Date: 30th October 2007

# Chevron Lubricants Lanka

# Upgrade to Buy on Strong Margin Improvement

**Recommendation**
**Buy**
**(Previously hold)**

**Ticker**
**LLUB**

**Share Price***
**Rs.84.25**

**Market Cap***
**Rs.5055 million**

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

**ASPI***
**2614.73**

**MPI***
**3522.24**

**Analysts**
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*CSE DATA

- We are changing the Hold recommendation we had on LLUB to a Buy recommendation given the sharp improvement seen in Gross Margins in the third quarter.

- We have upgraded our forecasts for the counter and our DCF based fair value is now Rs90, and with dividends projected over the next twelve months, the counter offers investors a total return of 23.2%.

- This return in our view matches what investor should require as a premium over fixed income instruments and as such we are upgrading our recommendation.

- The counter will also clearly outperform a bearish equity market with a dividend yield of over 16%.

- Provisions in the new Companies Act could potentially be utilized by the company for a capital repositioning and such actions could 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.

- A key risk is that the government could again look to tax the industry specifically given its very visible profitability.

# Upgrade in Recommendation to Buy

## Gross Margins improve, pushing up profitability.

We are changing our recommendation on Chevron Lubricants Lanka (LLUB) to a Buy from the Hold recommendation we had on the counter previously. A primary reason for the change in recommendation is the improvement in the Gross Profit margin seen in the third quarter as well as some indications of a higher dividend payout.

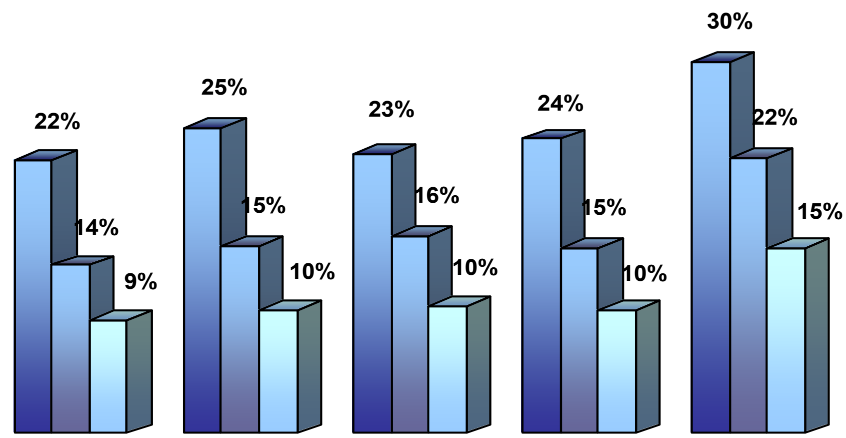
## Recent Results

**Performance for the three months ended 30th September 2007**

For the quarter ended 30th September 2007 the company's revenue rose by a mere 8% YoY to reach Rs.2,149 million. The gross profit for the period ended, was Rs.653 million, an impressive 48% YoY rise, while the Gross Margin rose to 30% from last years Gross Margin of 24%

The operating profit for the three months ended rose by 78% YoY to reach Rs.483 million. The operating profit margin was 22%YoY. The Distribution costs and Administrative Expenses continued to be at similar levels YoY, and stood at Rs.92 million and Rs.82 million respectively.

All of this led to LLUB's net profit growing by 78% YoY, a marked improvement compared to the previous quarters, to reach Rs.325 million. This represented a net profit margin of 15.1% which is ahead of 2006's quarter margins as well.




| | 3Q06 | 4Q06 | 1Q07 | 2Q07 | 3Q07 |
|---|---|---|---|---|---|
| GP Margin | 22% | 25% | 23% | 24% | 30% |
| OP Margin | 14% | 15% | 16% | 15% | 22% |
| NP Margin | 9% | 10% | 10% | 10% | 15% |

