

Initiating Coverage	Caltex® Lubricants Lanka Limited	BUY
	Driving Yield	Target Rs.106

<p>26 October 2006</p> <p>Ticker: LLUB</p> <p>Price on 26/10/06: 84.50</p> <p>52 Week Range: 87.25-52.25</p> <p>Market Cap.: US\$ 53.3m</p> <p>Shares Outstanding: 60m</p>	<p>Initiating coverage with a buy; price target Rs. 106 We expect a 25% price upside, with a 12 month price target of Rs.106, while our calculated fair value is Rs.121. With retained earnings forecast to pass the Rs.1 billion threshold in 2007 and strong cash flow generation, high pay-out policy is likely to continue and current dividend yield hovering close to 15%.</p> <p>Brand and distribution strength likely to limit market share deterioration Limited risk from new entrants to the lubricant market, with LLUB holding 85% of the local market with a strong hold on distribution channels. The bulk of the lubricant sales of the company is via service stations. LLUB has a strong hold of close to 300 service stations through exclusive agreements. Further, 90% of the independent service stations purchase LLUB products due to the demand for Caltex® and Lanka® brands.</p> <p>Potential sales increase from NE region could provide upside According to the company, sales to the North and East regions affected by deteriorating security situation amounts only to 4% of total revenue. Therefore, the situation in the North and East has limited impact for LLUB, with the potential to record sharp growth given an end to escalating violence.</p> <p>Deregulation continues to provide certain risks Government incentives to promote competition within the industry remain a risk factor. Further LLUB could expect aggressive competition from Servo®, once the Lanka IOC blending facility commences operations in 2007.</p>
--	--

	2003	2004	2005	2006E	2007E
Revenue (Rs. mn.)	4,214	4,546	5,560	7,784	9,341
YoY%		8	22	40	20
Operating Profit(Rs. mn.)	958	814	943	1,190	1,519
OM%	23	18	17	15	16
EPS(Rs.)	13.9	10.8	11.7	13.4	17.0
YoY%		-22	8	15	27
PE(x)	5.1	5.9	5.0	6.3	5.0
NAVPS (Rs.)	46	23	25	27	29
Divd Yld(%)	16.7	51.7	16.8	14.5	17.0

From monopoly to a competitive environment

Competition within the Sri Lankan lubricants market of approximately 48 million litres per annum is intensifying. The market leader, LLUB is faced with competition from two fronts. *Servo*® marketed by Lanka IOC, attempts to compete based on price while other brands concentrate on a niche marketing strategy, limited in scale. The other competitors are *Mobile*®, *Valvoline*®, *BP/Castro*®, and *Shell*®. Prior to the entry of *Servo*® LLUB enjoyed close to approximately 95% share of the Sri Lankan lubricants market. According to the company LLUB currently enjoys 85% of total market share. The lubricants market is growing nearly 6% per annum mainly due to the new vehicle additions to the island.

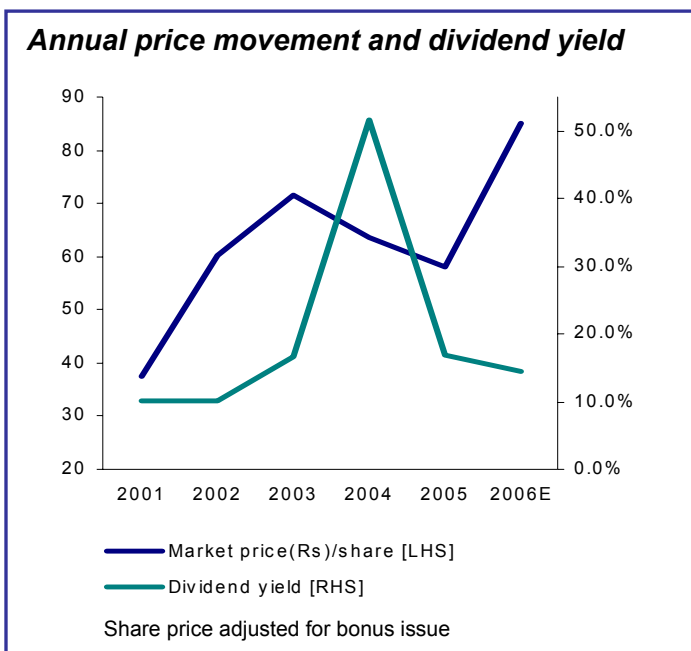
From 1999 with the end of monopoly status within the lubricants market in Sri Lanka, LLUB was faced with a more challenging competitive environment. The *Servo*® brand, lubricants marketed by Lanka IOC has grabbed market share from LLUB while further challenges are visible with the provision of licensing for new lubricant blenders and if there were to be a revision of the prevailing adverse tax environment for finished lubricant importers.

