

Date: 5<sup>th</sup> July 2007

## Chevron Lubricants Lanka

**Recommendation**  
**Hold**  
**(Previously Buy)**

**Ticker**  
**LLUB**

**Share Price\***  
**Rs.83.00**

**Market Cap\***  
**Rs.4,979 million**

**52 Week High\***  
**Rs.97.5**

**ASPI\***  
**2539.21**

**MPI\***  
**3503.79**

**Analysts**  
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**Varuni De Zilva**

\*CSE DATA



## Downgrade to Hold due to rise in interest rates

- ◆ We are changing the Buy recommendation we had on LLUB to a Hold recommendation as we believe current long term real interest rates places a major dampener on the prospects for most equity investments including LLUB.
- ◆ The imposition of a cess on base oil has also contained company profitability from what it could have been.
- ◆ However our very positive view of the company's management and the strength of the company's brands has not reversed or deteriorated, but in fact, further improved.
- ◆ Our DCF based base case fair value for the company is now Rs87, and with the dividend yield expected of the counter, we expect the counter to offer investors a total return of around 19% on a 12 month horizon. This does not offer a sufficient premium to the return offered by fixed income instruments.
- ◆ However given that we expect the equity market to fall further in the next 12 months, the counter clearly would outperform the overall market in bearish conditions.
- ◆ Provisions in the new Companies Act could potentially be utilized by the company for a capital repositioning and such actions could however lead to significant value creation beyond that projected and is a factor that could create more upside than we have projected if it were to occur.

Summary	2006	2007E	2008E
Revenue	7,694	9,387	10,513
YoY%	38%	22%	12%
Net profit	807	978	1,060
YoY%	15%	21%	8%
EPS	13.45	16.30	17.66
DPS	9.50	11.41	13.25
P/E	6.17	5.09	4.70
Return on equity	54%	54%	51%
NAPS	26.90	31.71	37.23
DY	11.45%	13.75%	15.96%



## **Downgrade in Recommendation to Hold**

**Not attractive compared to fixed income, though it will outperform in a falling market.**

We are changing our recommendation on Chevron Lubricants Lanka (LLUB) to a Hold from the Buy recommendation we had on the counter previously. A primary reason for the change in recommendation is the continued rise in the long term risk free rate along with a fall in our inflation expectations. Given this, the expected long term real interest rate has now risen to very attractive levels. The discount rate by which we discount the cash flow and dividends from Chevron Lubricants Lanka (LLUB) has also been pushed up with a corresponding decrease in the fundamental valuation of the counter. The downgrade of our view on the counter is very much in line with our overall pessimistic view on equities due to the rise in the risk free rate. We however believe that the counter will still outperform the overall market which is still expected to continue to fall even on a 12 month horizon. The returns we expect from LLUB will however not be attractive compared to what is on offer by fixed income instruments.

**Tax on base oil has led us to revise down our forecasts.**

Furthermore following our original report, a cess of 6% on base oil was imposed, and the impact of the tax has somewhat contained company profitability from what it could have been, therefore we have revised down our forecasts. In our view even more than the specific impact of the tax, the imposition of the tax highlights a future risk that authorities may choose to specifically target industries that are generating high and conspicuous profit figures in absolute terms. The high ROE numbers of LLUB's would work against LLUB as authorities could argue that the company is generating an excessive level of profit. With the downward revision to our forecasts the valuation for the company also comes down further in addition to the impact of higher interest rates.

**Risk of more cautious investor perceptions following opening of Trinco blending plant by LIOC**

Furthermore investors may turn somewhat more cautious with regard to their perceptions of the competitive position of the company, with Lanka IOC opening it's lubricants blending plant in Trinco, in the coming months. LIOC which markets the Servo brand has invested around Rs. 500 million in the manufacturing facility in Trincomalee. In our previous report we had a detailed



discussion of the reasons that the brand recognition and distribution strength of the company would serve to limit market share deterioration. We still maintain the view that the company would retain its dominant position in the market, but news flow related to the market penetration strategies of Lanka IOC may in the immediate term dampen investor sentiment towards LLUB.