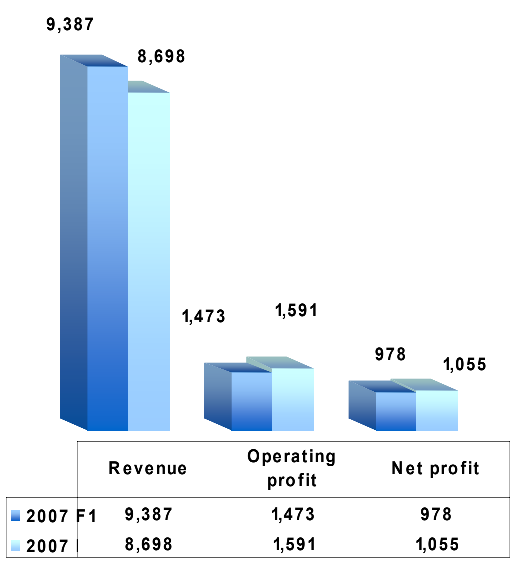
| **Income Statement** *(Rs. millions)* | 3Q06 | 4Q06 | 1Q07 | 2Q07 | 3Q07 |
|---|---|---|---|---|---|
| Revenue | 1,982 | 1,946 | 2,305 | 2,103 | 2,149 |
| YoY% | 33% | 36% | 28% | 7% | 8% |
| COGS | 1,540 | 1,461 | 1,779 | 1,597 | 1,496 |
| **Gross profit** | **442** | **485** | **526** | **506** | **653** |
| GM% | 22% | 25% | 23% | 24% | 30% |
| YoY% | 28% | -67% | 22% | 6% | 48% |
| **Operating profit** | **272** | **298** | **371** | **318** | **483** |
| OM% | 14% | 15% | 16% | 15% | 22% |
| YoY% | 42% | 5% | 21% | -9% | 78% |
| **Net profit** | **183** | **195** | **239** | **212** | **325** |
| **NP %** | **9%** | **10%** | **10.4%** | **10.1%** | **15.1%** |
| **YoY%** | **-9%** | **51%** | **24%** | **-10%** | **78%** |
| **EPS** | **3.05** | **3.25** | **3.99** | **3.54** | **5.41** |

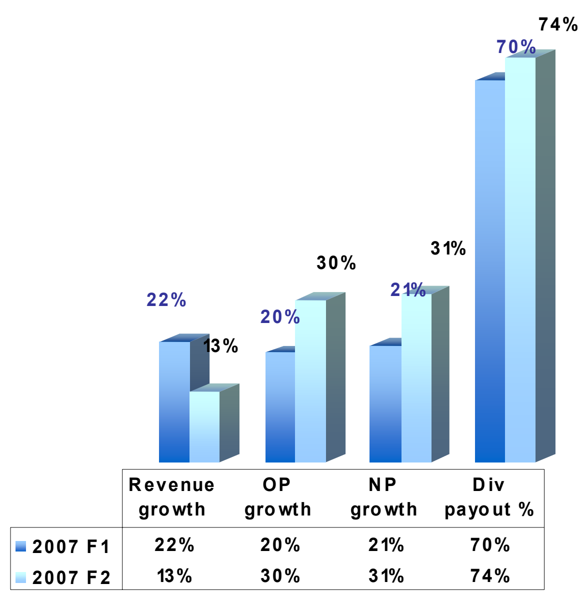
# Upgrade in Earnings Forecast

The company has managed to improve the margins significantly, resulting in higher profitability than our forecast. The main reason the company cited for this, was the higher proportion of premium brands' contribution to the sales mix, thus improving the gross margins. Further the base oil prices have been under control although the crude oil prices have sky rocketed.

Also, the management has proven that they are competent to manage the operating cost prudently as administration expenses and distribution expenses of the company have remained at a constant percentage of the revenue at a period of high inflation.

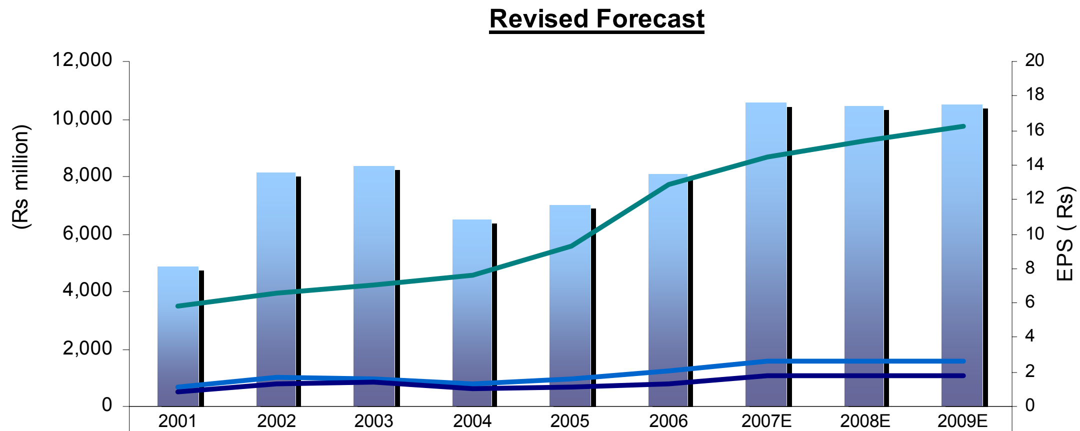
However we are compelled to lower our previous revenue growth forecast of 22%, as the revenue growth for the 9 month period ended 30 September 2007 is only 14% compared to last year's revenue. The lower then expected revenue growth was mainly due to a low growth in volume, which the company mentioned that remained flat.




