribution by accounting for c.68% of total hard alcohol industry volumes while MELS Special Arrack business represented c.80% of total Special Arrack industry volume as of FY16. Total Coconut & Processed Arrack market showed a solid volume growth by FY16, accounting for c.17% of total hard alcohol industry volumes cf.11% in FY13. MELS’s Coconut & Processed Arrack business represented c.46% of total Coconut & Processed Arrack industry volume as of FY16.Hence the gradual shift of product mix towards Coconut & Processed Arrack puts pressure on MELS which is currently capitalizing on Special Arrack business. Molasses Arrack and Country made foreign liquor accounted for c.15% of MELS’s beverage sales in terms of volume as of FY16.

Considering Sri Lankan Special Arrack being in the maturity levels of market, we believe the total market would grow at a moderate 4% CAGR over FY17-21E. However, we expect a solid 11% volume CAGR for Coconut & Processed Arrack for which Sri Lanka is the largest producer in volume terms. Further we notice the demand for Molasses Arrack (c. 2% Market Share for MELS as of FY16) and Country made foreign liquor (c. 20% Market Share for MELS as of FY16) would continue to gradually contract over FY17-21E.

*Per capita liquor consumption of Sri Lanka has grown to 4.5 Liters in 2015 from 3.7 Liters in 2010.Increasing trend of Per Capita income and healthy growth in tourism industry would support industry wide volume growth.*

*Entry barriers in terms of legal compliance, Economies of Scale of being the largest player of the market and health concerns over illicit-substitute alcohol products would help MELS to protect market share*

**Beverage Segment volumes to grow at an overall 5% CAGR over FY17-21E**



Source: Department of Excise of Sri Lanka AR15, APSL estimates

**Strong brand name and wide distribution network to secure market leadership position**

Despite inability to involve in active advertising in Sri Lanka due to legal constrains, MELS has been able to secure the market leadership position of the Hard Liquor industry. MELS accounted for c.81% share of Special Arrack market and c.46% share of Coconut and Processed Arrack market as of 2016.

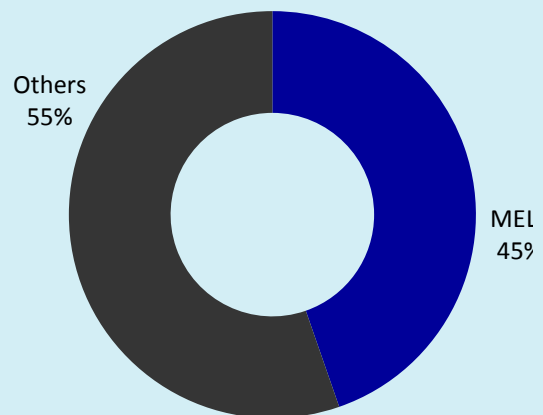
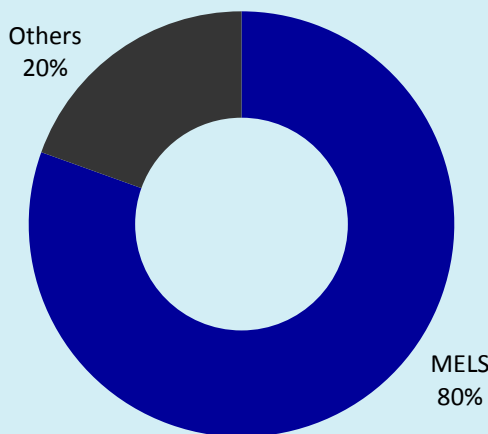
*We believe MELS would maintain the market leadership position in Special Arrack business by securing c.80% market share.*

We believe MELS would be able to maintain its current share of market in Special Arrack business over FY17-21E. However, we expect a gradual decline in MELS’s volume wise market share of Coconut & Processed Arrack business by five percentage points (5pp) from 46% in 2016 to 41% in 2021E. This is mainly due to increasing competition from its three major competitors: Rockland Distilleries Ltd (20% market share in 2015), W.M Mendis & Co. Ltd (18% market share in 2015) and International Distilleries Ltd (11% market share in 2015)

*Increased completion in Coconut & Processed Arrack category would lead to a 5pp market share drop over FY17-21E*

**MELS held c.80% share of Special Arrack market as of 2015.**

**MELS held c.45% share of Coconut & Processed arrack market as of 2015.**



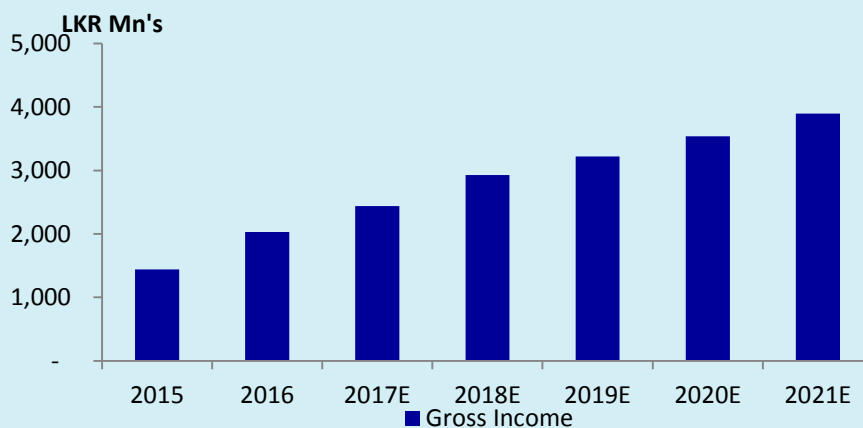
Source: Department of Excise of Sri Lanka AR15. APSL estimates

MELS operates Molasses and Country made foreign liquor categories through its fully owned subsidiary Periceyl (Pvt) Ltd (PCL). However, PCL has been unable to compete with International Distilleries Ltd (42% market share as of 2015) and Rockland Distilleries (Pvt) Ltd (33% market share as of 2015) and witnessed a Ten percentage points (10 pp) decline from 12% market share in 2013 to 2% market share in 2015 in Molasses liquor segment. Country made foreign liquor industry showed a marginal 4% decline during 2013-2016 where MELS market share witnessed a six percentage points (6 pp) decline from 26% in 2013 to 20% in 2015. Hence we assume c.1-3 pp decline in Molasses and Country made foreign liquor categories sales volumes.

## Melsta Regal Finance (MRF) and Continental Insurance (CNI) to support topline growth

MELS's financial arm started operations during FY15 and has recorded a healthy income growth of c.41% over FY15-16 period. Financials segment accounted for c.6% of group total income in FY16 cf. 5% in FY15. We expect the financial services segment would continue its growth trajectory lead by CNI's effective presence in general insurance business. We believe MRF and CNI together would record c.12% gross income CAGR over FY17-21E contributing c.6% to the group net revenue.

**We expect financial segment revenue to grow at an overall 6% CAGR over FY17-21E**



Source: DIST AR's, APSL estimates

### Melsta Regal Finance (MRF)

MRF recorded LKR 200m and LKR 442m gross revenue in FY14 and FY15 respectively posting over 100% YoY growth. Further, Loans and advances grew at a rate over 100% to mark LKR 1,419m as of the end of FY15 cf. LKR 586m as at the end of FY14. However, customer deposits base contracted by c.21% during FY14-15 to settle in LKR 485m as of the end of FY15 cf. LKR 611m as at the end of FY14. Despite the substantial increase in Debt-to-Equity ratio from c.18% to c.147% during FY14-15, we expect MRF to record c. 12% gross revenue CAGR over FY17-21E given its effective penetration into finance leasing and hire purchase businesses under the strong MELS umbrella.

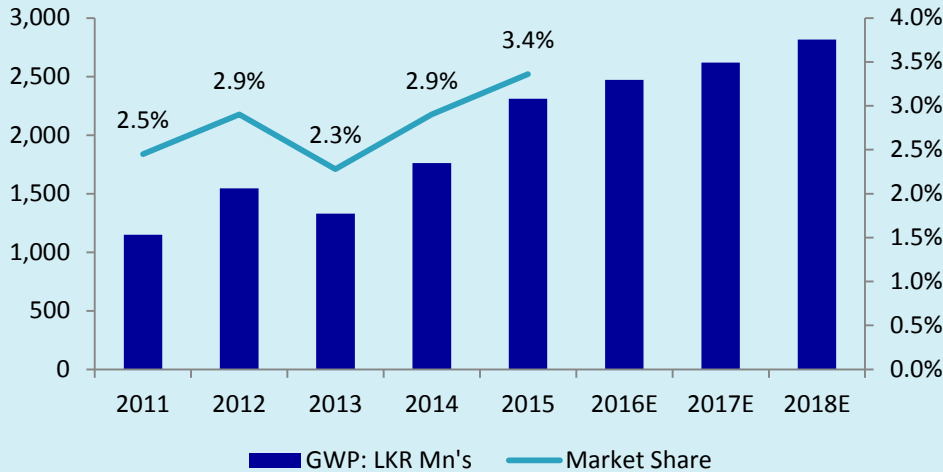
*MRF operates with relatively lower level of financial leverage recording c.1.47x Debt-to-Equity ratio as of FY14-15 cf. 2.36x of PLC and 7.15x of LFIN.*

### Continental Insurance (CNI)

We expect CNI to continue its strong growth profile in Sri Lankan general insurance business by recording c.7% gross revenue CAGR over FY17-21E. Further, healthy financial status of CNI with strong capital adequacy and Return on Investment (ROE) would support topline growth in terms of risk and equity holders' perspectives.

CNI recorded a healthy solvency margin of 2.35x as of FY15 cf. 2.73x of AIA general insurance, 1.38x of Ceylinco general insurance and 2.28x of Janashakthi general insurance. Further, CNI accounted for 3.36% of local general insurance market during FY15 cf. 2.90% in FY14.