**Taxation advantage as sole local blender of lubricants ends.**

The competitive edge on import taxation LLUB enjoyed as the sole local blender of lubricants will come to an end with the commencement of operations at the LIOC plant. LLUB enjoyed a significant tax advantage as the sole manufacturer compared to all the other players who imported their products as finished goods. Furthermore given that the Lanka IOC cost structure would improve, competitive pressure should result in some reduction to the gross margins of LLUB in the coming years. At the beginning of the year the government also announced the approval for 5 more entrants into the lubricant market. These were Bharat Petroleum of India, Gulf Oil International of the United Kingdom, French companies Mobil and Total S.A., and Sinopec of China. We don't expect the new entrants to pose a significant threat to LLUB market position and has a much lower impact than the risks related to Lanka IOC opening a blending plant. It however does indicate a tougher market environment for LLUB than previously.

**Thus we downgrade to hold with a fair value of Rs87.**

With this possible rise in risk perceptions along with a now relatively unattractive dividend yield compared to fixed income instruments, we no longer recommend Buy on the counter. Our fair value of the counter, based on a DCF ( discussed later ) is Rs87 . Even if this were to be realised on a 12 month horizon it translates to a total return including dividends of around 19% which just matching that available in fixed income returns with less volatility. The premium over fixed income does not sufficiently compensate investors for new buying into the counter. However given that we expect the market to fall further in the short to medium term, the counter clearly would outperform the rest of the market in bearish market conditions, and as such within a Sri Lanka Equity portfolio LLUB could at an overweight position.



## Original recommendation Summary

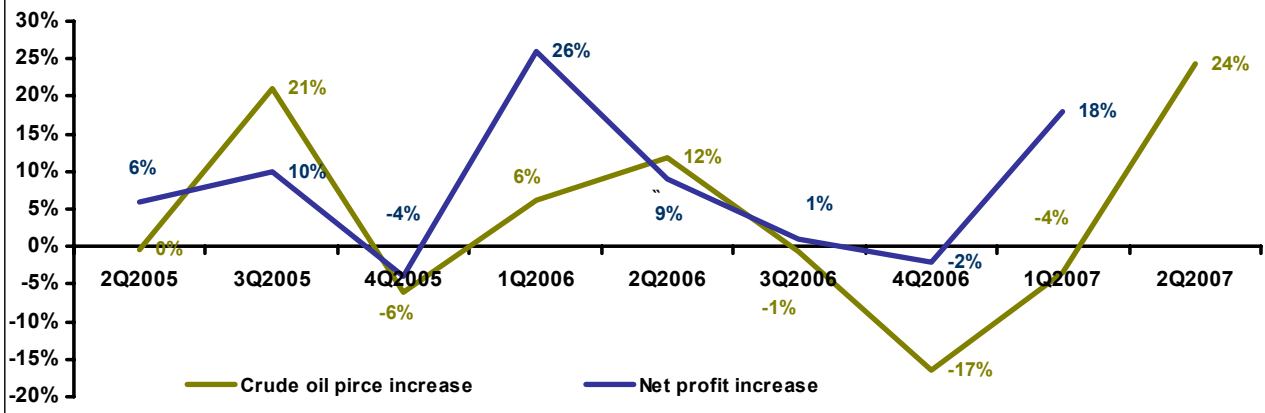
On 26<sup>th</sup> October 2006 we initiated coverage of Chevron Lubricant with a Buy recommendation at a price of Rs.84.50. Since that point the market has risen by meagre 1.2% and though LLUB has fallen in price to Rs83 including dividends paid during the period has returned investors 3.6%.

We were bullish on the counter as we felt that there was limited risk from new entrants to the lubricant market, with LLUB holding 85% of the local market with a strong hold on distribution channels, with the bulk of the lubricant sales of the company being 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.

None of our arguments about the competitive position of the company with regard to the competition has changed though there has been a downward revision to our forecasts on account on the tax on base oil that was introduced. Our very positive view of the company's management and its brand strength has in fact strengthened given the continued dominance that have displayed in the market. Our fundamental downgrade of the counter remains on account of our pessimistic view on valuations on account of the much higher interest rates and the impact and implications of the base oil tax.

Below is a graph that shows how the company been able to deal with rising crude oil prices which we have used as a rough proxy for base oil prices. Actual base oil price movements relative to crude oil are impacted by refining capacity issues and in recent months this has proved to be more favourable than previously.

