



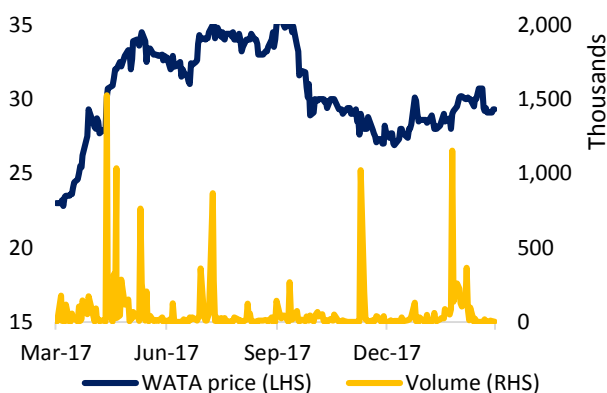
WATAWALA PLANTATIONS PLC **CSE: WATA** **Bloomberg: WATA SL** **DOWNGRADE TO HOLD**

Mar 2018 Current Price – LKR 29.4 Fair value [FY19E] – LKR 32.0 / [FY20E] – LKR 44.0 3QFY18 Reported Earnings ↓ 57%YoY

KEY DATA			
Share Price (LKR)	29.4		
52w High/Low (LKR)	35.8 / 22.5		
Average Daily Volume (Shares)	60,526		
Average Daily Turnover (LKR)	1,871,232		
Issued Share Capital (Shares Mn) ¹	197		
Market Capitalisation (LKR mn)	5,798		
Price Performance (%)	1 mth	3 mths	12mths
WATA	-3%	5%	27%
ASPI	-1%	2%	5%
Major Shareholders as at 31st Dec 2017			
Estate Management Services (Pvt) Ltd	75.64%		
Dr.T.Senthil Verl	10.28%		
K.C.Vignarajah	0.95%		
HSBC Int. Nominees-SSBT-Deutsche	0.69%		
Deutsche Bank/Candor Opportunities	0.61%		
Estimated Free Float	24.35%		

1. Adjusted for the share buy back of 39.4Mn shares

Price – Volume Chart



ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 6.

“Dairy losses and lower palm oil prices lead to a temporary downgrade”

P/e 31 March (LKR Mn)	FY16	FY17	FY18E	FY19E	FY20E
Revenue- continuing ops	2,108	2,593	2,801	3,351	4,102
YoY % Growth	3%	23%	8%	20%	22%
Revenue with tea	6,299	6,502	5,234	NA	NA
Net profit- continuing ops	880	1,219	1,023	1,072	1,335
Net Profit with tea	518	1,228	1,189	NA	NA
EPS- continuing ops (LKR) ¹	4.46	6.19	5.20	5.44	6.78
YoY % Growth	-5%	39%	-16%	5%	25%
EPS with tea (LKR)	2.19	5.18	8.34	NA	NA
Valuations adjusted for continuing ops					
PER (x)	6.5	4.7	5.6	5.3	4.3
PBV (x)	1.2	0.9	1.5	1.4	1.1
Dividend yield (%)	2.6%	5.2%	3.6%	11.3%	8.2%
NAVPS (LKR) ¹	24.2	30.7	18.8	21.0	25.4
DPS (LKR)	0.8	1.5	1.0	3.3	2.4
Payout ratio	17%	24%	20%	60%	35%

1. Adjusted for the share repurchase assuming all 39.4Mn shares offered were accepted by shareholders

Continuing ops (LKR Mn)	3QFY17	3QFY18	YoY	FY16	FY17	YoY
Revenue	584	594	↑ 2%	2,108	2,593	↑ 23%
Gross profit	332	240	↓ -28%	900	1,350	↑ 50%
Net profit	272	202	↓ -26%	880	1,219	↑ 39%
Net profit- reported	466	202	↓ -57%	518	1,226	↑ 137%
Continuing ops (LKR Mn)						
Revenue	556	675	681	594	↓ -13%	
Gross profit	144	326	319	240	↓ -25%	
Gross margin	26%	48%	47%	40%	↓ -6%	
Net profit	130	287	291	202	↓ -31%	
Net margin	23%	43%	43%	34%	↓ -9%	

Disclosure on Shareholding:
First Capital Group and its affiliates hold 37,500 shares of WATA and will not trade in this share for the three trading days following the issue of this document.

