

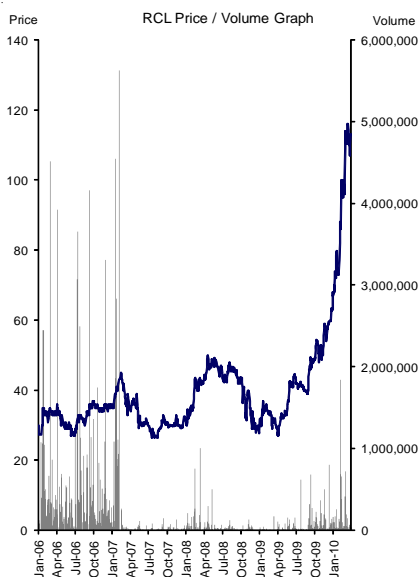


Royal Ceramics Lanka PLC (RCL)

Rs 113.00

BUY

RCL				Fiscal year	Earnings (Rs.m)	EPS (Rs)	EPS Growth (%)	PER (X)	P/BV (x)	ROE (%)
Reuters Code	RCL.CM									
Bloomberg Code	RCL.SL			2008	610.79	11.03	85.63	10.25	1.88	23.02
Share Price LKR	113.00			2009	517.88	9.35	(15.21)	12.09	1.72	19.52
Issued Share Capital (Shares)	55,394,692			2010E	924.87	16.70	78.59	6.77	1.40	30.22
12 mth High/Low (Rs.)	100.00 / 28.00			2011E	1,122.78	20.27	21.40	5.58	1.13	29.88
Average Daily Volume	36,762			2012E	1,408.14	25.42	25.42	4.45	0.90	30.27
Market Capitalisation Rs. mn	6,260			2013E	1,780.86	32.15	26.47	3.51	0.71	30.53
Price Performance (%)	1 mth	6 mth	12mth							
ASPI	2.19	27.85	127.38							
TILE.N	12.16	131.79	289.66							



Royal Ceramics is the current market leader in porcelain and ceramic floor tiles with an estimated market share of 40%. The company has two production facilities at Eheliyagoda and Horana which have a capacity of 11,000 square meters a day. Of the two facilities, Eheliyagoda produces only porcelain tiles with a capacity of 3,500 square meters.

The government doubling the minimum tariff applicable to ceramic tile imports to Rs. 200 per square meter from the previous Rs. 100 per square meter has also helped local producers immensely and the company even estimates that the share of mostly Chinese imports for the total market may have dropped by as much as 50%.

Industry

The long awaited post-war economic boost is estimated by the Central Bank to double per capita income to US\$4,000 by 2014. The resulting higher living standards should boost overall housing unit growth and remodeling along with the broader construction sector. Royal Ceramics should also greatly benefit from the opening up of the North and East markets. We expect this demand to kick in only after FY2011 as tiling and bathware stages for retail construction would only kick in after a significant time lag.

We estimate tile industry growth at 15-20% pace for floor tiles and 9-10% for wall tiles. The total market for floor tiles is estimated at 12.5m square meters per annum or Rs.13.5bn with growth rates in the past five

years averaging 6-7%. The wall tile market is estimated at 5m square meters per annum or Rs.4.8-5.0bn a year.

Tile industry sales have traditionally been dominated by the Western and Southern provinces, with demand of at least 60-70% of volumes. With an imminent construction boom expected in the North and East (which has traditionally accounted for at least 15% of the country's GDP) we expect RCL to benefit from not only state sponsored rebuilding projects but also retail construction.

The average consumption of 0.6 square meter demonstrates the potential of the market when taking into account other averages like China (2 square meters per person), Europe (5 to 6 square meters per person) or Brazil (2.5 square meters per person). Averages tend to be boosted by larger scale construction which would follow with higher income levels.