**Crude oil price increase Vs Net profit increase(QoQ)**



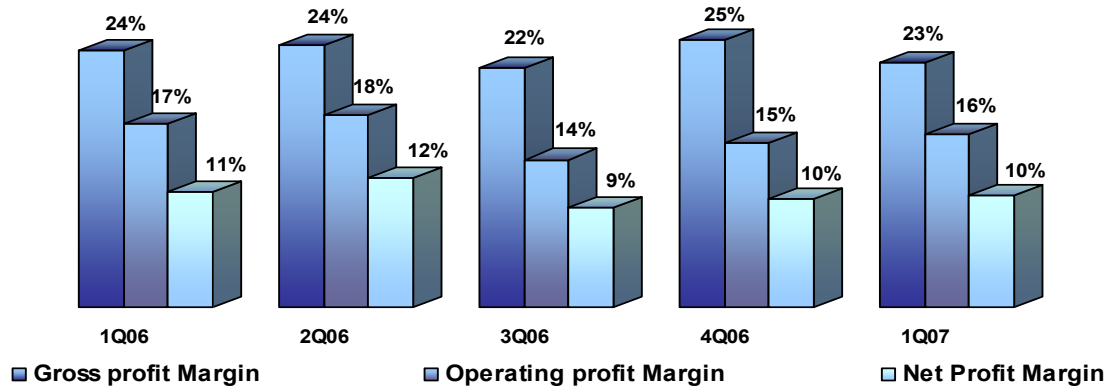
## Recent Results

### Performance for the three months ended 31<sup>st</sup> March 2007

For the quarter ended 31<sup>st</sup> March 2007 the company managed to increase its revenue by 28 % YOY to reach Rs.526 million. The gross profit for the quarter ended, was Rs.526 million which is an increase of 22% YOY. Gross profit margin for the quarter ended was at 23% which is slightly lower than the gross profit margin of 24% the company enjoyed for the previous financial year.

The operating profit for the quarter ended improved by 21 % YOY to reach Rs.155 million. The operating profit margin was 16%. The company has witnessed a significant increase in distribution expenses over the past four quarters. Compared to the 1Q2006, the distribution expenses have increased by 51%. As the distribution expenses increased the company's operating profit margin has declined from 17% in 1Q 2006 to 16 % in 1Q 2007.

The net profit of the company improved by 24% YOY to reach Rs.239 million. This represented a net profit margin of 10.4% which is more or less equal to the average net profit margin the company achieved for the last financial year.



Income Statement (Rs. millions)	1Q06	2Q06	3Q06	4Q06	1Q07
Revenue	1,801	1,965	1,982	1,946	2,305
YoY%	41%	45%	33%	36%	28%
COGS	1,370	1,487	1,540	1,461	1,779
<b>Gross profit</b>	<b>431</b>	<b>478</b>	<b>442</b>	<b>485</b>	<b>526</b>
GM%	24%	24%	22%	25%	23%
YoY%	7%	21%	28%	-67%	22%
<b>Operating profit</b>	<b>306</b>	<b>351</b>	<b>272</b>	<b>298</b>	<b>371</b>
OM%	17%	18%	14%	15%	16%
YoY%	6%	12%	42%	5%	21%
<b>Net profit</b>	<b>193</b>	<b>237</b>	<b>183</b>	<b>195</b>	<b>239</b>
NP %	11%	12%	9%	10%	10.4%
YoY%	20%	13%	-9%	51%	24%
EPS	3.22	3.94	3.05	3.25	3.99