FY19E recommendation downgraded to HOLD as start-up losses in Dairy and declining palm oil price outlook trims continuing profit forecast by 15%: FC Research maintains WATA's FY18E profit forecast from continuing operations (i.e. profit w/o tea and rubber segments) almost unchanged at LKR 1,023Mn, however cuts FY19E forecast by LKR 182Mn (-15%) to LKR 1,072Mn (previous forecast of LKR 1,254Mn). This is primarily due to the increase in the loss forecast for the Dairy segment to LKR 112Mn for FY18E and LKR 72Mn for FY19E as it has incurred larger than expected start-up losses in 3QFY18 (previous forecasts: FY18E loss of LKR 73Mn, FY19E loss of LKR 20Mn). Despite the lower Net Sales Averages (NSAs), palm oil segment's FY18E profits are in line with forecast at LKR 948Mn while FY19E profits are cut by 10% to LKR 1,002Mn (previous FY19E forecast: LKR 1,114Mn). Accordingly, FC Research has adjusted the fair value estimate downwards by 20% to LKR 32, from previous estimate of LKR 40 yielding an annualized total return of 16% which downgrades the FY19E recommendation to a **HOLD**. Yet, from FY20E we expect the Dairy segment to contribute 20% to the topline and 8-10% to the bottom line resulting in a profit growth of 24%. Accordingly, FC Research estimates a fair value of LKR 44.0 for WATA in FY19E providing a total return of 29%.

Recommendation summary
Dec 2016 – S. BUY @ LKR 19.0 [TP: LKR 30 for FY18E]
Jan 2017 – Maintain S. BUY @ LKR 23.5 [TP: LKR 32 for FY18E]
Sep 2017 – Maintain S. BUY @ LKR 33.0 [TP: LKR 42 WATA + LKR 5 HPL for FY19E] **post spin off value**
Dec 2017 – Maintain S. BUY @ LKR 26.0 (**spin off complete**) [TP: LKR 40 for FY19E]
Mar 2018 – Downgrade to HOLD @ LKR 29.0 (**post share buyback**) [TP: LKR 32 for FY19E]



Earnings performance: Absence of the tea segment reflects the plunge in reported earnings while lower prices in Palm Oil segment coupled with Dairy losses dipped profits from continuing operations in 3QFY18 as expected

3QFY18 reported earnings down by 57% on the absence of the tea segment's profits: WATA recorded earnings of LKR 202Mn in 3QFY18, down 57% from LKR 466Mn in 3QFY17. This primarily reflects the absence of the tea segment's profits, which were spun off to Hatton Plantations PLC with effect from 30th September 2017. In 3QFY17, tea segment recorded a net income of LKR 194Mn (42% of 3QFY17 net income).

Net income from continuing operations dipped 26%YoY due to start-up losses in Dairy segment: The profit from continuing operations dipped 26%YoY to LKR 202Mn in 3QFY18 from LKR 272Mn in 3QFY17 driven by Dairy segment. The gross profit from continuing operations dipped 28%YoY as the palm oil segment's gross profits declined. Revenue from continuing operations increased marginally by 2% as Dairy segment's revenues started materializing. Net margin from continuing operations dropped to 34% in 3QFY18 from 47% in 3QFY17.

Palm oil segment profits dip by 14% however in line with expectations: Palm oil segment recorded profits of LKR 204Mn in 3QFY18, a reduction of 14% from LKR 238Mn in 3QFY17. This was primarily driven by the continued effect of lower palm oil prices due to the reduction of import duties and lower prices in the global market as expected and accounted for in our forecasts. Net sales averages remained almost stable between 2QFY18 and 3QFY18 at approximately LKR 180/kg levels. In 3QFY18, palm oil reflects 101% of WATA's bottom-line.