Introducing a high yield privatisation

Caltex Ceylon Limited commenced operations in Sri Lanka in 1994, following the privatisation of the state owned Lanka Lubricants Limited. Caltex Ceylon Limited a subsidiary of Chevron Corporation Inc. owns 51% of Lanka Lubricants Limited while the remainder is held by institutional, high net worth and retail investors. Subsequently Lanka Lubricants Limited was renamed as Caltex Lubricants Lanka Limited (LLUB) in 1999. The smooth transition from government to private ownership coupled with the continuation of monopoly status in the lubricants market till 1999 under state patronage provided the best scenario for LLUB to thrive in its line of business.

LLUB is in the business of blending, importing, distributing and marketing of lubricant oils, greases and other non-lubricant products used for automobile engine maintenance. The majority of its products are produced locally at the company owned blending facility situated at Kolonnawa, Sri Lanka.

At present LLUB is among the top few stocks with respect to dividend yields within the Colombo Stock Exchange (CSE). Thus the provision of high dividend returns compared to alternative investments has made LLUB an investment hold rather than a trading pick. Therefore the prevailing high yield dividend policy practised by the company has curtailed the liquidity of the stock.



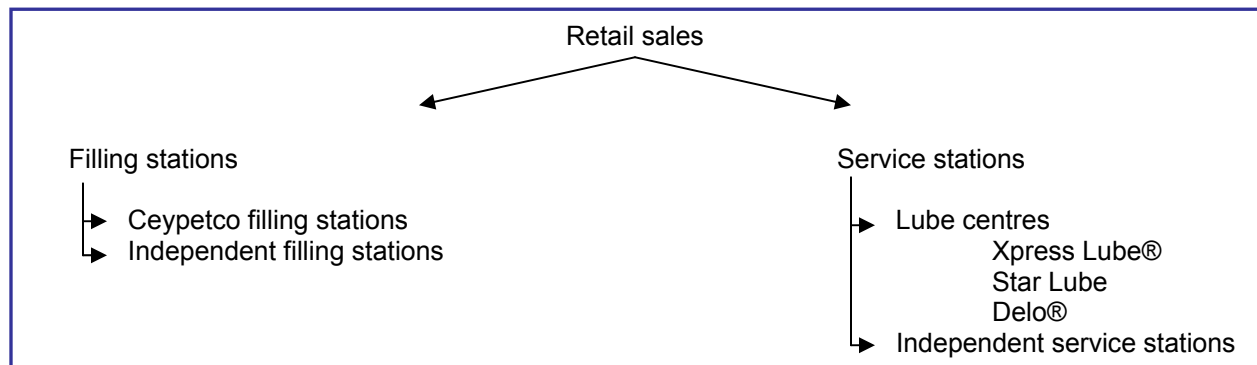
Dominant retail sector

LLUB services the overall lubricant requirements of Sri Lanka under two broad segments, namely; retail and industrial. Retail segment accounts for approximately 65% of total company sales while the industrial sector derives the remainder of approximately 35%.

Within the retail segment LLUB practices a twin-brand strategy (explained in page 6 under brand power) for both petrol and diesel engines. For petrol engines the company markets products under the Lanka Super Plus® and Caltex Havoline® brands. Lanka DS® and Delo® are the two main brands targeting the diesel engines.