**CNI gross written premiums to grow at c.7% CAGR over FY16-18E**

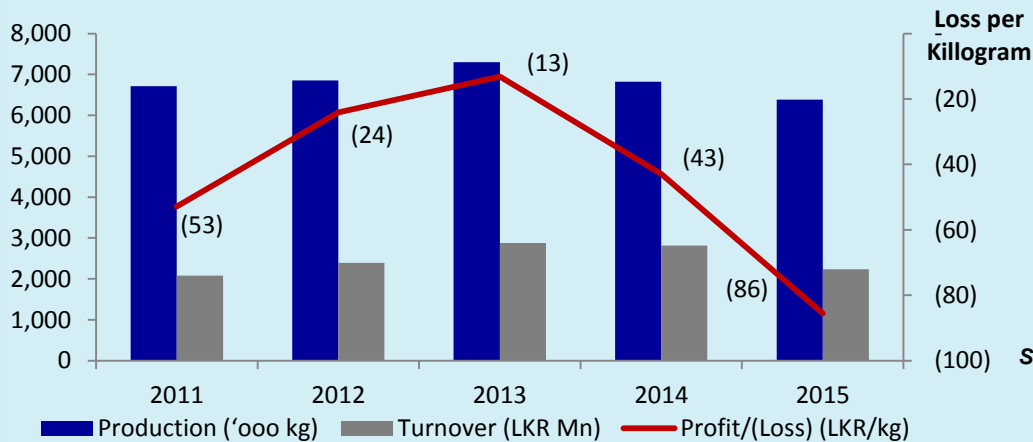


Source: IBSL AR15, APSL estimates

**Plantations continues to witness decline: Balangoda Plantations**

Balangoda Plantations (BALA) reflects MELS’s plantation arm with c.7% contribution for the group total income in FY15/16. BALA’s tea segment accounted for c.91% of total plantation business income and c.2% of Sri Lanka’s Tea production where Rubber segment accounted for the rest (c. 9%). However, BALA recorded net losses since FY14 due to Tea price decline of the industry and supply limitations caused by dry weather conditions. Hence we believe plantation segment’s contribution to total group income would decline from c.7% in FY16 to c.4% by FY21E.

**Gross loss per Kilogram of Tea increased since FY14 dragging down BALA profits**



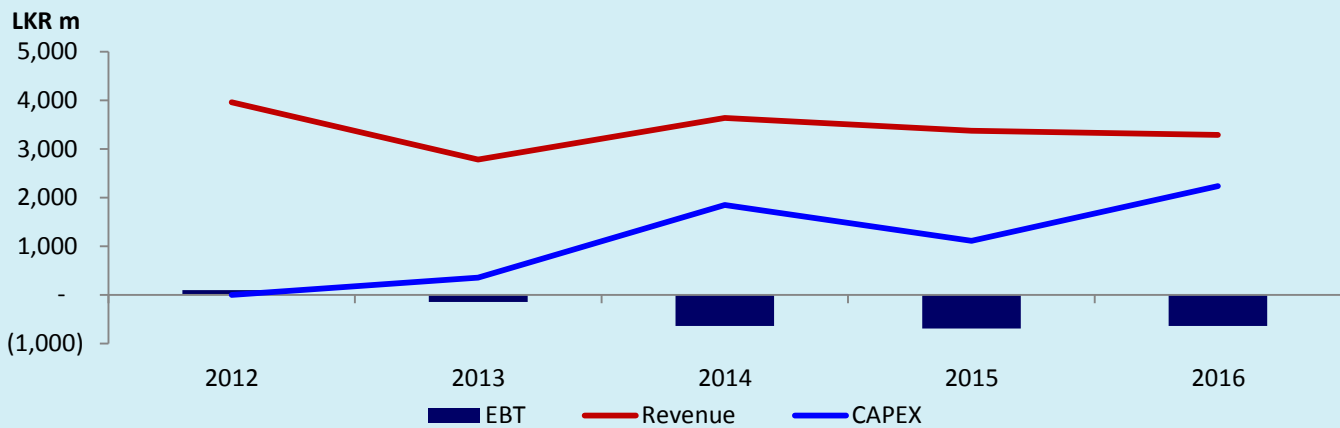
Source: BALA AR's



### Lanka Bell: The Telco arm yet to recover from losses

Telecommunications segment accounted for c. 10% of MELS's total income in FY16. Telco arm witnessed a slight income drop during FY16 to result LKR 3.29bn cf. LKR 3.37bn in FY15. MELS continued to witness net losses from Lanka Bell business which amounted to LKR 642m in FY16 cf. LKR 692m in FY15. However we believe Lanka Bell Ltd would grab the opportunities created by 4G business and increase the profitability of Wireless Fixed- Data connections throughout the country. Growing Per Capita Income and growth in private investments would further support increased Fixed-Data subscriptions.

### Lanka Bell incurred substantial CAPEX over FY12-16 marking an average of c.51% of gross income



Source: DIST AR's

### Diversified Segment

MELS's diversified segment accounted for c.6% of total group income in FY16 by posting LKR 1.9bn which converted into LKR 692m before tax earnings. Hence, diversified segment operates with relatively higher margins compared to other MELS's businesses. Eleven different entities are included in the diversified segment spreading into wide sectors from Fabric printing, power generation, BPO services, Real estate to leisure and logistics. We conservatively expect Diversified business would grow at c.5% revenue CAGR over FY17-21E supported by high growth potential of BPO-Bell vantage, Leisure: Browns Beach Hotels/ Heritance (Negambo) and Logistics business.



## Upside potential to top-line growth

### ***Wireless Data to drive future Telco growth***

Upgrading Data network for 4G facilities would unveil Lanka Bell to capture growing corporate demand for wireless internet facilities. However, industry faces intense completion from DIAL and SLT while requiring higher levels of CAPEX.

### ***Growth Potential of Diversified segment***

Continental Insurance has recorded a solid growth in Sri Lankan general insurance market over the years. Further, inter-relationship between leasing arm of Mesta Regal finance and general insurance business of Continental insurance would support mutual earnings growth. We believe Melsta Regal Finance and Continental Insurance would continue its healthy growth profile making increased earnings contribution for MELS overall profits.

### ***Improved weather conditions for plantations.***

Dry weather conditions over past few quarters worsened the already declining tea industry of the country. We believe the buyers of Sri Lankan tea (Russia and Middle East Countries) would turn back to Ceylon Tea brand with the aid of effective marketing and development projects undertaken by the Ceylon Tea Board.

## Downside risks to revenue expectations

### ***Tax hikes***

Excise duties accounts for c.2/3 of gross beverage income which is the major business of MELS. Despite increase in purchasing power of buyers as reflected in increased per capita income, demand for legal alcohol products may not show a drastic increase due to product adulteration and illicit products. Further, increase of ASP's would challenge the price inelasticity of products.

### ***Greater competition***

International Distilleries and Rockland Distilleries continue to record market growth in domestic hard alcohol market, especially in Coconut & processed Arrack business. Further, Lanka Bell faces intense competition from Dialog Axiata (DIAL) and Sri Lanka Telecom (SLT) in the Data market. This would require continues substantial CAPEX for technological upgrades.

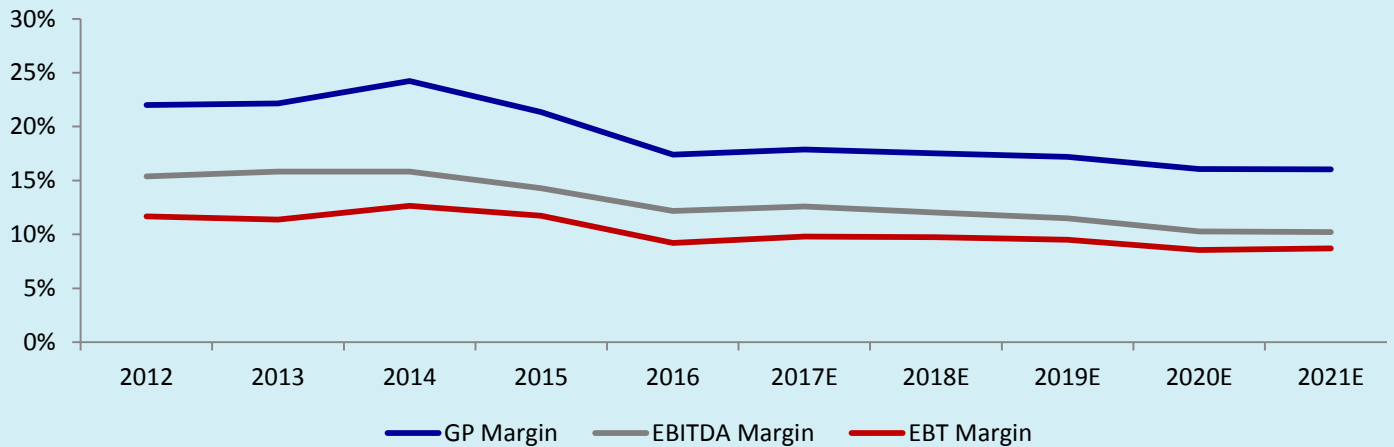
### ***Increased Health Concerns over alcohol consumption***

Though the total liquor market is growing, most of the growth is coming from Malt liquor products. Further, historical records reflect a gradual shift of customers from hard liquor to malt liquor. Increased health concerns affects consumer demand patterns to select liquor products with lower levels of alcohol (Malt Liquor).

**EBT margins to sustain at 9-10% levels over FY17-21E**

MELS’s historical EBT margins has fluctuated around 9%-13% range of gross revenue. We expect MELS to record 9%-10% EBT margins over FY17-21E backed by the continuous dominance of Beverage business which is expected to post 9%-10% EBT margins over the same period. Further, net losses of Telecommunications and Plantations businesses would drag the group EBT margins below the stand alone beverage business.