### Specific Details of Change in Forecasts

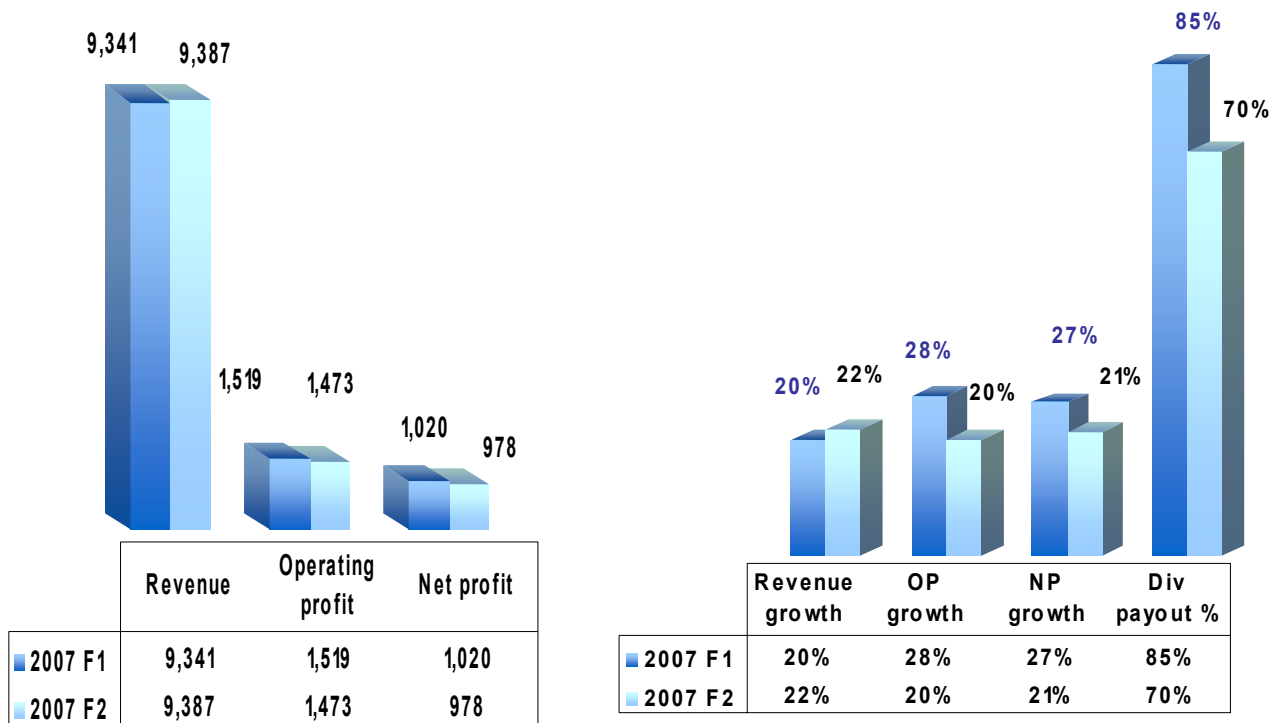
We have changed our forecast on revenue growth from 20% to 22% in 2007 to take into account the price increases for the company's products since the last report, that have come above our expectations. In terms of margins, for YE 2006 the company managed to achieve a gross profit margin of 24%. The gross profit margin witnessed a slight drop during 1Q 2007 to 23%. However we believe that with the price increases the company made during June the company will manage



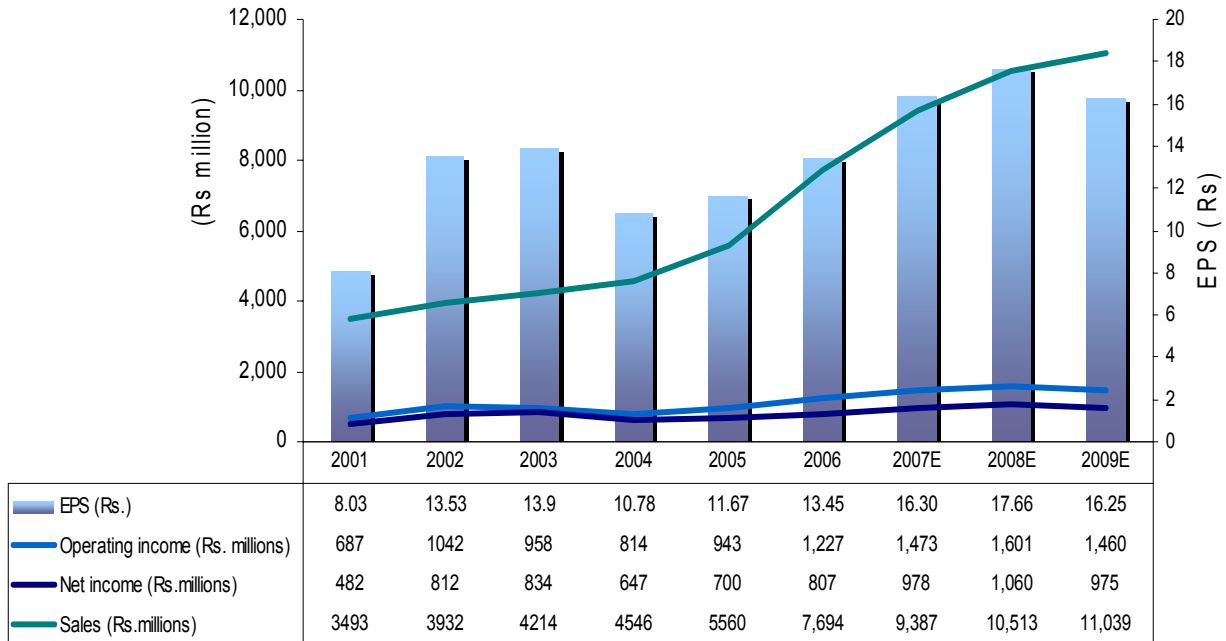
to increase their gross profit margin from 23% achieved in 1Q 2007. As such our full year forecast for Gross Margins in 2007 is 24.5%. This however is less than our earlier forecast of 25% as we have taken into account the impact of the increase in the base oil tax and the increase in the Port and Airport levy from 2.5 % to 3 % with effect from January. The overall favorable trends in base oil price levels this year relative to crude oil is a factor we have considered and has mitigated the impact of the tax but the overall impact compared to our original forecasts has been negative. However the continued competitive strengths and abilities of its management team are seen in the fact that Gross Margins will rise this year despite the rise in taxation though the rise is less than what we anticipated.