The ceasefire agreement signed in 2002 opened up an untapped market for LLUB in the North and East. According to the company North and East share of total sales, amounts to a mere 4%. With the deteriorating security situation in the North and East of the island, LLUB would have to curtail their expansion and promotional strategies in these volatile regions. Therefore the comparatively mediocre share of revenue generated by the North and East, limits the downside for LLUB as a result of escalating violence within the region.

Reaching the customer



Service stations; the key points of sale

Bulk of the retail sales are executed at service stations rather than filling stations. Observation reveals the practicality of lubricant sales through service stations since most of the automobile users would purchase and use lubricants when and where their vehicles are been serviced.

The service stations advises vehicle owners to service their vehicles every 3000km though in reality vehicles may be serviced on a monthly basis, every 3 months or based on another parameter depending on the vehicle owner's attitude and requirement. Further the service interval may vary based on the type of lubricant been used since usable mileage differs.

Presently increasing prices have influenced lubricant usage and sales. However the price inelastic nature of the product provides a buffer for LLUB and other industry participants. The possible impact of temporally lengthening service intervals due to increasing lubricant prices



would be short lived with the price inelastic nature of the product. Further any adverse volume movements would be overcast by the addition of new vehicles to the Sri Lankan road network.

Independent service stations

According to the company, close to 90% of the independent service stations supply and stock only products marketed by LLUB. The reason attributed for this is the strong distribution network and the dominance of Caltex® and Lanka® brands marketed by the company.

Lube centres

Lube centres are an initiative taken by LLUB to secure the customer service points within the supply chain. The portfolio of Lube centres consist of Xpress Lube®, Star Lube and Delo®.

Xpress Lube®

This is the most recent introduction to the Sri Lankan market. Xpress Lube® is a service brand widely used internationally to provide a one-stop total solutions service to the upstream automobile owners. Highly trained personnel render their services utilising the full range of Caltex® products. These one stop service shops numbering 7 are operated and maintained by LLUB to serve the niche upmarket clientele of the cities. A further addition of 2 Xpress Lube® centres could materialise in the coming years.

Star Lube

LLUB has signed a 5 year agreement with independent service stations to obtain exclusivity for Caltex® products. Further experts from LLUB continuously monitors the performance and operations pertaining to service levels and quality standards of these service stations and make them members of the Star Lube portfolio under the co-branding strategy followed by the company. Presently 150 independent service stations have achieved Star Lube status, and the company is aggressively promoting this concept to increase member numbers under this umbrella brand.

Delo®

Similar to the Star Lube concept, LLUB obtains 5 year's exclusive access to service stations unable to meet the quality and service levels pertaining to the Star Lube service stations and brands them as Delo® service stations. To date the company has tied up with 100 service stations under this co-branding strategy.

LLUB loosing out on the 2 stroke and loose lubricant sales

The 3-wheelers and motorbikes with 2 stroke engines demand the most cost efficient lubricants in loose form. Further a similarity among lubricant requirements could be identified between owners of ailing commercial vehicles and the owners of 2 stroke engines. Both of these market segments would need to regularly refill their engines with lubricants thus making filling stations as the ideal channel to meet their needs. Therefore this market segment which also demand the least cost lubricant products are more price conscious rather than brand conscious and would be an ideal target market for a generic producer. The higher value product strategy of LLUB is not inline with the bottom tier of the lubricant market. Thus the high value product strategy



implemented by LLUB miss out on the opportunity to compete in the price conscious market segment in which *Servo*® is the dominant competitor.

With the launch of *Servo*® in 2003 LLUB lost a significant amount of the market segment which purchase and use lubricant products at filling stations. The *Servo*® brand has obtained exclusivity for lubricant products among the Lanka IOC branded filling stations. To date Lanka IOC owns 100 filling stations along with close to 65 stations franchised by Lanka IOC. Therefore LLUB has lost its ability to compete within these 165 filling stations located in key locations with very high fuel sales.