Dairy segment's losses mount to LKR 86Mn, larger than expected: The Dairy segment reported losses of LKR 39Mn in 3QFY18 mounting losses of LKR 86Mn for 9MFY18. The main reason is that the imported herd is not yet fully ready to be milked while the feed cost and other fixed costs are being incurred which results in a loss from the operation.

Investment case: Startup losses of Dairy segment and lower palm oil prices may affect FY19E earnings, yet the long-term outlook remains positive

Palm oil prices to decline but yield to increase: As explained in the previous update in Dec 2017, palm oil prices continued to see a declining trend where global prices have dropped ~8%YoY as of Mar 2018. However the net sales averages remained at ~LKR 183/kg. We expect the declining global palm oil prices and the fluctuating duty component in the domestic prices to negatively affect WATA's earnings for FY19E. Malaysian palm oil prices are expected to decline further given the expectation on higher output. We estimate the gross margin of the palm oil segment to be ~52% between FY19E-FY20E (average 9MFY18: 59%). However, since 78% of WATA's palm oil nurseries are mature, FC research estimate the yields to keep increasing going forward by ~15% over the next 3 years. As such we cut the segment's profit forecast by 10% to LKR 1,002Mn while maintaining the FY18E profit forecast almost unchanged at LKR 988Mn.

Dairy farm is ~85% complete and ready to produce 30,000 liters a day by FY19E: The Company has completed ~85% of the USD 12Mn investment in its Dairy Farm and currently has a herd of 1,000 of which ~500 cows are milking in the farm's automated milking parlor at Lonach Estate. The company receives government subsidies for importing cows. The farm is in line with its expectations to produce ~30,000 liters per day by FY19E, from its current level of ~10,000 liters per day. At the end of FY19E the herd is expected to grow to ~2,000 with 1,000 milking cows. Once in full operation, the Dairy segment is expected to yield gross margins of ~40%. FC Research estimates the segment to contribute to revenues by 12% in FY19E and 20% in FY20E. FC Research has increased the segment's loss forecast for FY18E to LKR 112Mn (previous: loss LKR 73Mn) and FY19E loss to LKR 72Mn (previous: loss LKR 20Mn) however estimates the FY20E profit to be LKR 112Mn, a growth of 255%. Further, the company expects to do value addition to its milk production from its present status of being a mere supplier.

Recommendation

For FY19E, FC Research cuts WATA's fair value to LKR 32.0, a 20% downward adjustment to the previous forecast of LKR 40.0 after spinning off the tea segment providing a total return of 17% (capital gain 10%, dividend yield 7%) in FY19E with an annualized return of 16%. As such we downgrade the recommendation to **HOLD** from a **STRONG BUY**. The key drivers of the downgrade are the declining palm oil price outlook and the startup losses in the Dairy segment, which will keep the profits flat between FY18E and FY19E. However, we see an attractive long-term outlook in WATA where the profits would grow 24% in FY20E as Dairy segment stabilizes and start making profits reflecting 8-10% of the total profits and ~20% of total revenue. Accordingly, we estimate the fair value for FY20E at LKR 44.0 providing a total annualized return of 29%.

Investment risks

Commodity price risk: The global palm oil prices declined 8%YoY in Mar 2018 due to weaker demand and abundant supply. European Union is phasing palm oil out of the biofuel production while United States is looking forward to impose anti-dumping duties on palm oil imports from Indonesia. India has increased levies on edible oil imports which has discouraged demand for palm oil from India, one of the largest buyers. On the plus side, Malaysia and Indonesia are in talks with China to supply for a B5 biodiesel program which may lead to higher demand.