**29%YoY growth expected for Net Profit in 2008 but a 4% fall from our original forecast**

We expect the Net profit of the company to reach Rs978m which would represents a YOY growth of 29% and a net profit margin of 11% which is slightly higher than the net profit margin the company achieved during the previous year which was 10.5%. This is however less than the previous Net Profit forecast of Rs1020m.



### Revised Forecast



## Valuation change

### DDM Valuation

In our previous report on LLUB we calculated a valuation for LLUB using a one stage dividend discount model. Since that report the Risk free return which we assumed to be equivalent to the long term Treasury bond rate has increased significantly from 13% to 15.30%. Furthermore we have revised down our forecast on dividend pay out ratio in 2007 of the company from 85% to 70 % in view of the fact that the dividend payout ratio for the year ended 2006 was reduced to 71% from 84 % in 2005.

Given the reduced payout ratio and fall in our profit projection for 2007, our dividend projection for 2007 is now Rs11.4 compared to Rs14.4 previously.

For our valuation we continue to use a risk premium of 10% and a beta of 0.79. We assume a dividend growth rate of 11%. Under the new assumptions on the risk free rate and the new dividend expectation the value of the company in the simple one stage DDM comes to Rs94.

$$\text{Value based on one stage DDM} = \frac{\text{Dividend for 2007}}{\text{Cost of equity} - \text{Dividend growth rate}}$$

$$\text{Cost of equity} \rightarrow Ke = Rf + B(Rp)$$

Assumptions

- $Rf \rightarrow$  Treasury Bond rate of 15.30%
- Risk Premium is 10%
- Beta is 0.79

