

Distilleries Company of Sri Lanka PLC (DIST.N0000)

It's still about beverages

Distilleries Company of Sri Lanka PLC (DIST) is the leader in the domestic hard liquor market with a 71% volume market share. We expect gross revenue to grow at a 5.5% CAGR over FY14E-FY16E, with the PBT margin improving 64bps to 28.7% in FY16E. Our growth forecasts center around DIST's core beverage segment (86% of FY13 revenue), which should enhance revenue growth through higher average selling prices (ASPs) mainly to incorporate increases in excise duty, despite flat volume growth. We expect modest margin expansion on the back of DIST's strong market position and top-line growth in beverages, along with economies of scale and higher associate income. However, volatility in the diversified segments should temper any significant positive margin growth from beverages. DIST has maintained strong free cash flow (FCF) generation over the years; however, this may not translate into higher dividend payouts to shareholders (despite low gearing), as we believe DIST funds all its capex requirements using internal sources. Our DCF/SOTP valuation, along with our P/E-based relative valuation analysis, suggests a valuation range of LKR171-218, compared with the share price of LKR203 as of 28 March 2014.

Gross revenue to grow at a 5.5% CAGR through FY16E, driven by beverages.

Continuous tax increases are a common feature within the Sri Lankan liquor industry; we believe that price inelasticity, driven by consumers' alcohol dependency, should allow DIST to increase its beverage segment ASPs (higher than tax hikes), amid flat volumes, yielding a net revenue CAGR of 5.8% over FY14E-FY16E. We believe that any incremental hard-liquor volume growth will come from the mix-shift away from illegal/illicit products to better-quality legal brands, driven by growing consumerism, higher GDP per capita and increasing consumer health awareness. However, continuous price increases may cause the more cost-conscious consumers to revert to illicit products, which give a more effective 'kick-per-buck'.

PBT margin to expand slightly over FY14E-FY16E. We expect the beverage segment's modest margin growth of 77bps over FY14E-FY16E to come from segmental top-line growth, economies of scale and cost efficiencies arising from the on-going factory modernization program. PBT should also benefit from associate income (particularly from conglomerate Aitken Spence PLC), which has previously accounted for roughly 16% of PBT. However, we believe this growth may be offset by variability in the diversified segments' margins, and maintain a conservative view, as we believe DIST still has to reorganize and restructure these operations before they can become margin accretive to the group.

Dividend payout remains low despite strong FCF. DIST's 2013 FCF came in at LKR1.3bn due to higher capex; since FY10, DIST's FCF has averaged LKR3.4bn. While we expect FCF generation to remain strong over our explicit forecast period, we do not believe shareholders would receive higher dividend payouts, largely due to capex and investment funding being sourced internally. However, low gearing (at an average of 16%) should provide further avenues for external debt funding if required.

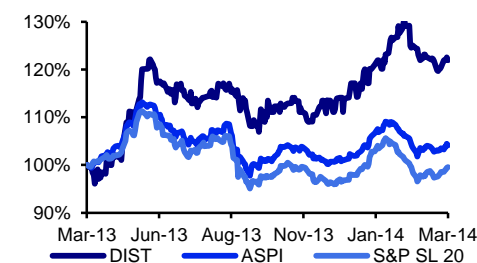
We establish a valuation range of LKR171-218. Our DCF/SOTP analysis implies a valuation range of LKR185-218, considering positive and negative factors that impact our base-case assumptions, as explained on pages 12 and 13. Our P/E valuation suggests that DIST currently trades at an FY14E P/E multiple of 10.7x – a 12.9% premium to its normalized two-year historical forward P/E average. Applying a 5% discount and a 5% premium to this normalized two-year average, we arrive at a P/E valuation range of LKR171-189.