Bathware

The company's factory which currently has a rated annual capacity of 250,000 pieces per annum is located in Panagoda and has a 90 cubic metre kiln, automated driers and glazing lines. Investment in the facility came to Rs.1.8bn. Production technology and bathware designs are from Italy. Products start at a price around Rs.20,000 and go up to Rs.80,000 targetting the middle and upper end of the market- the strategy being not to compete with cheaper Chinese and Indian products. The Rocell branding strategy of marketing tiles as lifestyle

trappings instead of generic building materials has been extended to bathware as well. This also however means that the product is not competing on a price advantage and margins are possibly lower than the tile business with raw materials like clay for sanitaryware even imported from locations like Britain.

The facility is currently operating at 65% capacity and as of December made PBT earnings of Rs.13.0m. Management states that many of the expected overheads are absorbed by the existing sales infrastructure and believes they have already captured 25% of the domestic market. The size of the bathware market is estimated at around 600,000 pieces a year, including the market for squatting pans which is around 175,000 pieces a year.

Rocell competes with brands such as Kohler, American Standard and Toto. The market had previously been dominated by imports and market shares were fragmented with no single dominant supplier. The duty percentage on bathware pieces is 28% along with a Rs.125 per kg cess.

Tiles

Royal Ceramics produces around 11,000-12,000 square meters of tiles. Along with the 3,500-4,000 porcelain capacity of Eheliyagoda another 15% of the Horana production is also glazed porcelain. Both factories are currently operating at 80% of capacity. Royal Ceramics is the main local producer of porcelain tiles which are higher value added products and provide higher margins. Porcelain tiles are prepared from a clay mixture that provides a very dense body tile. It is impervious to moisture with low absorption rates of less than 3% to 0.5% depending on the quality of the tile.

Royal Ceramics has benefited from using a direct network of company owned showrooms as their main distribution channel. Currently they have 41 showrooms but do not anticipate a substantial increase in this number.

Expansion Plans

The company had initially planned investments in their 33 acre property in Kiriwaththuduwa for a new porcelain tile factory with a capacity of 10,000 sq meters as well as subsidiary involved in roofing material manufacturing that were deferred due to the economic downturn. We expect work on the tile facility to commence in late FY11. Additionally the planned eventual capacity for the bathware production facility is 500,000 pieces. A substantial proportion of this will be earmarked for export.

3QFY10 Performance

RCL's 3Q earnings were up 124.3% on the back of a 30% growth in net revenue. GP margins were up to 48.4% from 44.0% last year while also sequentially up from 2Q's GP margin of 46.1%. Net margins were also up significantly to 26.3% for the quarter from last year's 15.2%.

Distribution expenses were only up 6.2% although admin expenses were up 94.2%. Finance expenses were down 32.0% from the year before. Inventories were essentially flat with a 1.81% increase over last year although they have decreased sequentially from the 2Q by 6.6%. Long-term debt has reduced by 19.6% YoY while short term debt has reduced by 14.5% YoY.



Valuations

We expect RCL to make Rs.925m in earnings for the current FY10 year which would be a growth of 78.6%. We subsequently expect earnings to grow over the next three years at a 24.4% CAGR on the back of a 22.0% three year revenue growth CAGR. Admin and distribution expenses are expected to grow at an average of 12.9% and net margins are expected to stay essentially flat over the period. We feel that the expected increased economic growth in post-war Sri Lanka will see a boost in retail construction as well as larger scale construction of projects like shopping malls and condominiums.