A change in government policy with further privatisation of filling stations, could attract new entrants with exclusive sales agreements with other brands competing in the lubricants market. Further, the expected intention of Ceypetco to market a single brand of lubricants from 2007 onwards, creates an inherent risk for LLUB to maintain its position among the state run filling stations. The most probable outcome could be that LLUB with 90% lubricant sales via Ceypetco filling stations would be considered the most suitable partner for Ceypetco in future. Whereas the negative scenario would be that LLUB may loose out on the opportunity to market their products via the Ceypetco channel. However the downside of such a negative scenario would be limited since nearly approximately 90% of product sales are via other channels rather than through filling stations. LLUB's strategy remains not to concentrate on the bottom tier of the lubricants market with low usage but to service the market segment which has high volumes and is knowledgeable enough to differentiate quality and value.

Boom in industrial sales possible with macro level investments and incentives

The industrial market is comprised mainly of thermal power plants, marine lubricants, Sri Lanka Armed Forces and other industries. Approximately 40% of the revenue from industrial sales is derived from power plants. LLUB markets lubricants under the *Taro*® brand for plants generating thermal power. Consumption of lubricants by power plants would depend on the level of usage, which has increased in recent times. Thermal power generating plants has the capacity to supply close to 65% of total demand for the national grid. However with timely monsoons and capacity increases in hydro-power generating plants demand from thermal power plants could be below installed capacity resulting with reduced demand for lubricants. Furthermore, the government has taken the policy decision not to commission new thermal power generating plants capping the total lubricant sales to this sector. With the most forecasts revealing that the coal power plant in Norrichcholai will only be commissioned in 2010 and with an annual increase of approximately 7% - 8% for electricity demand in Sri Lanka, lubricant sales to thermal power plants could be expected to rise given the continuation of normal weather patterns. Thus it would be prudent to expect the continuation of close to 6 million litres of lubricant sales from LLUB annually. Further sales to this industrial sector could witness a sharp increase if the island is faced with drought conditions.

LLUB maintains a strong position in the marine lubricants market with annual sales of approximately 5 million litres representing approximately 35% of total sales to the industrial sector. Further expansion of this sector would depend on related operations such as harbour refuelling facilities. Presently the Colombo Port does not enjoy a dominant position among global sea refuelling hubs, due to capacity constraints and high cost of servicing vessels. However with a significant improvement in bunkering facilities, LLUB could gain indirect advantage through increased sales to the marine sector.



Sticking to the knitting; concentrating on the core operations

LLUB is engaged in the business of blending and marketing lubricants and other engine maintenance related products. Apart from the core activities LLUB has outsourced or delegated its non-core operational activities to partner organisations. These partnering organisations are industry leaders in their respective disciplines and have created a win-win situation through their partnership with LLUB.

The focus on the primary core activities has enabled LLUB to streamline its entire operation with a high level of efficacy. Therefore the operating model of LLUB takes a simple and clearly defined approach with the main focus areas being;

- Blending and producing lubricants and related products
- Brand building
- Developing and maintaining an independent distribution network
- Outsourcing non-core activities

Brand power and brand strategy

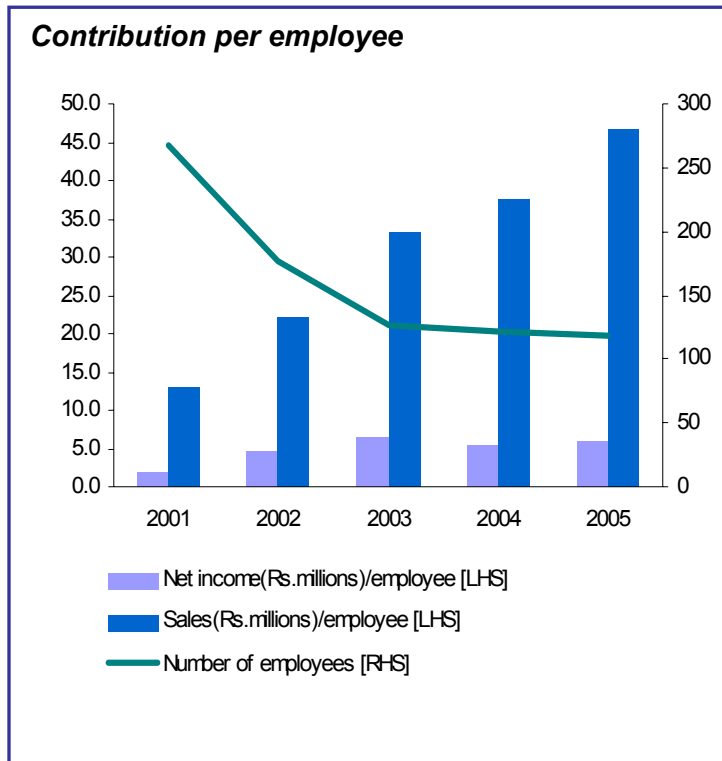
In 2005 Brand Finance in association with STING Consultants recognised Caltex® as the 5th most powerful and 11th most valuable brand among all products and services marketed in Sri Lanka. Brand recognition and awareness along with continuous effort to improve brand equity serves as a source of competitive advantage for LLUB.