$$Ke = 15.30\% + 0.79(10\%)$$

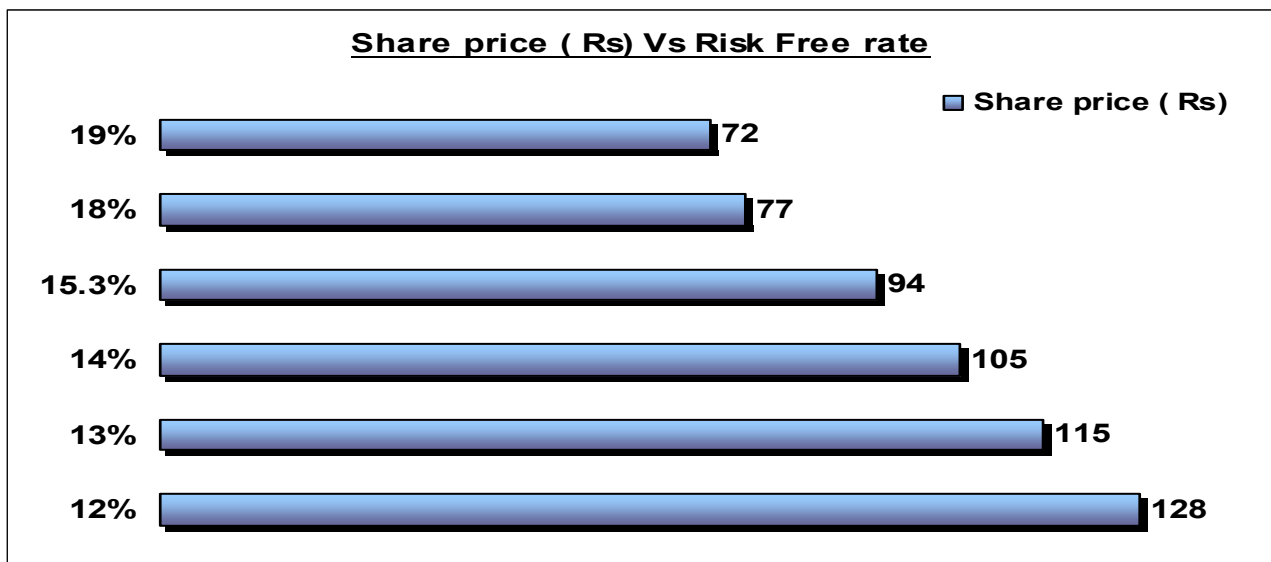
$$= \underline{23.2\%}$$

$$\text{Dividend growth rate} \rightarrow 11\%$$

$$= \frac{11.41}{23.2\% - 11\%}$$

$$= \underline{\text{Rs.93.55}}$$

Below is a depiction of the valuation under different risk free rates. Clearly under the old risk free rate the valuation under this DDM of the counter would have been Rs105 compared to Rs93.55 even with the revised forecasts.



The 10% risk premium for the counter may be considered unattractive as may be the long term forecast growth so a table of sensitivity to the overall discount rate and forecast growth is also provided for investors who may prefer to see the valuation under different assumptions to our forecasts. Clearly an investor who believes the company can continue to grow dividends of 15% in may see company as been worth Rs139 under a one stage DDM valuation.

<b>Sensitivity of DDM valuation</b>							
<b>Dividend growth rate</b>	<b>R<sub>f</sub></b>						
	<b>7%</b>	<b>12%</b>	<b>13%</b>	<b>14%</b>	<b>15.3%</b>	<b>18%</b>	<b>19%</b>
<b>7%</b>	88	82	77	70	60	57	
<b>9%</b>	105	96	88	80	68	64	
<b>11%</b>	128	115	105	94	77	72	
<b>13%</b>	165	144	128	112	88	82	
<b>15%</b>	233	193	165	139	105	96	

### Discounted cash-flow valuation (DCF)

Given the sensitivity to dividend growth and the fact that a one stage dividend discount model could be simplistic we prefer to use a DCF valuation of the counter, forecasting specific cash flows up-to 2015 and taking a terminal growth rate from that point.

Our DCF valuation is the same as a Free Cash Flow to Equity valuation as we have assumed zero debt and as such the WACC works out the same as the Cost of Equity. However we have maintained it as a DCF, to later be in a position to calculate the upside if the company chooses to gear itself up, reduce it's WACC and avail itself of the tax shield on debt. The new Companies Act and share buy back options may increase the attractiveness of such a capital repositioning and such actions could lead to significant value creation for shareholders and could raise the fair value of the company and make our Hold recommendation pessimistic.

However on the basis of the current capital structure with an assumption of a terminal growth rate in earning of 11% beyond 2015, we arrive at a valuation of Rs.87 for the company. The table below gives an indication of further sensitivities in our DCF assumptions. It is the Rs87 that we take as