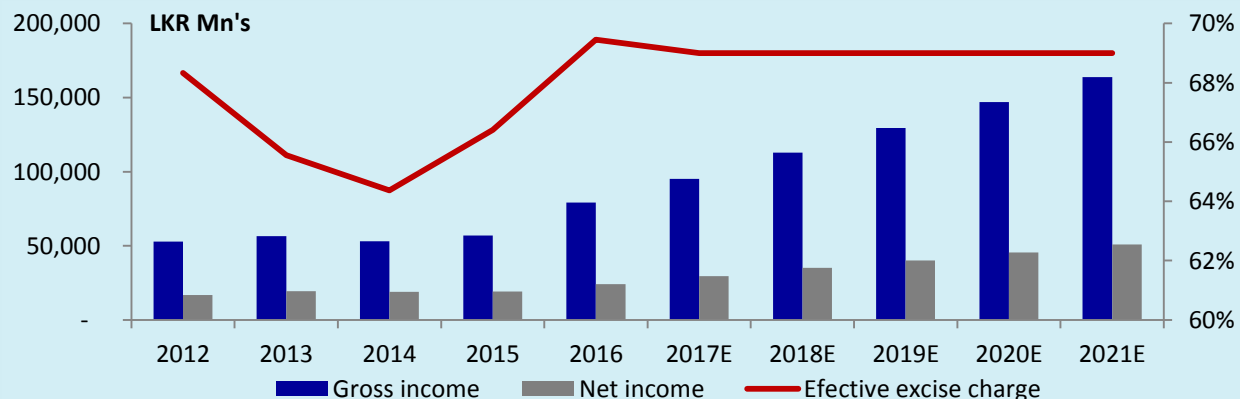
**MELS’s EBT margins to settle around 9-10% levels over FY17-21E**



Source: DIST/MELS financials, APSL estimates

**Government Excise duty continues to account for over 2/3 of beverage gross revenue**

Highly regulated and penalized Sri Lankan alcohol industry continues to operate with relatively higher levels of duties and charges imposed by government. Historically, MELS’s beverage arm DIST has witnessed c.64-69% range of effective excise charges against gross income from the sale of alcohol. We conservatively assume DIST would continue to operate with c.69% excise charge on beverage gross income.



Source: DIST/MELS financials, APSL estimates

### DIST: Beverage segment margins to settle at 9%-10% levels over FY17-21E

Despite witnessing higher excise duties, we believe MELS's beverage arm DIST would be able to maintain its EBT margins to sustain around 9%-10% range over FY17-21E.

Inelastic nature of alcohol products would support DIST to shift the excise charge increases to the end customers by increasing the prices which would result in increased margins. Further, DIST being the market leader in hard alcohol industry (Especially in Special Arrack and Coconut & Processed Arrack categories) gives DIST the advantage of economies of scale which would drive average production costs down. High growth profile of diversified segment would effectively contribute positively towards overall profits margins since standalone diversified margins are relatively higher than that of other segments.

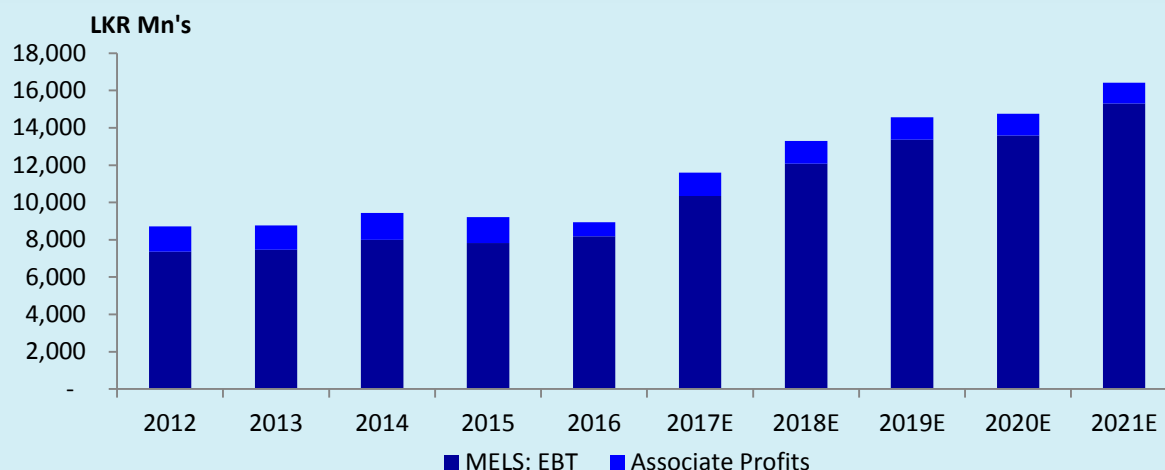
Additionally, factory upgrades for efficient machineries and effective personnel & distributions cost management programs would further improve overall profits margins.

### SPEN: Associate profits to make significant contribution towards group earnings

Profits contribution from equity accounted investees has continued to support MELS's bottom line over the years. MELS's associates include Aitken Spence PLC [SPEN] (43.45%) and Madulsima Plantations PLC (45.90%). SPEN contributed for almost all the total profit share from associates while Madulsima Plantations continues to report losses.

We expect income from associates to achieve LKR 1.2bn mark over FY17-19E which would be largely contributed by SPEN. High growth potential of tourism, transportation and logistics industry would further support SPEN's ability to generate increased returns on investment.

### Associate's profit contributions to reach LKR 1.2bn level over FY17-19E



Source: DIST/MELS financials, APSL estimates

### Downside risks for margin expansion

***Continuous increases of excise duties would affect the price inelasticity of beverage products.***

Substantial increase in excise duties over consumer income growth rate would negatively affect overall demand and hence would put an extra pressure on DIST to lower the selling prices in order to retain the market share against rising completion from International Distilleries, Rockland Distilleries and W.M Mendis & Co.

***Increase in direct and indirect operational costs would hinder room for margin expansion.***

Price increases of major raw materials such as Toddy Spirits would negatively affect DIST margins and ultimately MELS margins. Further, interest rate increases would increase interest expenses of Melsta Regal dragging down the net interest margins.

***Underperformance of dominant associate SPEN would affect MELS bottom line substantially.***

SPEN being the largest profit contributor, any decline in SPEN performance would negatively affect MELS's overall EBT and EAT margins. Associate profits accounted for c.8% of total group EBT in FY16 where it was recorded as c.14% in FY15 where SPEN contributed for almost all the total profits.

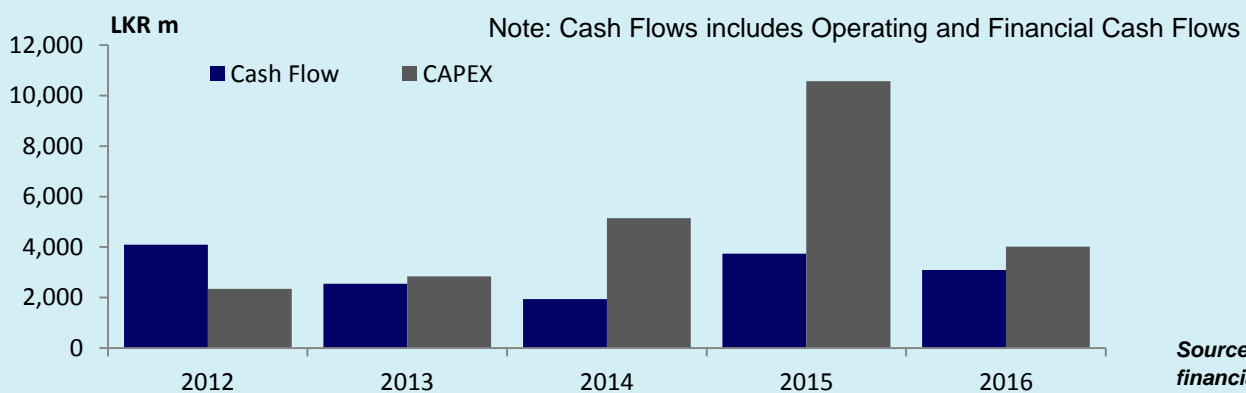
***Bellow than expected performance of currently loss making Plantations and Telecommunications segments would contract overall MELS's EBT***

Adverse weather conditions would negatively affect plantations output and turnover negatively. Rising wage costs and fertilizer issues further pressurizes BALA (Balangoda Planatations) to achieve assumed output growth. Increasing completion in wireless 4G data market would threaten MELS's Telco arm Lanka Bell in securing the existing market share. Further higher than expected CAPEX for Telco related technology updates would increase depreciation expenses.

**Higher CAPEX requirements to limit dividend increases beside solid Free Cash Flows**

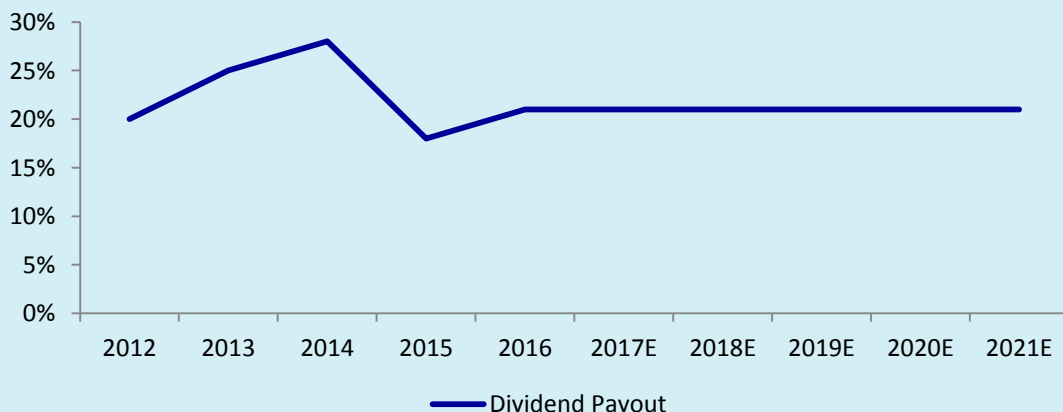
Necessary technological upgrades in Telco business especially in 4G and geographical expansion of customer base would require continuous large initial capital outflows. Overall group CAPEX amounted to c.LKR 4.02bn in FY16 cf. LKR 9.7bn in FY15. However we believe MELS would be able to effectively use its unutilized debt capacity to partially finance the CAPEX requirements while funding the rest using internal resources by maintaining a steady dividend policy.

**Higher CAPEX requirements outside of beverage business outweigh the overall Cash Flows**



MELS’s payout ratio was recorded as c. 21% in FY16 cf. c. 18% in FY15. This was caused by higher CAPEX requirements for Lanka Bell business, diversified segment asset acquisitions and plat upgrades of beverage business using internal reserves. Therefore we believe MELS would continue to mix debt capital with internally generated funds to finance increased levels of CAPEX leaving the existing low-dividend payout policy largely unchanged.