Key statistics

CSE/Bloomberg tickers	DIST.N0000/DIST SL
Share price (28 Mar 2014)	LKR203
No. of issued shares (m)	300
Market cap (USDm)	466
Enterprise value (USDm)	565
Free float (%)	30%
52-week range (H/L)	LKR217/160
Avg. daily vol. (shares,1yr)	71,889
Avg. daily turnover (USD '000)	106

Source: CSE, Bloomberg
Note: USD/LKR=130.1 (average for the one year ended 28 March 2014)

Share price movement



Source: CSE, Bloomberg

Share price performance

	3m	6m	12m
DIST	6.7%	7.4%	21.9%
S&P SL 20	1.0%	2.0%	-0.6%
All Share Price Index	2.0%	3.2%	4.5%

Source: CSE, Bloomberg

Summary financials

LKRm (year end 31 March)	2013	2014E	2015E
Gross revenue	65,790	69,712	73,418
Net revenue	28,766	29,709	31,965
EBIT	6,679	7,302	8,329
PBT	8,084	8,678	9,143
Net profit	5,140	5,679	5,827
Recurrent EPS	17.13	18.93	19.42
ROE (%)	11.5	11.4	10.8
P/E (x)	9.7	10.7	10.5

Source: DIST, Copal Amba estimates

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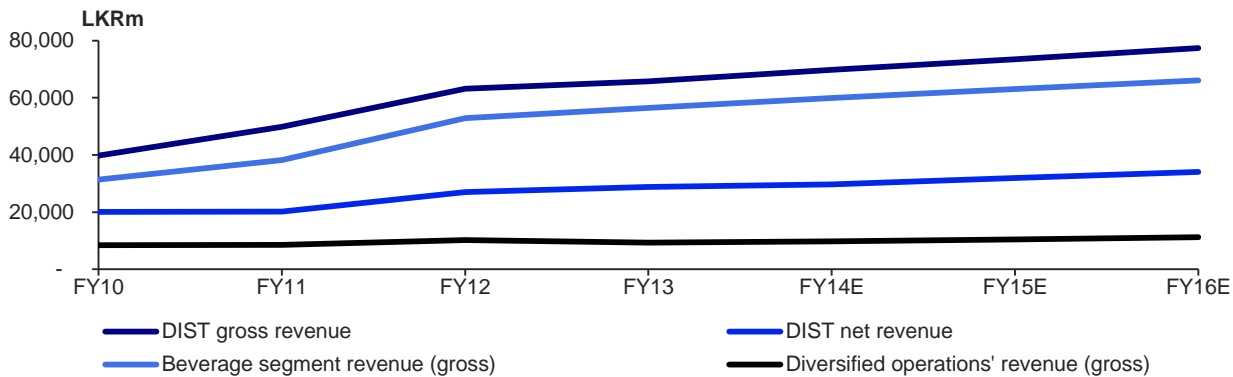
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DIST to post 5.5% gross revenue CAGR over FY14E-FY16E

We expect DIST to post a 5.5% gross revenue CAGR over FY14E-FY16E (compared with a 12.7% CAGR over FY10-FY13), driven largely by continued growth in its core beverages segment. In addition, the diversified business operations (through investment holding company Melstacorp Ltd) should contribute to the top line, with a gross revenue CAGR of 6.5% over FY14E-FY16E, albeit off a relatively small base. Furthermore, we expect a net revenue CAGR of 5.8% over our explicit forecast period, as we believe DIST has the ability to directly pass on price increases resulting from tax hikes to its consumers, largely due to the inelastic nature of the product.

Higher ASPs to drive beverage segment revenue growth

Figure 1: DIST's gross revenue to grow at a 5.5% CAGR over FY14E-FY16E fuelled by its solid beverage business