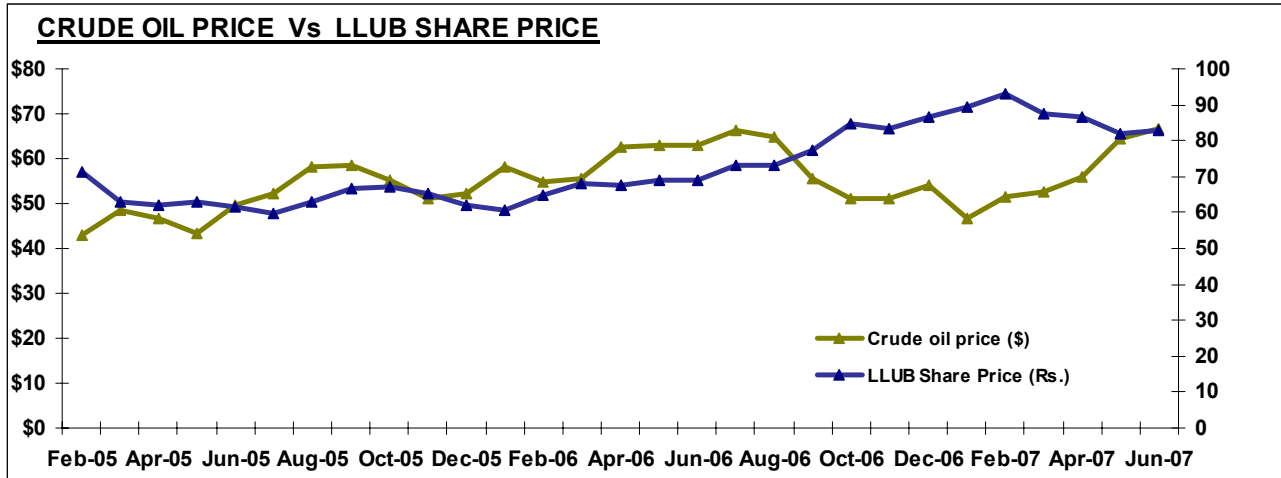


the 12 month forward target price for the company. The table below provides an indication of the DCF values under varied assumptions on the WACC as well as the terminal growth rate.

Sensitivity of DCF valuation						
Terminal growth rate	WACC					
	19.9%	20.90%	23.20%	24%	25%	26%
-1%	83	79	70	68	65	62
5%	93	87	76	72	69	65
8%	102	94	80	76	72	68
11%	116	105	87	82	77	72
13%	133	117	93	87	81	76
15%	163	138	103	95	87	80

Income Statement (Rs. millions)	2001	2002	2003	2004	2005	2006	2007E	2008E
Revenue	3,514	3,932	4,214	4,546	5,560	7,694	9,387	10,513
YoY%	12%	12%	7%	8%	22%	38%	22%	12%
COGS	2,231	2,403	2,745	3,228	4,088	5,858	7,087	7,990
<b>Gross profit</b>	<b>1,282</b>	<b>1,529</b>	<b>1,469</b>	<b>1,317</b>	<b>1,472</b>	<b>1,836</b>	<b>2,300</b>	<b>2,523</b>
GM%	36%	39%	35%	29%	26%	24%	25%	24%
Other operating expense / (income)	(8)	(9)	(12)	(18)	(20)	(5)	(3)	(3)
Distribution Costs	294	268	245	262	302	324	469	526
Administration expenses	310	228	278	259	247	291	361	399
<b>Total operating expenses</b>	<b>595</b>	<b>487</b>	<b>511</b>	<b>503</b>	<b>529</b>	<b>610</b>	<b>827</b>	<b>922</b>
<b>Operating profit</b>	<b>687</b>	<b>1,042</b>	<b>958</b>	<b>814</b>	<b>943</b>	<b>1,227</b>	<b>1,473</b>	<b>1,601</b>
YoY%		52%	-8%	-15%	16%	30%	20%	9%
Finance expense / (income)	(109)	(176)	(228)	(78)	(51)	(19)	(32)	(29)
<b>Pre-tax profit</b>	<b>796</b>	<b>1,218</b>	<b>1,186</b>	<b>892</b>	<b>994</b>	<b>1,246</b>	<b>1,505</b>	<b>1,630</b>
Tax expense	315	406	352	245	294	439	527	571
Tax rate%	40%	33%	30%	27%	30%	35%	35%	35%
<b>Net profit</b>	<b>482</b>	<b>812</b>	<b>834</b>	<b>647</b>	<b>700</b>	<b>807</b>	<b>978</b>	<b>1,060</b>
YoY%		68%	3%	-22%	8%	15%	21%	8%
Shares outstanding	30	30	60	60	60	60	60	60
Gross dividends	228	369	690	2,040	585	570	685	795
EPS (Basic unadjusted)	16.06	27.06	13.90	10.78	11.67	13.45	16.30	17.66
<b>EPS (adjusted)</b>	<b>8.03</b>	<b>13.53</b>	<b>13.90</b>	<b>10.78</b>	<b>11.67</b>	<b>13.45</b>	<b>16.30</b>	<b>17.66</b>
DPS (unadjusted)	7.60	12.30	11.50	34.00	9.75	9.50	11.41	13.25
<b>DPS (adjusted)</b>	<b>3.80</b>	<b>6.15</b>	<b>11.50</b>	<b>34.00</b>	<b>9.75</b>	<b>9.50</b>	<b>11.41</b>	<b>13.25</b>

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



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