***F1**-5th July2007 Forecast*

***F2**-30th October 2007 forecast*




| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007E | 2008E | 2009E |
|---|---|---|---|---|---|---|---|---|---|
| EPS (Rs.) | 8.03 | 13.53 | 13.9 | 10.78 | 11.67 | 13.45 | 17.58 | 17.42 | 17.51 |
| Operating income (Rs. millions) | 687 | 1042 | 958 | 814 | 943 | 1,227 | 1,591 | 1,579 | 1,575 |
| Net income (Rs.millions) | 482 | 812 | 834 | 647 | 700 | 807 | 1,055 | 1,045 | 1,051 |
| Sales (Rs.millions) | 3493 | 3932 | 4214 | 4546 | 5560 | 7,694 | 8,698 | 9,220 | 9,773 |

# Valuation change

**Discounted cash-flow valuation (DCF)**

Given the sensitivity to dividend growth we continued 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 of Free Cash Flow to the Firm (FCFF) is the same as a Free Cash Flow to Equity (FCFE) 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 FCFF 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. Compared to our previous base case value of Rs87 in July, our new base case valuation with the new forecasts is Rs90.

**New DCF Sensitivity table**

| Sensitivty of DCF valuation | | | | | | |
|---|---|---|---|---|---|---|
| | WACC | | | | | |
| Terminal growth rate | 20.90% | 22.00% | 23.20% | 24% | 25% | 26% |
| -1% | 80 | 76 | 72 | 69 | 66 | 63 |
| 5% | 89 | 83 | 78 | 75 | 71 | 68 |
| 8% | 97 | 89 | 83 | 79 | 75 | 71 |
| 11% | 109 | 99 | 90 | 85 | 80 | 75 |
| 13% | 123 | 109 | 98 | 92 | 85 | 79 |
| 15% | 145 | 125 | 109 | 100 | 92 | 85 |

**July 5th DCF Sensitivity table**

| Sensitivty of DCF valuation | | | | | | |
|---|---|---|---|---|---|---|
| | WACC | | | | | |
| Terminal growth rate | 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 |

**Thus we upgrade to buy with a fair value Rs90.**

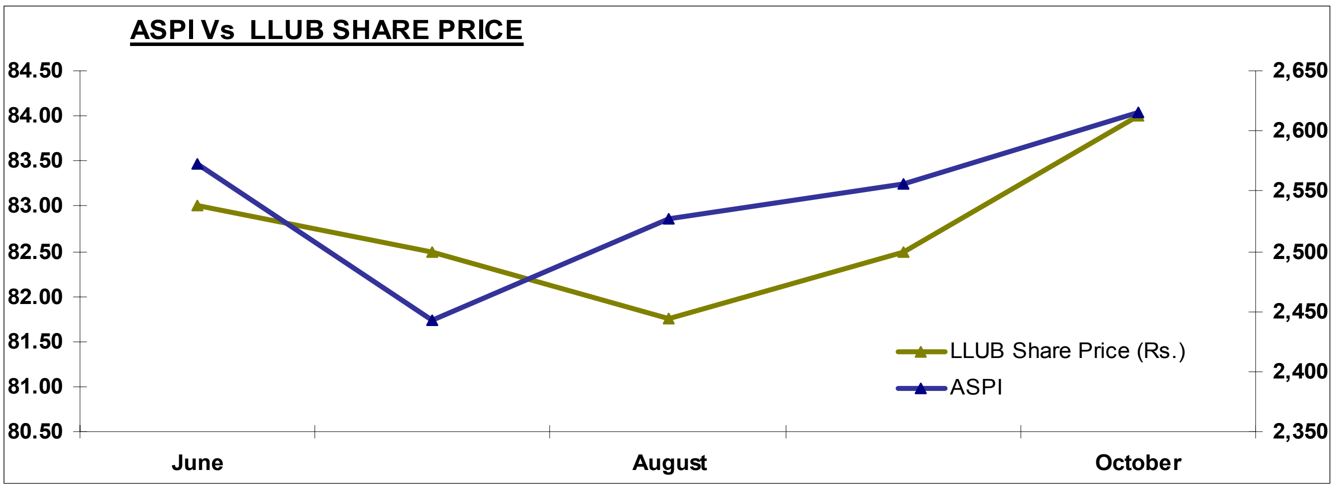
With an upgrade to our dividend forecasts and a revised fair value of Rs90, we believe the counter on a twelve month horizon can offer investor a total return of 23.2% which matches the required return on equity. We are therefore upgrading the counter to a Buy.