**MELS to continue with its relatively low dividend payout over FY17-21E**

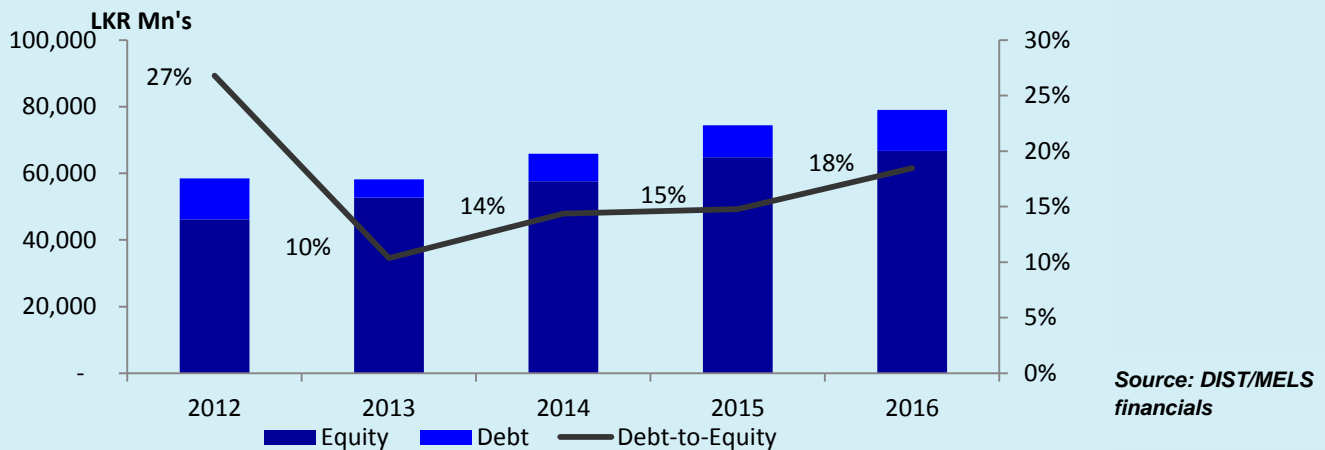


Source: DIST/MELS financials, APSL estimates

**Unutilized debt capacity provides vital advantage of flexible output expansions**

Historically MELS has been operating with relatively lower levels of debt capital which has been translated into relatively low financial risk compared to its peers. MELS recorded c.18% Debt-to-Equity ratio as of FY16 cf.15% as of FY15. We expect this trend of gradually increasing level of debt would continue over FY17-21E period reaching 20%-22% levels.

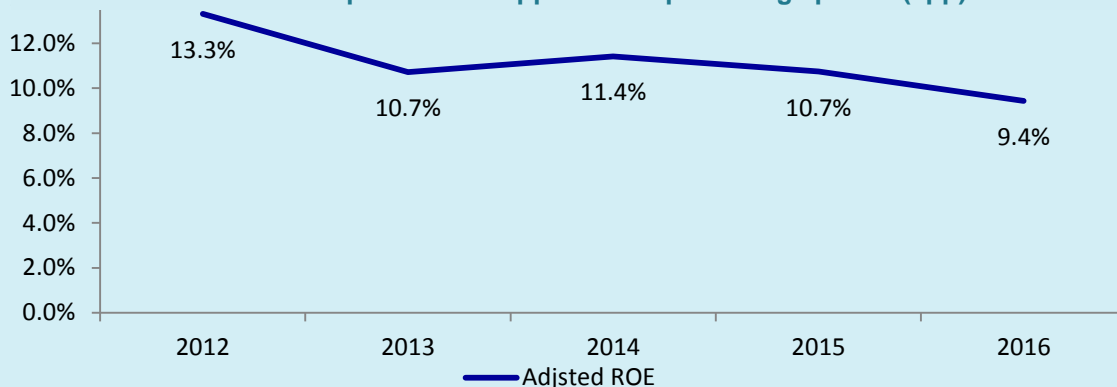
**Historically MELS has been operating with relatively lower levels of financial leverage**



**Return on shareholder’s funds yet to recover from gradual decline since FY11**

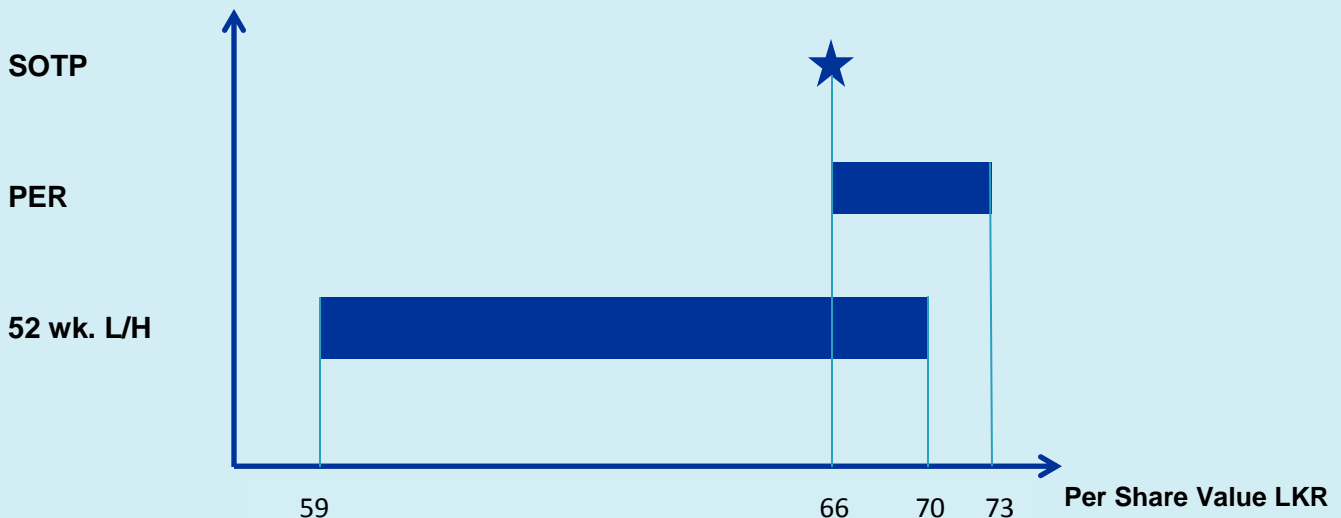
MELS recorded c. 9.44% Return on Equity (ROE) in FY16 cf.10.74% in FY15. Increased losses in Plantations and substantial decline of Telco business together with increased excise duties on alcohol products caused a significant deterioration of ROE during the year. However, we expect Lanka Bell to gradually recover from losses given its high growth potential in Wireless 4G Data connections business. Further growing trend of diversified segment has been historically recording relatively higher ROE would further support group ROE.

**Overall ROE shows a sharp decline of approx. four percentage points (4pp) over FY12-16**



### We establish a valuation range of LKR 66-73 for MELS shares

We establish LKR 66-73 per share valuation range for MELS, based on our current performance outlook of the diversified conglomerate. We have used Sum-of-the-parts (SOTP) as the base case valuation methodology to value MELS equity shares since the diversified nature of operations requires a blend of different types of valuation techniques.



Our base-case assumptions of a risk-free rate of 11.0% and a market risk premium of 5.0% yields LKR 66 value per share. Adjusting these assumptions (to allow for bull- and bear-case scenarios on multiples based methodology) implies a valuation range of LKR 66-73

We have valued the beverage segment using a standard DCF approach, applying a risk-free rate of 11.0% and a market risk premium of 5.0%. DIST's current capital structure is 18% debt and 82% equity. We have assumed a 20/80 target capital structure, along with a terminal growth rate of 1.0%, and a 35% corporate tax rate. We have estimated the terminal value by considering levered free cash flows after the explicit forecasting period. Finally, we arrived at our segment equity value by discounting the leveraged FCF values over the explicit period together with discounted terminal value at the segmental WACC.

We have valued the telecommunications segment (Lanka Bell) by applying a PBV of 1.00x after considering the underperformance of Lanka Bell compared with two listed domestic Telco's ( SLT&DIAL)



Plantations segment comprising by Balangoda Plantations has been valued on PBV basis considering a PBV multiple of 0.17x compared with closely related peers. (UDPL, BOPL, TPL and HOPL)

MELS's financial arm which is constituted by Melsta Regal Finance and Continental Insurance has been valued based on PBV methodology. We have considered a PBV multiple of 0.81x after carefully adjusting for closely related peer multiples and potential growth profile of the segment.

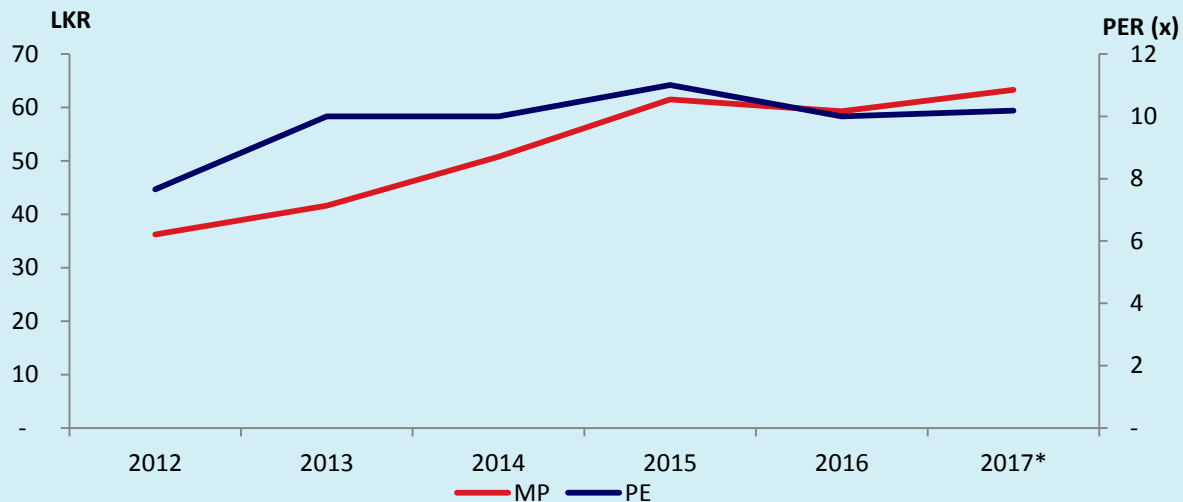
**Valuation Summary: Base Case Sum-of-the-parts (SOTP) Valuation for MELS equity shares;**