Valuation summary

Expected WATA price	FY19E	FY20E
DCF based valuation	32	48
PER based target price	33	41
Average price (post spin)	32	44
Buy below price	29	35

Return	FY19E	FY20E
Target price	32.0	44.0
Current price	29.0	29.0

Capital gain	3.0	15.0
Dividend	3.3	2.4

Capital gain %	10%	52%
Dividend yield %	15%	19%

Total return	25%	71%
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Total return (annualised)¹	16%	29%
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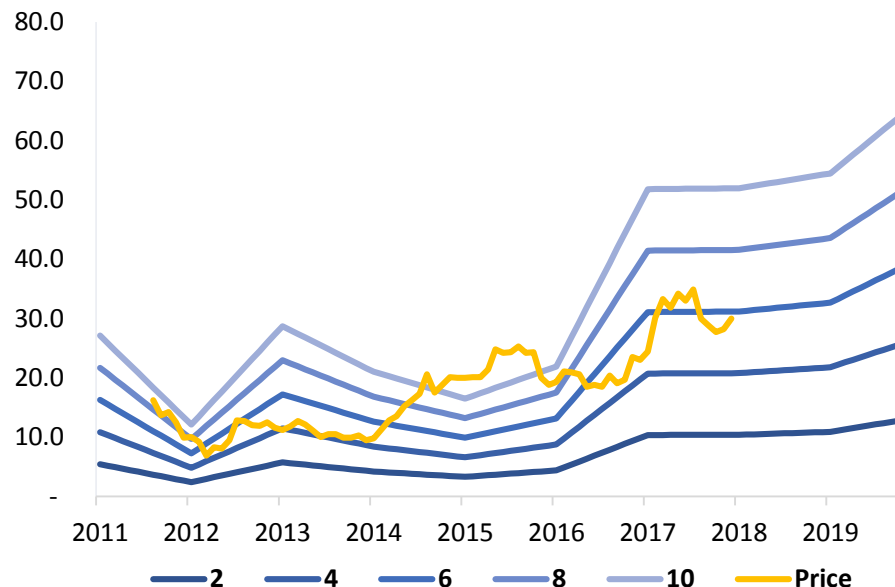
1. FY19E price annualised over 378 days

DCF valuation

Valuations (LKR Mn)	FY19E	FY20E
NPV	7,902	10,441
Less: debt	1,625	1,607
Add: cash and cash equivalents	14	692
Equity value	6,291	9,526
No. of Shares (Mn)	197	197
Value of Equity per share	32	48

COE		WACC	
R_f	9%	K_e	21%
R_m	18%	K_d	11%
$R_m - R_f$	9%	D/ E	30 / 70
β	1.3	Terminal Growth rate	3%
$K_e = R_f + \beta (R_m - R_f)$	21%	WACC	18%

WATA PE band



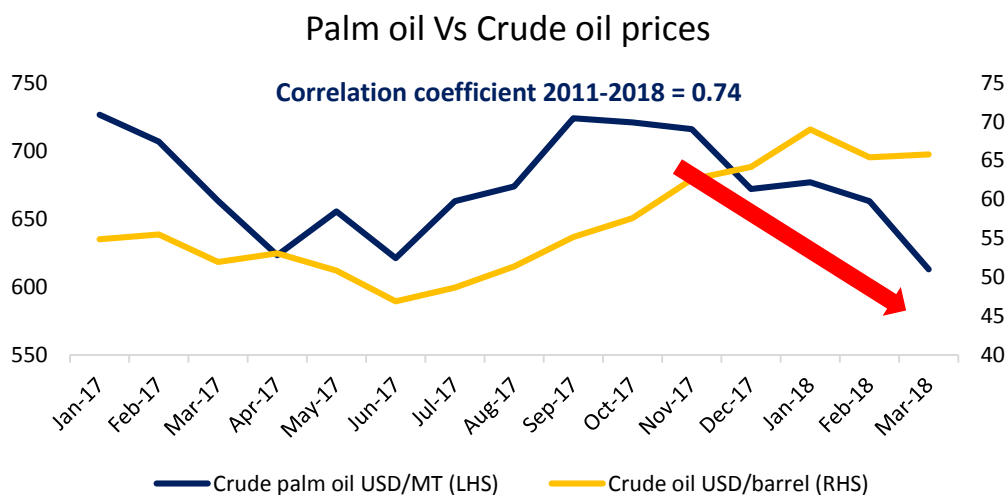
PER valuation	FY19E	FY20E
Earnings (LKR Mn)	1,074	1,322
No of shares (Mn)	197	197
EPS (w/o tea)	5.4	6.7
Expected PER	6x	6x
Price at 6x expected earnings	33	40