LLUB practices a twin brand strategy, with the continuation of Lanka® brand a descendent of the state owned Lanka Lubricants Limited and the increased emphasis on the Caltex® brand. This strategy has enabled the company to capture the market from two fronts. Lanka® brand enabled LLUB to capture the loyalty and patronage of the price conscious market segment with the added advantage of becoming a defence against imported lubricants from a nationalistic point of view. Caltex® brand provides the opportunity for capturing the more knowledgeable market segment pursuing technological advancement and internationally recognised quality and product standards and specifications.

Increased efficacy in HR management

Maintaining and developing operations in the core areas of business while outsourcing the other activities has resulted in a reduced workforce requirement. Thus till 2004 the company created an annual voluntarily retirement scheme and further permanently transferred employees to the outsource partners with agreements to safeguard employee security.

The resultant had been a reduction of 56% in permanent employees from 268 in 2001 to 119 in 2005. Similarly the requirement of contract staff has decreased significantly from 67 in 2001 to 7 in 2005. Thus the human resource strategy has paved way to increased value added per employee and improves the overall efficacy of the human capital.



Competitive pressure increasing in both fronts; retail and industrial

To date LLUB is the only player within the lubricants industry able to service both retail and bulk driven market demand while maintaining a fully fledged laboratory and blending facility. However this position is soon changing with Lanka IOC moving towards a blending facility based in Trincomalee and the possibility of another local player (Laughs) entering the business of blending and marketing lubricants in the near future. Thus the new entrants could challenge the dominant position in bulk demand enjoyed by LLUB. During 2006 Lanka IOC has won a tender to supply the Sri Lanka Air Force for a period of six months upon which the supply is open for re-negotiation.

An available competitive tool for the competitors is price penetration. However the management of LLUB is confident that this strategy by the competitors would be unsustainable due to the increasing raw material costs. Nevertheless the competition could create intense pressure on LLUB if they commence operations to blend lubricants locally. Thus in such a scenario the competitive edge for LLUB would arrive via operational efficacy and economies of scope. Furthermore the government policy on revising the tax structure for lubricant imports is unclear. Currently LLUB pays an import duty close to 14% while the other lubricant importers face an import duty of nearly 28% with respect to finished good imports.

Further LLUB would enjoy a competitive edge in respect of distribution even with fully operational blending facility operated by Lanka IOC in Trincomalee. Due to the limitations of the



road network linking Trincomalee with the key locations in the island, the competitor Lanka IOC would be faced with a higher distribution cost compared to LLUB.

Adverse movement of base oil prices and other raw materials

During the past few years world petroleum prices have been on the increase resulting with increasing prices for base oils which is the main raw material component in lubricants blending. However, the adverse raw material price movement is an issue affecting all the global lubricant blenders rather than being limited to LLUB. Therefore the industry is compelled to exploit the inelastic nature of the lubricant products and to pass on the increased cost to the consumers.

Exports; the new frontier though dwarfed by local sales volumes

Though export margins are below that of local sales, LLUB has identified direct regional exporting paving way to sales led growth facilitated by a blending facility with over 60% idle capacity at present. LLUB maintains strong consolidated presence in Maldives supplying half a million litres per annum. The most recent addition to the export portfolio of the company is Bangladesh boasting a lubricants market of 100 million litres per annum.