Valuation fact sheet					
Beverage		Non Operating Assets		Diversified Operations	
Assumed WACC	13%	SPEN LKR m	10,496	Estimated group EPS	0.43
Enterprise Value LKR m	52,852	MADU LKR m	428	Assumed PER (x)	10.67
Equity Value LKR m	48,072	Excess Cash LKR m	2,902		
Per share intrinsic value LKR	41.2	Other financial investments LKR m	3,880	Estimated per share value	4.6
		Total LKR m	17,706		
		Value per share LKR	15.2		
Telecommunications				Plantations	
Estimated NAVPS LKR	3			Estimated NAVPS LKR	89
Assumed PBV (x)	1			Assumed PBV (x)	0.17
Estimated per share value	2.6			Estimated per share value LKR	15
				Number of Shares 000's	23,636
Financial Services				Equity value of BALA LKR m	361
Estimated NAVPS LKR	2.2			Number of Shares (MELS) m	1,165
Assumed PBV (x)	0.81			Value per MELS share LKR	0.3
Estimated per share value	1.8	<b>Total per share value LKR</b>	<b>66</b>		

## Multiples based valuation

We believe MELS should at least trade at 11.2x PE which is a conservative 1% premium selected peer group average PER and 45% discount to diversified sector multiple arriving c.LKR 70 base case per share value which is an c.11% upside to the current market price.

### MELS has historically traded within the range of 8-11x PER as of each YE over FY12-17



Source: CSE/ MELS/DIST AR's

\*as of 3<sup>rd</sup> March 2017

**Optimistic scenario:** Here we assume MELS would be able to secure its dominance in domestic hard liquor industry notwithstanding excise duty increases. Further we assume currently loss making Balangoda Plantations and Lanka Bell businesses would recover fast and make positive contributions to group total earnings. Accordingly, we have applied a 5% premium to the base case PER and arrived at a forward multiple of 11.74x. Application of 11.74 PER arrives LKR 73 per share value.

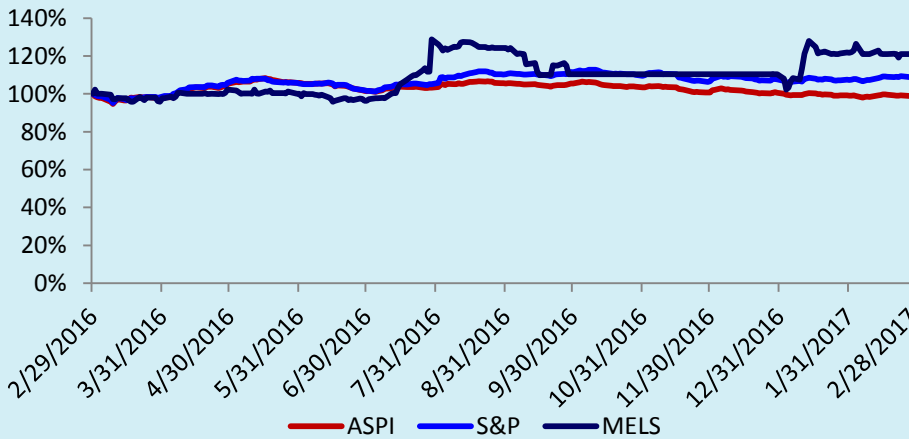
**Pessimistic scenario:** Here, we assume a 5% discount to the base case PER of 11.40, resulting a forward multiple of 10.63x. This is mainly driven by larger than expected losses in Plantations and Telco arm together with deteriorating nature of price inelasticity for beverage segment hard alcohol products. Applying this multiple to our FY17E EPS, we arrive at a fair value of LKR 66 per share.

**Share price performance**

MELS shares closed at LKR65.0 on 28 February 2017, LKR 11.25 higher than 12 months earlier (adjusted market price for DIST shares), an increase of 21%, compared to an 1% decrease in All Share Price Index (ASPI) and a 9% increase in the S&P SL 20 Historical performance.

MELS has been generating c.20% return over the past few years except in FY16 which ended up with a substantial loss of c.13%

**MELS has outperformed both ASPI and S&P indices over the last 12 months**



YE: 31st March	2014	2015	2016
Dividend Yield	1.6%	1.4%	1.6%
Capital Gains Yield	21.9%	18.5%	-14.3%
Total Annual Return	23.5%	19.8%	-12.6%

Source: DIST AR's

Source: CSE

MELS has outperformed the CSE's two main indices ASPI and S&P SL 20. However MELS shows lesser volatility in share price than that of ASPI and S&P SL 20. This supports lower than 1 beta value attributed to MELS's major business: beverage segment for valuation purposes since MELS is slightly less risky than the market portfolio.

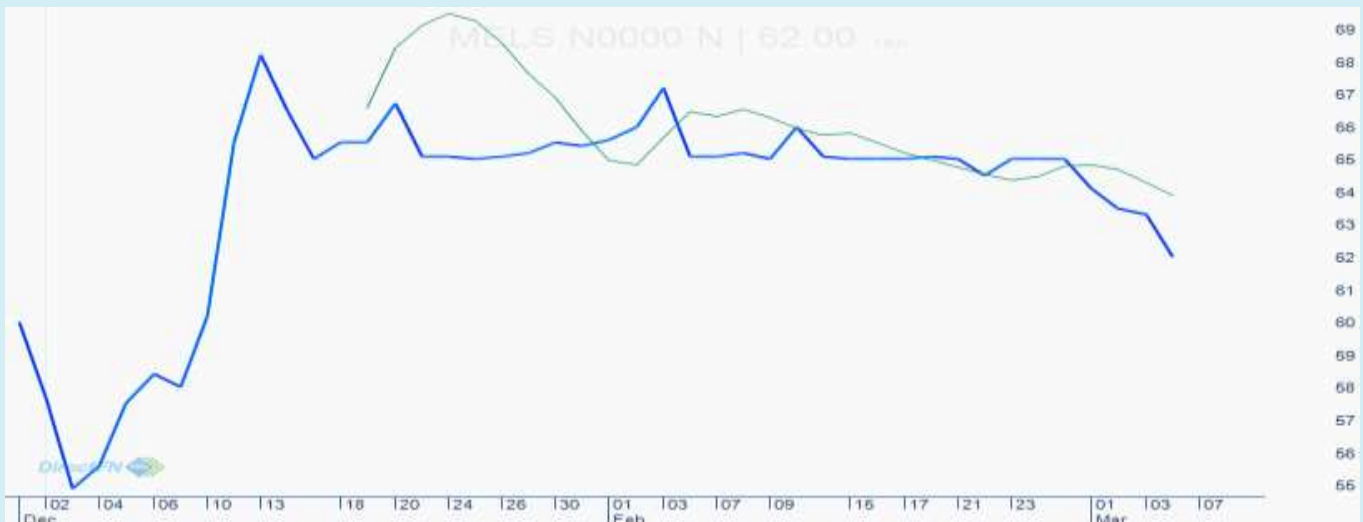
MELS posted a healthy 21% return in terms of price over past 12 months

	3m	6m	12m
MELS	10%	-3%	21%
S&P	2%	-1%	9%
ASPI	-2%	-6%	-1%

Source: CSE

Time series analysis employing 14 sessions of historical averages forecasts LKR 63.90 per share price as of 6<sup>th</sup> March 2017 cf. actual traded price of LKR 62.00.

Note: Green color line represents time series predictions and Blue color line represents actual traded prices.



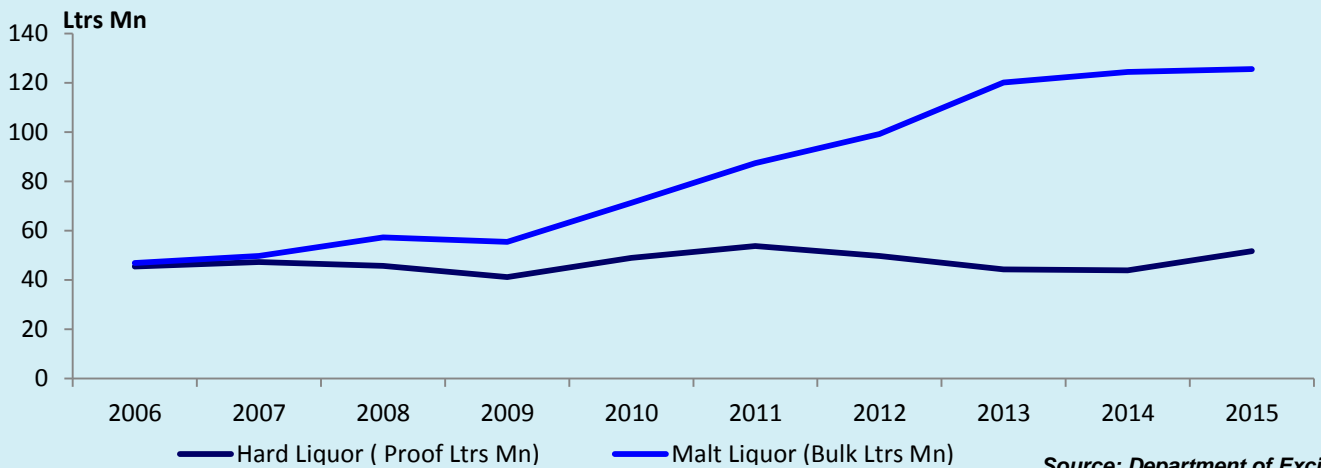
**Appendix 1**

**Sri Lankan Alcohol Industry**

Sri Lanka is the largest manufacturer of coconut arrack in the world. Coconut arrack is a distilled alcoholic drink produced from the fermented sap (nectar) of unopened coconut flowers. Sri Lankan coconut arrack is said to be among the purest, naturally-derived hard liquors in the world, and it is distilled through a natural fermentation process.