Recommendation criteria

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



Annex II – Palm oil Vs Crude Oil prices



Annex II – Impact of changes in WACC and terminal growth on FY19E fair value

FY19E		WACC				
		17%	17%	18%	19%	20%
Terminal growth rate	1%	31	31	30	29	28
	2%	32	32	31	30	29
	3%	34	34	32	31	30
	4%	35	35	34	32	31
	5%	37	37	35	33	32

Source: Company reports, Indexmundi, FC Research Estimates

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

LKR (Mn)	FY16	FY17	FY18E	FY19E	FY20E
Continuing operations					
Revenue	2,108	2,593	2,801	3,351	4,102
Cost of sales	(1,208)	(1,243)	(1,520)	(1,900)	(2,289)
Gross profit	900	1,350	1,282	1,451	1,812
Other operating income	134	147	148	135	122
Administrative expenses	(112)	(156)	(214)	(252)	(299)
Operating profit	922	1,341	1,216	1,333	1,635
Net finance cost	(14)	7	(11)	(53)	(80)
Profit before income tax	908	1,349	1,205	1,280	1,555
Income tax expense	(29)	(129)	(182)	(208)	(235)
Profit from continuing ops	879	1,219	1,023	1,072	1,320
Equityholders - continuing	879	1,221	1,025	1,074	1,322
NCI - continuing	-	(2)	(2)	(2)	(2)
Profit from discontinuing ops	(362)	6	165	-	-
Profit for the year with tea	517	1,226	1,188	1,072	1,320
EPS (continuing ops)	4.46	6.19	5.20	5.44	6.70
EPS (reported)	2.19	5.18			
Segmental revenue					
Palm oil	1,504	2,162	2,387	2,690	3,008
Export	605	429	241	273	290
Dairy farm	-	33	174	388	804
Other	-	-	-	-	-
Inter segmental adjustments	-	(31)	-	-	-
Total	2,108	2,593	2,801	3,351	4,102
Tea	4,118	3,909	2,410	-	-
Rubber	73	-	-	-	-
Segmental net income					
Palm oil	682	1,025	989	1,003	1,078
Export	65	48	40	44	47
Dairy farm	-	11	(112)	(72)	107
Other	134	134	107	97	88
Inter segmental adjustments	(2)	2	-	-	-
Total	880	1,219	1,023	1,072	1,320
Tea	(314)	6	165	-	-
Rubber	(48)	-	-	-	-



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

LKR (Mn)	FY16	FY17	FY18E	FY19E	FY20E
Assets					
Non current assets					
PPE	1,835	2,424	1,943	2,343	2,242
Biological assets	3,431	3,629	2,793	3,202	3,435
Other non current assets	586	586	376	369	362
	5,853	6,639	5,113	5,914	6,039
Current Assets					
Inventories	638	733	(188)	372	455
Trade and other receivables	561	537	135	282	296
Other current assets	-	315	317	319	320
Cash and cash equivalents	695	888	478	14	692
	1,894	2,474	742	986	1,763
Total assets	7,746	9,113	5,855	6,899	7,802
Equity and liabilities					
Capital and reserves					
Stated capital	460	460	460	460	460
Retained Earnings	4,320	5,299	2,961	3,390	4,250
Total equity - equityholders	4,780	5,759	3,421	3,850	4,710
Non controlling interest	-	291	289	288	285
Non current Liabilities					
Borrowings	389	325	514	1,095	912
Other non current liabilities	1,784	1,761	722	707	693
	2,172	2,086	1,236	1,802	1,605
Current liabilities					
Trade and other payables	611	688	333	386	459
Other current liabilities	183	288	576	573	743
	794	976	908	959	1,202
Total equity and liabilities	7,746	9,113	5,855	6,899	7,802
NAVPS	24.2	30.7	18.8	21.0	25.3