However LLUB plans to adopt a niche market strategy in Bangladesh with a highly conservative growth target of reaching sales of 3 million litres by end of 2007. The company identifies Bangladesh as a very difficult market to achieve volumes with the established presence of most of the international lubricant brands. Thus LLUB has partnered with the Bangladeshi agent for Toyota Motors and obtained exclusive promotion for its products. Further the country has a substantial LNG market and LLUB with an already existent lubricant for LNG engines is strategising to capture a sizable portion of this market segment. According to the company export sales of LLUB is a negligible 4% of total sales with the potential of significant contributions to overall company sales, 5 – 10 years in future given the niche market strategy implemented in Bangladesh proves successful.

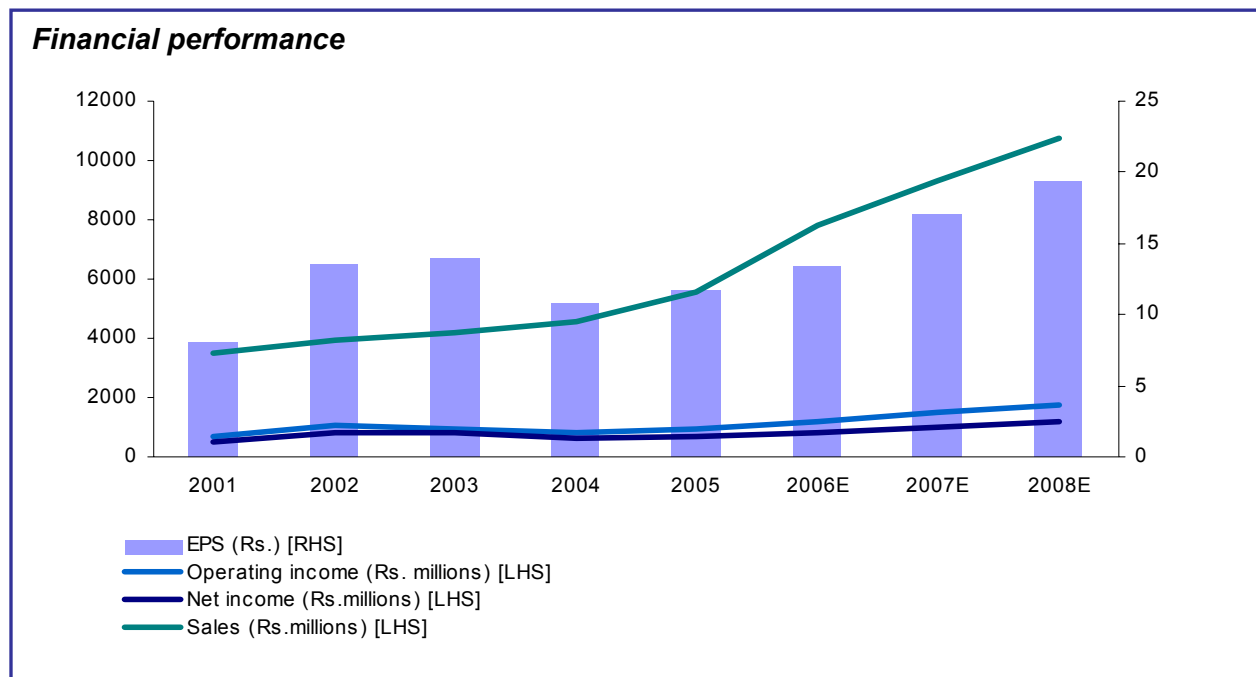
Regulation remains a concern along with increased competition

Sri Lankan government regulates the lubricants market through licensing. Thus regulatory action promoting competition within the industry could adversely affect the market position of LLUB. Therefore government incentives for new entrants could not be ignored in total.

Further, increased promotion and marketing activity for *Servo*® could deter demand for LLUB products. Subsequently with the *Servo*® blending facility in Sri Lanka commencing operations, Lanka IOC could blend lubricants at a lower cost enabling them to further lower prices of *Servo*® compared to products of LLUB. Therefore a significant price differential between competing lubricants could deter sales of LLUB with a move towards cheaper brands.