## Prior recommendations Summary

On 26th October 2006 we initiated coverage of Chevron Lubricant with a Buy recommendation at a price of Rs.84.50. However with rising interest rates, we downgraded our recommendation to a Hold on July 5th 2007, as we felt that though LLUB offered investors a total return of around 19% on a 12 month horizon, even this return did not offer a sufficient premium to the return offered by fixed income instruments, though we expected the counter to continue to outperform the market.

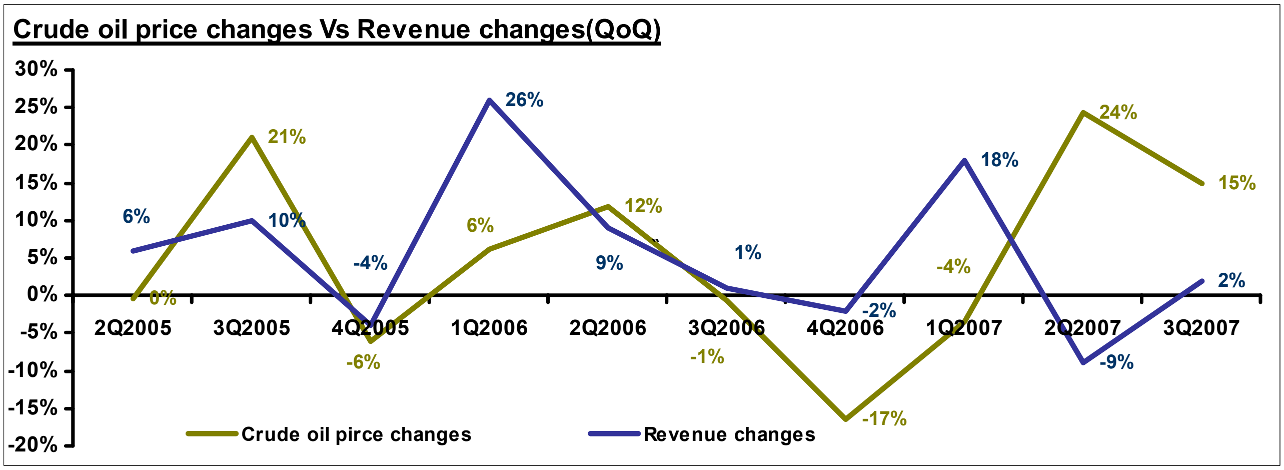
From our original Buy recommendation on 26th October 2006 to July 5th 2007, the market had risen by meagre 1.2% and though LLUB had fallen in price to Rs83 by July 5th 2007, including dividends paid during the period it had returned investors 3.6%.

From July 5th 2007, to date, the counter has given a total return of 5.1% slightly lower than that achieved in fixed income, though it continued to outperform an equity market which rose by only 3% in the period.