Despite the share outperforming the broader market in the last year we feel that valuations have not really improved much when looking at earnings multiples. We strongly believe that the company should trade at a premium to the market considering their prospects for earnings growth. RCL's forward multiples stand at 5.6x FY11E earnings (compared to a market earnings multiple of 12x FY11) which we feel is an unwarranted discount. **BUY.**



Profit & Loss Statement	2008	2009	2010E	2011E	2012E	2013E
For the year ended 31st March	Rs. mn	Rs. mn	Rs. mn	Rs. mn	Rs. mn	Rs. mn
Revenue	3,475	3,741	4,302	5,335	6,509	7,810
Cost of sales	(2,002)	(2,098)	(2,409)	(2,934)	(3,645)	(4,374)
Gross profit	1,472	1,643	1,893	2,401	2,864	3,437
Other operating income	56	75	35	35	35	35
Selling/Distribution expenses	(402)	(477)	(535)	(599)	(671)	(751)
Administrative expenses	(137)	(179)	(206)	(237)	(272)	(313)
Provision for diminution of investment	0	(122)				
Operating profit	989	940	1,188	1,600	1,956	2,407
Net finance cost	(346)	(403)	(102)	(112)	(78)	(47)
PBT	643	538	1,086	1,488	1,878	2,360
Tax	(33)	(20)	(161)	(365)	(469)	(579)
Net earnings	611	518	925	1,123	1,408	1,781

Balance Sheet	2008	2009	2010E	2011E	2012E	2013E
As at 31st March	Rs. mn	Rs. mn	Rs. mn	Rs. mn	Rs. mn	Rs. mn
Assets						
Non current assets						
PP&E	3,541	3,918	4,114	4,525	4,932	5,327
Intangible assets	1					
Other investments	13	13	13	13	13	13
Other receivables	138	173	173	173	173	173
	3,693	4,104	4,300	4,711	5,118	5,513
Current Assets						
Inventories	1,064	1,497	1,506	1,867	2,278	2,734
Trade and other receivables	330	377	430	533	651	781
Other investments	542	169	169	169	169	169
Income tax recoverable	1	6	6	6	6	6
Cash and equivalents	49	46	236	394	52	98
	1,987	2,095	2,346	2,968	3,155	3,787
Current Liabilities						
Trade and other payables	307	379	430	533	651	781
Dividend payable	11	8	8	8	8	8
Income tax payable	4					
Borrowings	1,206	1,633	1,190	907	635	381
	1,527	2,020	1,628	1,448	1,294	1,170
Non current Liabilities						
Borrowings	1,361	978	1,120	1,439	1,007	604
Deferred tax liabilities	86	86	86	86	86	86
Retirement benefit obligation	53	54	54	54	54	54
	1,499	1,118	1,260	1,579	1,147	744
Net Assets	2,653	3,061	3,757	4,652	5,832	7,385
Stated Capital	815	815	815	815	815	815
Reserves	468	468	468	468	468	468
Retained Earnings	1,371	1,778	2,475	3,369	4,549	6,102
Shareholder's Funds	2,653	3,061	3,757	4,652	5,832	7,385



Cashflow Statement	2008	2009	2010E	2011E	2012E	2013E
For the year ended 31st March	Rs. mn	Rs. mn	Rs. mn	Rs. mn	Rs. mn	Rs. mn
Net profit before tax	643	538	1,086	1,488	1,878	2,360
Depreciation / Amortization	203	235	340	278	292	306
Net finance costs	349	421	102	112	78	47
Other	(32)	39				
Change in working capital	(153)	(443)	(10)	(361)	(528)	(586)
Cash from Operations	1,009	789	1,517	1,517	1,720	2,128
Finance costs paid	(349)	(421)	(102)	(112)	(78)	(47)
Income tax paid	(49)	(26)	(161)	(365)	(469)	(579)
Other	(3)	(3)				
Net Cash from Operations	608	340	1,255	1,039	1,172	1,502
Net PPE	(1,236)	(611)	(536)	(689)	(699)	(701)
Net Investments	(34)	314				
Other	14	25				
Net Cash from Investing	(1,256)	(273)	(536)	(689)	(699)	(701)
Net Borrowings	601	(63)	(301)	36	(586)	(527)
Dividends paid	(65)	(114)	(228)	(228)	(228)	(228)
Other	(7)	(8)				
Net Cash from Financing	529	(185)	(529)	(192)	(814)	(755)
Net increase in Cash	(118)	(119)	189	158	(342)	46