Valuation and analysis

Despite the volatility revenue, operating income and net income have recorded positive growth during the past few years. Since 2001 revenue, operating income and net income recorded CAGR's of 12%, 8% and 10% respectively. We expect revenue for 2006 to display a YoY growth of 40% largely due to price increases rather than changes in volumes. Revenue increases beyond 2006 is likely to peter out with upward price revisions expected to slow down. Further with both net income and retained earnings expected to hover above the Rs.1 billion mark in 2007, we consider it likely for the company to announce an attractive bonus issue, given its track record and ability to positively impact liquidity of the stock.



We believe LLUB is a dividend play and should be valued accordingly. Therefore we consider the use of Dividend Discount Model (DDM) as the most prudent approach to valuing the stock. Historical dividend payments indicating a high pay-out ratio with YoY growth has enabled us to forecast an 85% pay-out ratio with a 9% dividend CAGR. We believe these assumptions are justifiable given inflation running at 10% and above, the net income CAGR of over 10% and the company policy of returning excess funds to the shareholders.

DDM Valuation

$$\text{Price of stock} = \frac{\text{Expected dividend in 2007}}{(\text{Cost of equity} - \text{dividend growth rate})}$$

Dividend payable for 2007, estimated at Rs.14.45 would be used as the next year's dividend and 9% would be taken as the annual dividend growth rate. However, estimating the cost of equity (ke) would be based on conservative assumptions to overcome the information limitations and the prevailing volatility among interest rates. Therefore ke would be determined using the following formula.



$$k_e = R_f + \text{Beta} * (R_m - R_f)$$

Assumptions;

R_f = 13%
 Risk Premium = 10%
 R_m = 23%
 Beta = 0.79 (CSE)

Based on the above assumptions, k_e = 20.9%

Therefore;

$$\begin{aligned} \text{Price of LLUB} &= \frac{14.45}{0.209 - 0.09} \\ &= \text{Rs.121} \end{aligned}$$

However the stock price would vary depending on the selected k_e rate and dividend growth rate as further illustrated by the table provided below.

Fair value sensitivity to cost of equity and dividend growth

Dividend growth rate	14.0%	371	209	146
	9.0%	162	121	97
	4.0%	104	86	73
	-1.0%	76	66	58
		17.9%	20.9%	23.9%
		k _e		

Therefore given a higher dividend growth rate a sharp upside potential exists for LLUB with a limited downside even with negative dividend growth. For our base fair value, we have considered a highly conservative annual dividend growth rate of 9% which falls below current inflation levels along with a cost of equity of 20.9%. Our one year price target is Rs106 is at a 12% discount to our fair value. Therefore we consider LLUB a buy at Rs.85 with over a 25% price upside within a twelve month horizon and a further dividend yield of close to 15%.

Discounted cash-flow valuation (DCF)

We believe it prudent to use a secondary valuation technique to strengthen the valuation of the stock. Therefore a DCF valuation has been used with WACC of 20.9% and a terminal growth rate of 5%. We have assumed the WACC to be same as the ke, since the company does not have any long term debt exposure. However this is not an efficient Capital Structure for the firm and as a result the WACC should be lower and this could provide further valuation upside.

The DCF valuation brings in an intrinsic value of Rs.123 per share for LLUB. Thus it remains in line with the DDM valuation which indicates significant upside for the stock. Further a sensitivity analysis has been conducted for the DCF valuation as displayed in the table below.

Sensitivity of DCF valuation

		Terminal Growth				
		-1.0%	2.0%	5.0%	8.0%	11.0%
WACC	10.9%	194	246	351	672	-18295
	15.9%	132	152	184	240	364
	20.9%	98	108	123	143	176
	25.9%	78	83	91	101	115
	30.9%	64	67	72	77	85