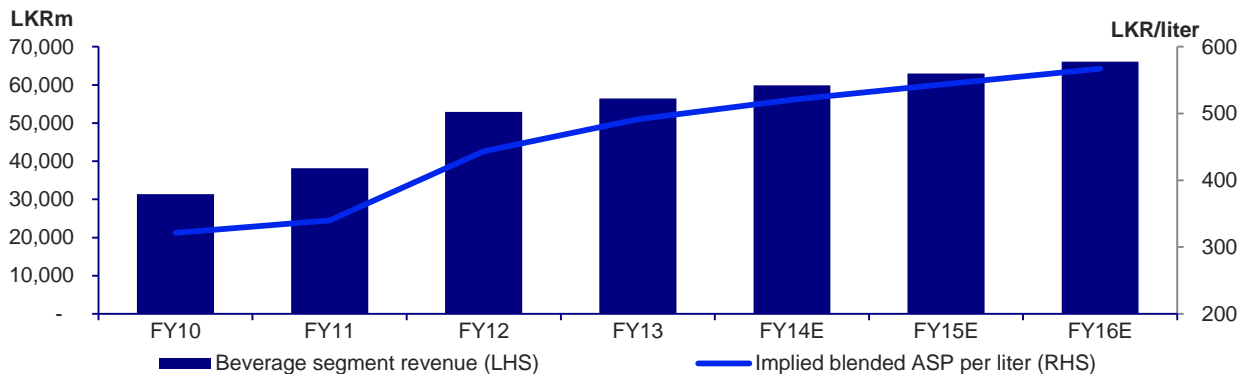


Source: DIST, Balangoda Plantations PLC, Excise Department of Sri Lanka, Copal Amba estimates

Beverage segment remains the key driver for the group

We expect the growth in group revenue to be driven mainly by a 5.4% CAGR over FY14E-FY16E in the beverage segment (which accounted for approximately 86% of DIST's FY13 revenue), primarily through an increase in the ASP CAGR of 4.9% during FY14E-FY16E.

Figure 2: Beverage segment revenue to grow at a 5.4% CAGR on the back of increasing ASPs



Source: DIST, Excise Department of Sri Lanka, Copal Amba estimates

Inelastic demand and higher disposable income to maintain stability in volumes, despite increasing ASPs

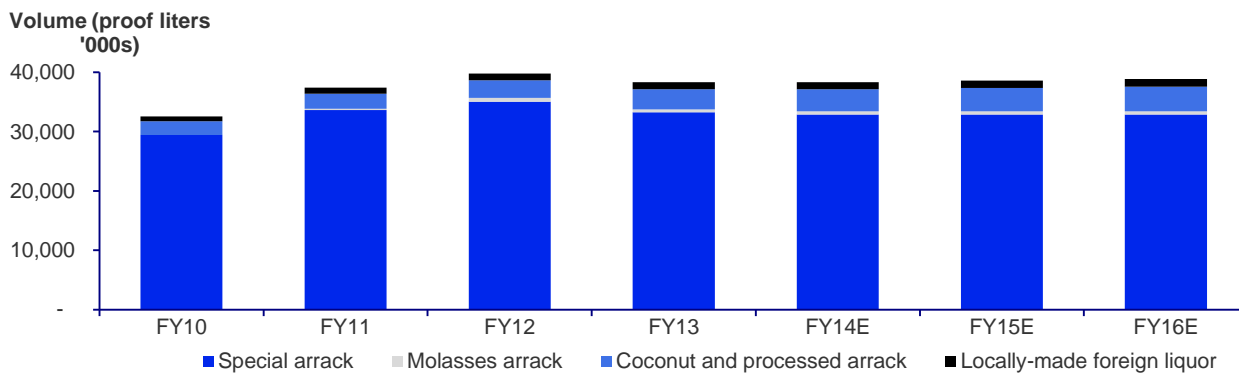
We believe that the price inelasticity due to consumers' dependency on alcohol will continue to support DIST's sales volumes, with volume growth remaining largely flat at a 0.5% CAGR over FY14E-FY16E over our explicit forecast period, compared with a 2.6% growth CAGR over FY10-FY13. This volume stability comes despite a forecast 4.9% increase in ASPs over FY14E-FY16E, primarily to account for the anticipated rise in excise duty, substantiating the inelastic nature of demand for alcohol.

Price inelasticity, consumerism, increasing health awareness and higher GDP per capita should influence a mix-shift away from illicit/illegal products to legally produced, better-quality liquors

As discussed in Appendix 1, we believe the domestic hard liquor industry is reaching maturity, having experienced only a 3% (consumption) volume CAGR over 2008-2012 despite the overall industry volume (soft and hard liquor) CAGR increasing at a rate of 10% over this same period. This overall industry growth was largely due to the 19% CAGR experienced in the malt liquor segment (resulting from the mix-shift towards soft liquors). Therefore, we believe that the hard liquor industry (legal, illegal and illicit) as a whole will not experience substantial volume growth, and we forecast DIST's volumes to remain relatively flat over our explicit forecast period.