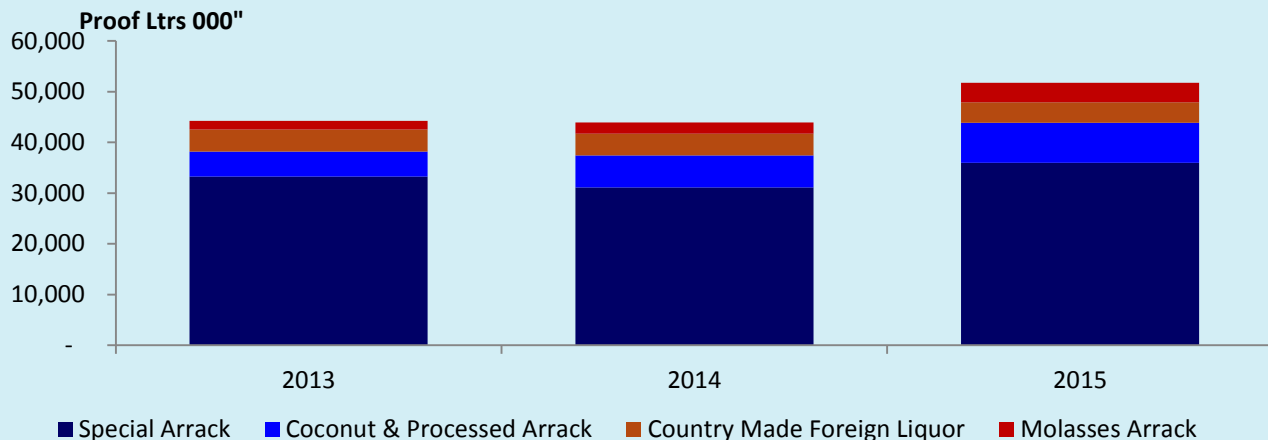
Total liquor market is comprised by two major types, hard liquor and malt liquor. Hard liquor market reflecting signs of maturity has recorded a low c.1% output CAGR during 2006-2015. However, Malt Liquor has recorded c.12% CAGR over the same period reflecting a clear shift of customers from hard liquor to malt liquor.

**Malt Liquor market has overtaken hard liquor to record 70:30 split ratio as of 2015**



Source: Department of Excise SL AR's

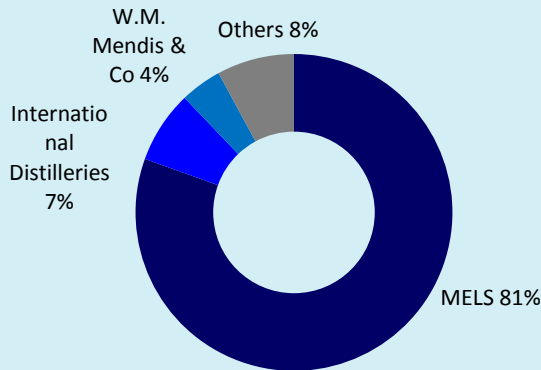
Hard liquor market is comprised by four major types namely Molasses Arrack, Special Arrack, Coconut & Processed Arrack and Country made foreign liquor. Special Arrack accounted for c.70% production of hard liquor by recording c.36m proof liters. Proof liters measure the amount of alcohol content in a beverage.



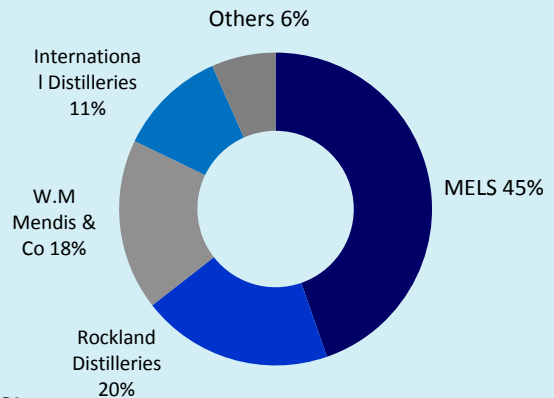
Source: Department of Excise SL AR's

MELS holds the market leadership position in Special arrack category (c.80% share) and Coconut & Processed arrack category (c.45% share). Overall MELS market share in Sri Lankan hard liquor market arrived at c.65% as of 2015.

**Key players in Special Arrack business**



**Key players in Coconut & Processed Arrack business**

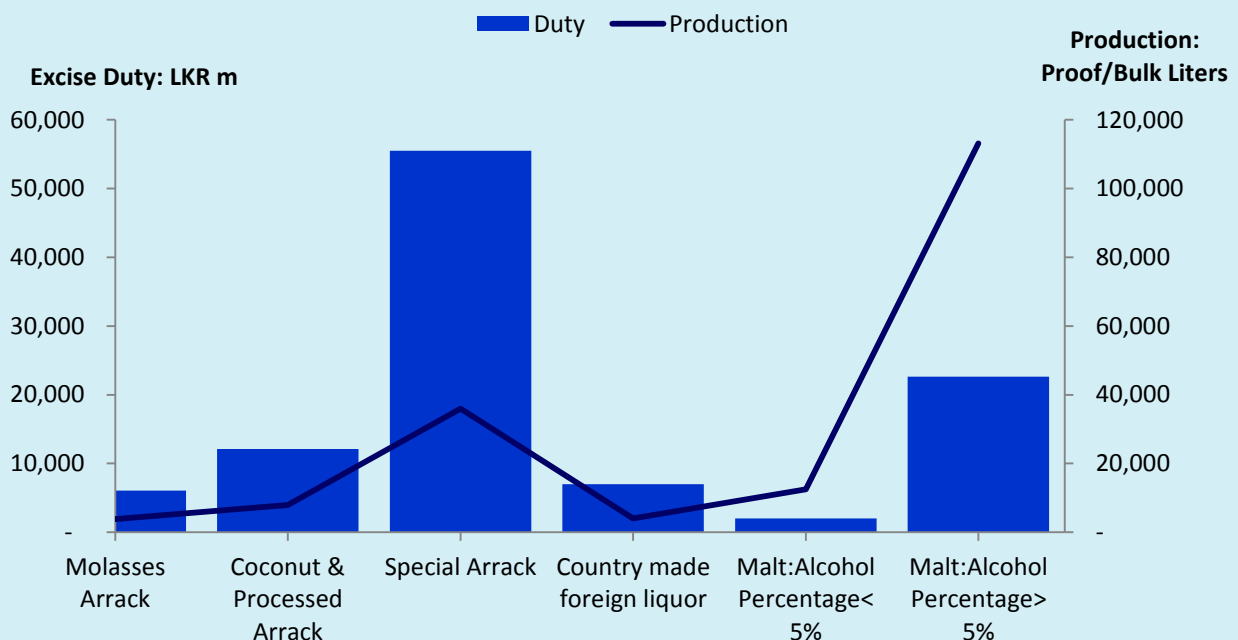


Source: Department of Excise SL AR's

**Government tax mechanism**

The Excise Department of Sri Lanka acts as the major regulator of the industry (Hard and Malt liquor). Excise duty on domestic alcohol industry is a major tax revenue source for the Sri Lankan Government, generating c.LKR105bn revenue in 2015.

Hard alcohol products accounted for c.77% of total excise duty in 2015 where Malt products with alcohol percentage below 5% and above 5% accounted for c.2% and c.21% respectively.