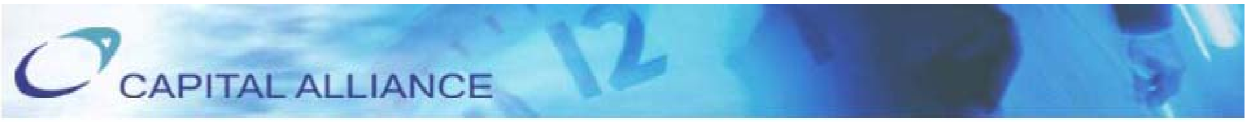


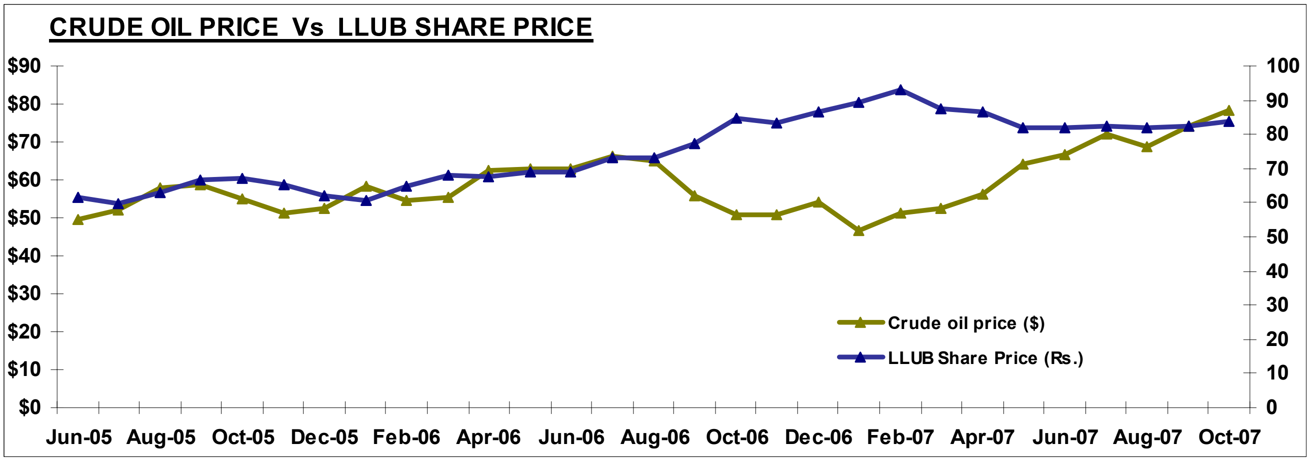

*Note: As at 29th of October*

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.




| 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 | 6,946 | 7,885 |
| **Gross profit** | **1,282** | **1,529** | **1,469** | **1,317** | **1,472** | **1,836** | **2,441** | **2,628** |
| *GM%* | *36%* | *39%* | *35%* | *29%* | *26%* | *24%* | *26.0%* | *25%* |
| Other operating expense / (income) | -8 | -9 | -12 | -18 | -20 | -5 | -3 | -3 |
| Disti Costs | 294 | 268 | 245 | 262 | 302 | 324 | 469 | 526 |
| Admin expenses | 310 | 228 | 278 | 259 | 247 | 291 | 361 | 399 |
| **Total operating expenses** | **595** | **487** | **511** | **503** | **529** | **610** | **827** | **922** |
| **Operating profit** | **687** | **1,042** | **958** | **814** | **943** | **1,227** | **1,614** | **1,707** |
| *EBIT%* | *20%* | *26%* | *23%* | *18%* | *17%* | *16%* | *17%* | *16%* |
| *YoY%* | | *52%* | *-8%* | *-15%* | *16%* | *30%* | *32%* | *6%* |
| Finance expense / (income) | -109 | -176 | -228 | -78 | -51 | -19 | -32 | -29 |
| **Pre-tax profit** | **796** | **1,218** | **1,186** | **892** | **994** | **1,246** | **1,646** | **1,735** |
| Tax expense | 315 | 406 | 352 | 245 | 294 | 439 | 576 | 607 |
| *Tax rate%* | *40%* | *33%* | *30%* | *27%* | *30%* | *35%* | *35%* | *35%* |
| **Net profit** | **482** | **812** | **834** | **647** | **700** | **807** | **1,069.81** | **1,128** |
| *YoY%* | | *68%* | *3%* | *-22%* | *8%* | *15%* | *33%* | *5%* |
| *Shares outstanding* | 30 | 30 | 60 | 60 | 60 | 60 | 60 | 60 |
| *Gross dividends* | 228 | 369 | 690 | 2,040 | 585 | 570 | 748.87 | 846 |
| EPS (Basic unadjusted) | 16.06 | 27.06 | 13.90 | 10.78 | 11.67 | 13.45 | 17.83 | 18.80 |
| **EPS (adjusted)** | **8.03** | **13.53** | **13.90** | **10.78** | **11.67** | **13.45** | **17.83** | **18.80** |
| **DPS (unadjusted)** | 7.60 | 12.30 | 11.50 | 34.00 | 9.75 | 9.50 | 12.48 | 14.10 |
| **DPS (adjusted)** | **3.80** | **6.15** | **11.50** | **34.00** | **9.75** | **9.50** | **12.48** | **14.10** |

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