Financial summary

Income Statement (Rs. millions)	2001	2002	2003	2004	2005	2006E	2007E	2008E
Revenue	3,514	3,932	4,214	4,546	5,560	7,784	9,341	10,742
YoY%	12%	12%	7%	8%	22%	40%	20%	15%
COGS	2,231	2,403	2,745	3,228	4,088	5,916	7,006	8,057
Gross profit	1,282	1,529	1,469	1,317	1,472	1,868	2,335	2,686
Other operating expense / (income)	(8)	(9)	(12)	(18)	(20)	(22)	(24)	(27)
Distribution Costs	294	268	245	262	302	389	467	537
Administration expenses	310	228	278	259	247	311	374	430
Total operating expenses	595	487	511	503	529	679	816	940
Operating profit	687	1,042	958	814	943	1,190	1,519	1,745
YoY%		52%	-8%	-15%	16%	26%	28%	15%
Finance expense / (income)	(109)	(176)	(228)	(78)	(51)	(51)	(51)	(51)
Pre-tax profit	796	1,218	1,186	892	994	1,240	1,570	1,796
Tax expense	315	406	352	245	294	434	549	629
<i>Tax rate%</i>	<i>40%</i>	<i>33%</i>	<i>30%</i>	<i>27%</i>	<i>30%</i>	<i>35%</i>	<i>35%</i>	<i>35%</i>
Net profit	482	812	834	647	700	806	1,020	1,168
YoY%		68%	3%	-22%	8%	15%	27%	14%
Shares outstanding	30	30	60	60	60	60	60	60
Gross dividends	228	369	690	2,040	585	685	867	992
EPS (Basic unadjusted)	16.06	27.06	13.90	10.78	11.67	13.44	17.00	19.46
EPS (adjusted)	8.03	13.53	13.90	10.78	11.67	13.44	17.00	19.46
DPS (unadjusted)	7.60	12.30	11.50	34.00	9.75	11.42	14.45	16.54
DPS (adjusted)	3.80	6.15	11.50	34.00	9.75	11.42	14.45	16.54

Margins	2001	2002	2003	2004	2005	2006E	2007E	2008E
GM%	36%	39%	35%	29%	26%	24%	25%	25%
EBIT%	20%	26%	23%	18%	17%	15%	16%	16%
Net income%	14%	21%	20%	14%	13%	10%	11%	11%

Balance Sheet (Rs. millions)	2001	2002	2003	2004	2005	2006E	2007E	2008E
Total current assets	2,346	3,020	3,392	1,659	2,055	2,735	3,137	3,610
PP&E	496	483	450	468	490	520	553	587
LT receivables	25	15	9	10	28	28	28	28
Total assets	2,866	3,519	3,851	2,138	2,572	3,283	3,717	4,225
Total current liabilities	897	913	1,101	777	1,101	1,692	1,972	2,305
Total liabilities	994	1,054	1,242	922	1,240	1,831	2,111	2,444
Share capital	300	300	600	600	600	600	600	600
Retained earnings	1,573	2,166	2,009	616	732	853	1,006	1,181
Total SE and Liabilities	2,866	3,519	3,851	2,138	2,572	3,283	3,717	4,225

Valuation table	2001	2002	2003	2004	2005	2006E	2007E	2008E
PE(x)	4.7	4.5	5.1	5.9	5.0	6.3	5.0	4.4
DY	10.1%	10.2%	16.7%	51.7%	16.8%	14.5%	17.0%	19.5%
NAVPS (Rs.)	33	43	46	23	25	27	29	32

This document has been prepared and issued on the basis of publicly available information, internally developed data and other sources, believed to be reliable. Capital Alliance Ltd however does not warrant its completeness or accuracy. Capital Alliance Ltd nor any directors, officer, consultants, employees, associates or business partners, shall in anyway be responsible for the contents. Opinions and estimates given constitute our judgment as of the date of the material and are subject to change without notice. The reports and presentation given are not intended as an offer or solicitation for the purchase or sale of any financial instrument. The recipient of this report must make their own independent decision regarding any securities, investments or financial instruments mentioned herein. Securities or financial instruments mentioned may not be suitable to all investors. Capital Alliance Ltd it's employees, its consultants associates and agents will not be responsible, for any claims damages, compensation, suits, damages, loss, costs, charges, expenses, outgoing or payments including attorney's fees which recipients of the reports suffers or incurs directly or indirectly arising out actions taken as a result of this report. This report is for the use of the intended recipient only. Access, disclosure, copying, distribution or reliance on any of it by anyone else is prohibited and may be a criminal offence.