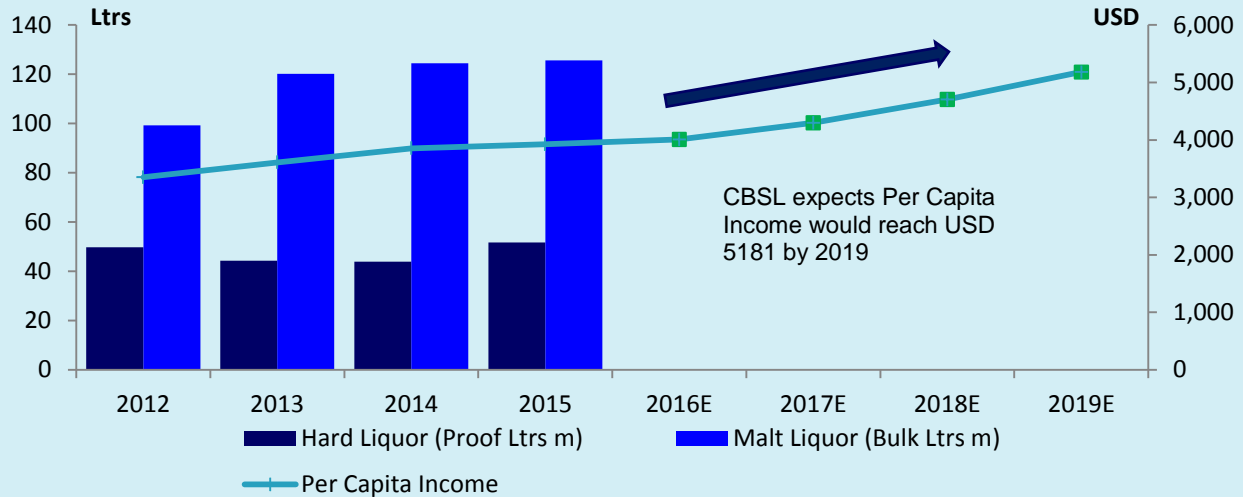


Source: Department of Excise SL AR's

**Industry Growth Drivers:**

**Per capita income**

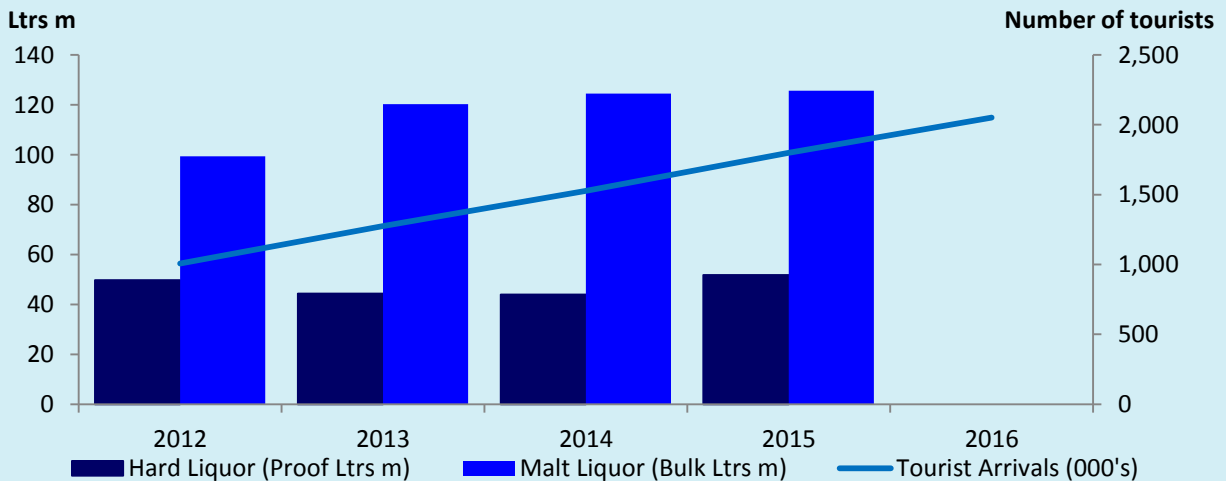
Besides downside inelasticity of alcohol products, rising per capita income has driven the per capita alcohol consumption (both hard and malt alcohol). Central Bank of Sri Lanka expects Sri Lankan Per Capita Income would achieve USD 5000-5100 levels over 2019. This would increase the demand for both hard and malt alcohols.



Source: Department of Excise SL AR's, CBSL AR's

**Tourist Arrivals**

We believe recent development projects aiming increased tourist attraction would benefit the country and increase the demand for liquor products.



Source: Department of Excise SL AR's, SLTDA data

**Appendix 2:**

**Company Overview**

Distilleries Company of Sri Lanka (DCSL) was established in 1913. In 1974 entity was incorporated into a state department while the Excise Department of Sri Lanka entered to act as the major regulator of the industry. In 1989, the DCSL was privatized and turned into a limited liability company. DCSL shares (DIST.N) were listed in Colombo Stock Exchange (CSE) in 1992. In 2016, the DCSL group was re-structured where Melstacorp Ltd (MELS.N) became the ultimate holding company of the group.

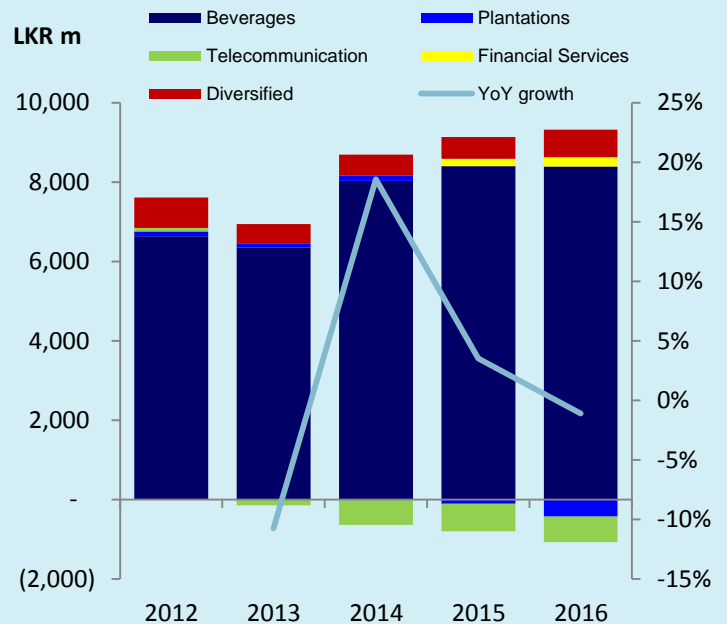
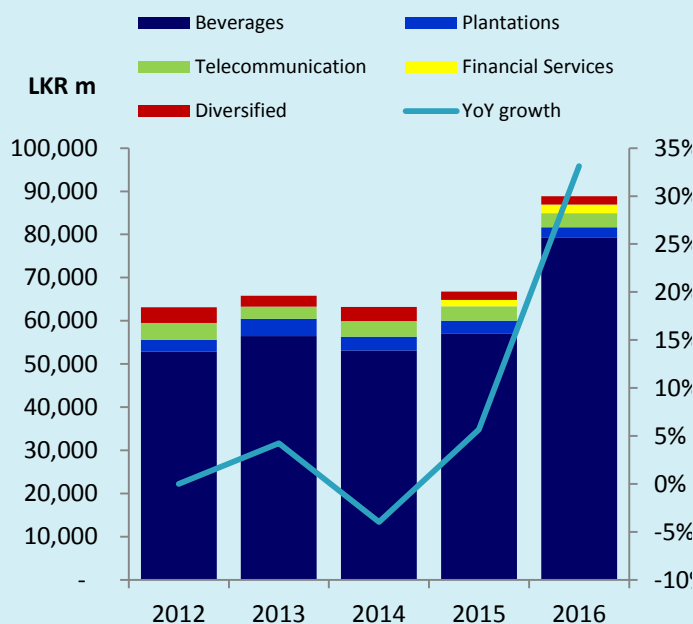
MELS recorded c.LKR 75.75b market capitalization as of 24<sup>th</sup> of February 2017 representing c.3.06% of the CSE market capitalization. Beverage business carried out by DIST contributes c.65-70% of total group income of MELS while DIST holding the market leadership position of domestic hard liquor market by holding c.64% of overall hard liquor market in Sri Lanka.

MELS recorded LKR 88.87bn gross income in FY16 which translated into LKR 33.84bn net income after paying excise duty of c.LKR 55.03bn to the Sri Lankan government. Group EBT for FY16 was recorded as LKR 8.99bn including c.LKR 749m net profit contribution made by associate companies, SPEN and MADU.

*MELS recorded c.9% gross income CAGR and c.2% EBT CAGR over FY12-16. However, beverage segment recorded c.6% EBT CAGR over the same period. Net losses in Plantations and Telco segments have caused MELS's overall EBT CAGR to decline.*

**MELS recorded c.9% gross income CAGR over FY12-16. Beverage segment continued to be the largest revenue generator by accounting for c.89% of group gross income in FY16.**

**MELS's EBT marked c.2% EBT CAGR over FY12-16. However, Beverage business posted a relatively higher EBT CAGR of c.6% over the same period.**





## Segmental Analysis

MELS is majorly engaged in distillation, manufacture and distribution of liquor products. Additionally MELS operates through four other segments, which include Plantations, Telecommunication, Financial Services and Diversified operations.

### ***Beverage Business***

Beverage business accounted for c.60-70% of group net revenue over FY12-16 and almost all EBT over FY14-16. Alcohol segment is operated through DIST and its fully owned subsidiary, Pericyl Pvt Ltd in producing and selling four types of hard alcohol products.

### **Special Arrack**

This category included “Special Arrack” and “Extra-Special” products. MELS is the market leader in Special Arrack Category holding c.80% market share as of FY16. Total Special Arrack accounted for c.68% of total hard liquor market in Sri Lanka as of FY16.

### **Coconut & processed Arrack**

Old Arrack, Coconut Arrack, Double Distilled Arrack represents this category of hard liquor which accounted for c.46% market holding for MELS.

### **Contry made foregin liquor**

This sub-segment operates under DIST’s subsidiary, Periceyl (Pvt) Limited, and includes flagship brands such as Franklin Brandy, Black Opal Premium Arrack, Tillsider whisky, Balmora white rum and Petroff vodka. MELS accounted for c.20% of the total market of this category of liquor.

### **Other imported Brands**

Through Periceyl, DIST is the exclusive distribution agent for foreign liquor brands by Pernod Ricard, including Royal Salute, Chivas Regal, Absolut Vodka, Havana Club Rum, Jacob’s Creek and Long Mountain.

### ***Plantations***

This segment consists of Balangoda Plantations PLC (BALA), which came under the MELS group in 1997. Plantations segment contributed c.7% to the group net revenue in FY16. Tea segment accounted for c.91.47% of total income in FY15.

BALA's cultivated land consists of approximately 4,204.15 hectares under tea and over 2,737.89 hectares under rubber. However, BALA witnessed net losses since FY15 caused by global demand decline for Sri Lankan Tea and adverse weather conditions.

### ***Telecommunications:***

This segment is composed majorly by Lanka Bell Pvt Ltd (LB). LB was formed in 1997 as the single largest BOI Company in Sri Lanka with an investment of over US \$ 150 Million. The Company continues to be the market leader in CDMA connectivity with a subscriber base of over 1 million customers. LB also is the landing partner for the FLAG submarine cable network in Sri Lanka. With an investment of over Rs. 3 billion, LB owns and operates the totally independent cable landing station thus providing true diversity in International connectivity to Sri Lanka as a country. A subsidiary of LB Limited, "Bell Solutions" is continuously pursuing the challenge of providing comprehensive Information & Communication Technology (ICT) solutions to its customers/partners. Other subsidiary of LB, "Telecom Frontier" is currently representing exclusively the entire range of Communications product portfolio of SIEMENS, KAREL, INFINITE and BITTEL in Sri Lanka. Telco segment accounted for c.10% of group net revenue in FY16. However, since FY13 the segment operates with net losses.

### ***Financial Services***

Financial arm consists of Melsta Regal Finance Ltd (MRF) and Continental Insurance Pvt Ltd (CNI). MRF involves in Leasing/Hire Purchase, Motor Bike Leasing, Trade Finance, Fixed Deposits, Savings, Factoring and etc. MRF accounted for c.35% of total financial services segment revenue in FY16 cf.31% in FY15. Further MRF posted LKR c.84m net profit in FY15 cf. LKR 13m net profit in FY14.

CNI involves in general insurance business providing a wide array of products categorized in to Business Insurance Solutions and Private Insurance Solutions. Business Insurance solutions are specially designed to cater to large corporates, SMEs and companies requiring industry-specific insurance covers plans including corporate Motor, Fire, Liability, Marine and Liability related products. Private Insurance group includes Home Insurance, Motor Insurance, Fire Insurance and Travel insurance. CNI held c.3.36% market share in general insurance business as of FY15 cf.2.9% as of FY14. CNI posted c.LKR104m net profit in FY14.