Source: CSE, Company reports, FC Research Estimates

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

(LKR Mn)	FY16	FY17	FY18E	FY19E	FY20E
Profit/Loss before tax	590	1,446	1,205	1,280	1,555
Adjustments for:					
Depreciation	310	313	337	261	279
Provision for retirement benefit and other	-	104	-	-	-
Profit from sale of PPE	(14)	(10)	(31)	(25)	(20)
Profit from sale of bio assets	(16)	(20)	-	(2)	(3)
Movement in live stock	13	(4)	(256)	(201)	(137)
Timber fair value (gain)/loss	(29)	(6)	(20)	(20)	(20)
Amortization of leasehold properties	7	7	3	3	3
Amortization of capital grants	(10)	(10)	(10)	(10)	(10)
Interest Income	(17)	(71)	-	-	-
Interest Expense	96	119	11	53	80
Changes in working capital	-	-	-	-	-
(Increase)/ decrease in inventories	55	(95)	422	(560)	(83)
(Increase)/ decrease in Receivable	(70)	(51)	46	(147)	(14)
Increase/ (decrease) Trade and Other Payables	(75)	78	4	53	73
Defined benefit obligations	172	(205)	-	-	-
Cash generated from operations	1,012	1,595	1,712	687	1,701
Interest paid	(96)	(119)	(11)	(53)	(80)
Tax paid	(0)	(31)	(182)	(208)	(235)
Defined benefit obligations paid	(98)	(140)	-	-	-
Interest received	17	71	-	-	-
Net Cash from operating activities	835	1,377	1,519	425	1,387
Cash Flow from Investing Activities					
Field development expenditure	(209)	-	-	-	-
Purchase of property, plant and equipment	(80)	(1,106)	(1,223)	(854)	(259)
Proceeds from sale of property, plant and equipment	20	11	42	33	26
Proceeds from sale of consumable biological assets	29	40	(18)	2	4
Re-investment in gratuity/ other	(14)	578	-	-	-
Purchase/ issue of shares	-	292	-	-	-
Net cash used in investing activities	(254)	(185)	(1,199)	(819)	(228)
Cash Flow from Financing Activities					
Dividends paid	(118)	(331)	(1,507)	(644)	(463)
Proceeds from borrowings	341	71	1,140	1,100	600
Repayment of borrowings	(78)	(128)	(355)	(522)	(613)
Repayment of lease principal	(6)	(8)	(5)	(5)	(5)
Net Cash Flow from Investing Activities	139	(396)	(726)	(71)	(480)
Increase/ decrease in cash and cash equivalents	720	795	(406)	(464)	678
Movement in Cash and Cash Equivalents					
At the beginning of the year	(62)	93	884	478	14
Increase/ decrease in cash and cash equivalents	720	795	(406)	(464)	678
Cash and cash equivalents at the end of the Year	658	888	478	14	692



Research Disclosure

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BRANCHES

Kandy	Kurunegala
2nd Floor, No.121 Kotugodella Veediya (E L Senanayake Veediya) Kandy	CSE - Kurunegala Branch, 1st Floor, Union Assurance Building, No 06, Rajapihilla Mawatha, Kurunegala 60000.

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Matara	Negombo
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Manager:	Rohana Jayakody	Manager:	Buddhika Edirisinghe
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