## Diversified segment

Includes automobile servicing and logistics (Melsta Logistics), textile dyeing and fabric printing (Texpro), BPO and KPO services (BellVantage), power generation (Bogo Power), leisure (Browns Beach Hotel), sugar and molasses manufacturing and trading (Pelwatte Sugar), as well as Splendor Media (Pvt) Ltd (media buying and creative services).

## Associates

Aitken Spence PLC (SPEN) and Madulsima Plantations PLC (MADU) represent MELS's associates which are reported based on equity method of accounting. MELS held 43.45% effective holding in SPEN and 45.90% effective ownership in MADU as of 31<sup>st</sup> March 2016. Net profit contribution of associates to Group total EBT amounted to c. LKR 749m accounting for c.9% of total group EBT.

## Board of Directors

**MELS is led by experienced and skilled Director Board with a clearly proven track record**

<b>Mr. D. H. S. Jayawardena:</b> Chairman / Managing Director	Chairman of Aitken Spence PLC, former Director of Hatton National Bank PLC, the only Sri Lankan honoured with the prestigious "Knight's Cross of Dannebrog"
<b>Mr. C. R. Jansz:</b> Executive Director	Chairman of DFCC Bank PLC, holds a Diploma in Banking and Finance from the London Guildhall University
<b>Mr. N. de S. Deva Aditya:</b> Independent Non-Executive Director	Aeronautical Engineer, Scientist and Economist. He is a Conservative Member of the European Parliament. He is a Fellow of the Royal Society for Arts, Manufacture and Commerce
<b>Dr. Naomal Balasuriya:</b> Independent Non-Executive Director	Dr. Naomal Balasuriya, a medical doctor turned-entrepreneur. He holds both the Master of Business Administration (MBA) and CIM (UK) qualifications.
<b>Mr. Amitha Gooneratne:</b> Alternate Director to N. de S. Deva Aditya	A Fellow of the Institute of Chartered Accountants, United Kingdom and Wales and a Fellow of the Chartered Accountants of Sri Lanka. Former MD of Commercial Bank of Ceylon PLC (COMB)

Source: DIST AR's

## Top Five Share Holders: AS of 31<sup>st</sup> December 2016

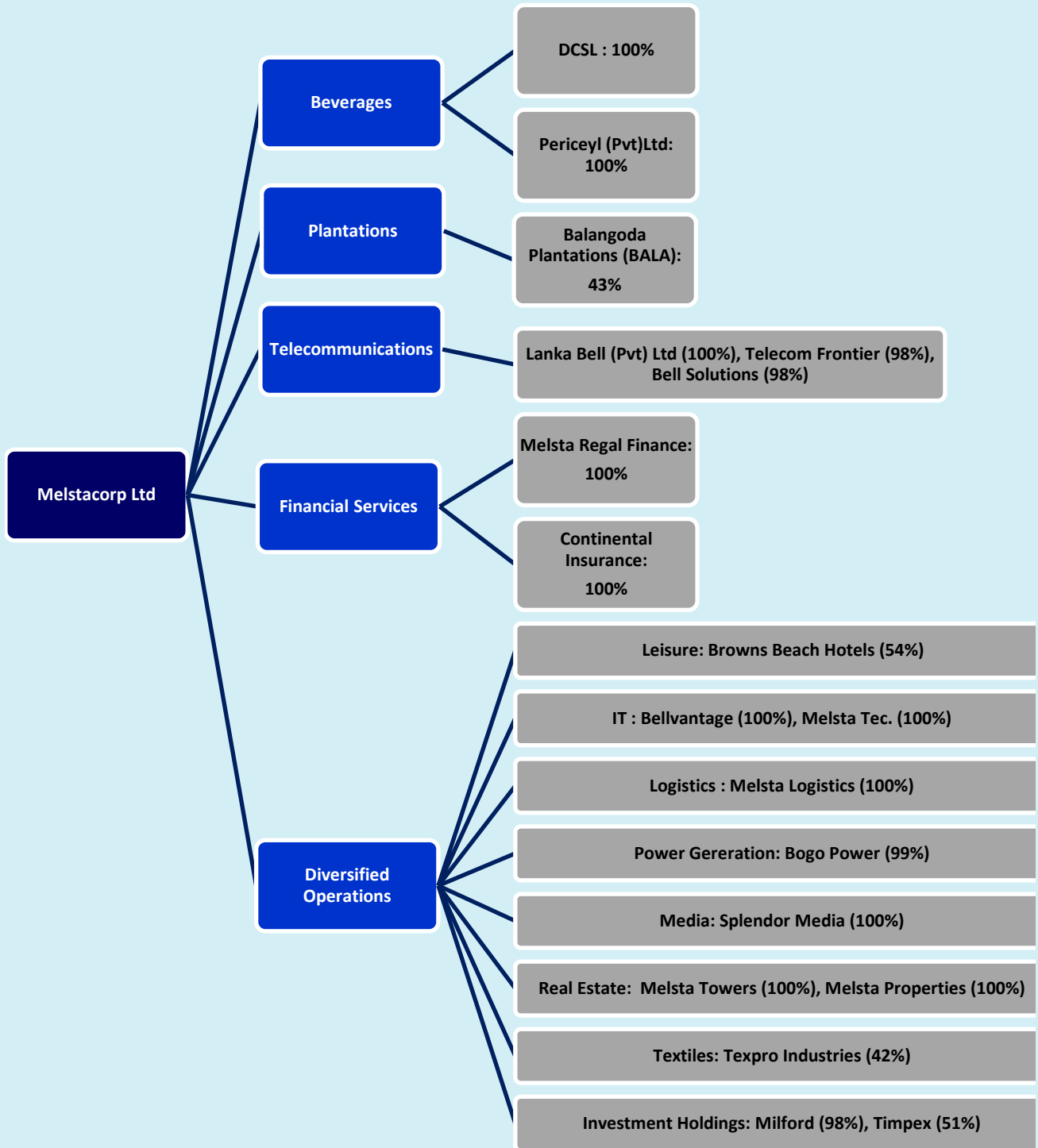
**Mr. Harry Jayewardene directly and indirectly possess significant influence over MELS**

Name	Number of shares	Percentage Holding %
<b>Milford Exports (Ceylon) (Pvt) Ltd</b>	497,882,000	42.72
<b>Lanka Milk Foods (CWE) Limited</b>	151,846,000	13.03
<b>Mr. M.A. Yaseen</b>	89,674,048	7.70
<b>COMB.N/ L E M Yaseen</b>	52,200,000	4.48
<b>Caceis Bank Luxembourg S/A</b>	27,920,236	2.40

Source: MELS AR's

**Corporate Holding Structure**

In addition to the following, MELS possess significant influence over SPEN (c. 43% effective stake) and MADU (c.46% effective stake)



## SWOT analysis

### Strengths

- Market leader in Sri Lankan hard liquor business by holding c.80% share of Special arrack market and c.45% share of Coconut & Proceed arrack market.
- Diversified business risk by operating cyclical income business together with addictive in nature alcohol products.
- Strong financial position backed by solid unutilized debt capacity. Future CAPEX requirements for both growth and maintenance purposes could be satisfied with the employment of debt capital. Inelastic nature of major business further supports increased debt utilization in the capital structure.

### Weaknesses

- Seasonality and Weather dependent Plantations segment continues to affect MELS overall margins negatively.
- Increasing competition in Telecommunications business would cause LB to lose its market share of Wireless Data/4G business while requiring substantial CAPEX for upgrading purposes.
- Besides operating with diversified companies, beverage business continues to be the major revenue generator by accounting for c.65-70% of total MELS income. This over-dependence on alcohol segment would lead future growth related issues since domestic alcohol market is almost matured.

### Opportunities

- Recent developments on Tourism industry together with increasing Per Capita Income levels would support both volume and consumption related growth of alcohol products.
- High growth potential in logistics business with country's expected maritime based development projects such as Colombo Port City/ Financial City projects.

### Threats

- Shift of customers from legal alcoholic products to illegal and illicit hard liquor products.
- Growing health concerns over alcohol related consumption risks would cause faster market saturation causing MELS overall revenue and profits

## Appendix 3:

## Group Summary Financials

Summarized Consolidated Income Statements: For the Y/E 31<sup>st</sup> March

LKR 000"	FY17E	FY18E	FY19E
<b>Net Revenue</b>	39,920,295	45,171,884	50,813,350
<b>COGS excluding depreciation</b>	(21,052,206)	(23,867,343)	(26,923,503)
<b>Gross Profit</b>	18,868,089	21,304,540	23,889,846
<b>Adjusted Other operating income</b>	1,217,706	1,181,118	1,039,362
<b>Distribution Expenses</b>	(2,102,782)	(2,413,478)	(2,765,092)
<b>Administrative Expenses</b>	(4,280,594)	(4,913,070)	(5,628,844)
<b>Other Operating Expenses</b>	(416,194)	(477,688)	(547,282)
<b>EBITDA</b>	13,286,224	14,681,422	15,987,991
<b>EBIT</b>	10,596,408	12,135,425	13,548,510
<b>EBT</b>	10,344,061	11,862,852	13,209,266
<b>EAT</b>	7,393,178	8,272,019	9,058,379

Source: DIST/ MELS financials, APSL estimates

## Key Ratios:

Y/E 31st March	2012	2013	2014	2015	2016	2017E	2018E	2019E
<b>Gross Margin</b>	22%	22%	24%	21%	17%	18%	18%	17%
<b>EBITDA Margin</b>	15%	16%	16%	14%	12%	13%	12%	12%
<b>EBIT Margin</b>	13%	13%	13%	12%	9%	10%	10%	10%
<b>EAT Margin</b>	9%	9%	10%	9%	6%	7%	7%	7%
<b>Gross income growth: YoY</b>	-	4%	-4%	6%	33%	19%	15%	15%
<b>Adjusted EPS: LKR</b>	4.98	5.10	5.30	5.11	4.82	6.34	7.10	7.77

Source: DIST/ MELS financials, APSL estimates

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