We believe that any meaningful volume growth for DIST's hard liquor business would come from the mix-shift toward legal brands, with consumers moving away from illicitly and illegally manufactured products. One reason for this shift would be increasing awareness among consumers of the health risks linked to the consumption of illicit products.

Figure 3: Beverage segment volume growth to remain flat over FY14E-FY16E



Source: DIST, Excise Department of Sri Lanka, Copal Amba estimates

Another key driving factor of segmental revenue growth would be rising consumerism in Sri Lanka, spurred by a growing middle class with increasing per capita GDP and greater disposable income. Sri Lanka's GDP per capita in 2013 was recorded at USD3,282, with the government of Sri Lanka (GoSL) anticipating this to reach USD4,000 by 2016. Therefore, we believe DIST will benefit from stable volumes, despite increasing ASPs. We feel that these assumptions are justified, given that the per capita consumption of alcohol (accounting for both hard and soft liquor) in Sri Lanka has been on an upward trajectory in the past, with our estimates of per capita consumption (based on data from the Excise Department [ED] of Sri Lanka and the Central Bank of Sri Lanka [CBSL]) at approximately 11 liters in 2012, compared with just roughly 7 liters in 2008 (see Figure 25).

Per capita liquor consumption has been on an upward trend, recorded at 11 liters in 2012, versus 7 liters in 2008

Market positioning and product quality should support top-line growth

We believe that DIST's strong brand presence (despite its inability to advertise and carry out marketing campaigns to promote top-of-the-mind awareness, as this is not legal in Sri Lanka) has allowed it to retain its market leadership position in the legalized local hard liquor space over the years. As at 2012, DIST's overall market share stood at approximately 71%, with DIST retaining the #1 position in its flagship product, 'special arrack' (88% market share in 2012), as well as in the 'coconut and processed arrack' product segment (60% volume share in 2012).

Figure 4: DIST retained a volume market share of 88% in the special arrack segment in 2012...

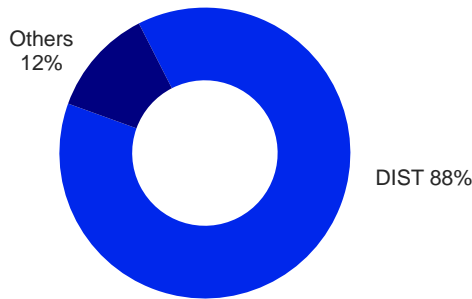
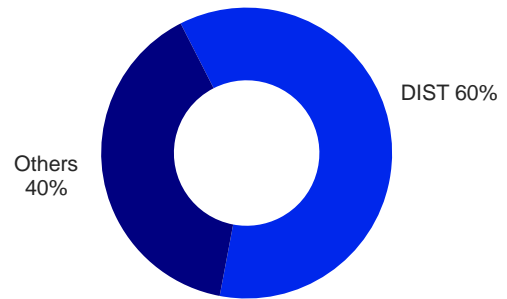


Figure 5: ... and retained its market leadership in the coconut and processed arrack segment in 2012 as well



Source: Excise Department of Sri Lanka, Copal Amba estimates

Source: Excise Department of Sri Lanka, Copal Amba estimates

This dominance is also sustained through the high quality of DIST's products, which we believe appeals to the quality-conscious consumer. Furthermore, DIST offers a wide variety of products, sizes and brands, ranging from pure coconut arrack, coconut arrack blended with imported neutral spirits, flavored arrack and a portfolio of premium imported foreign brands as well. We believe this allows the company to cater to the more flexible demands of its consumers – another reason for it to remain the preferred choice.

Top-of-the-mind recognition has helped DIST maintain its market dominance in the special arrack and coconut and processed arrack segments

Diversified operations make a modest contribution through Melstacorp businesses

Melstacorp Ltd, DIST's investment holding arm, holds investments in smaller companies in sectors ranging from telecommunications to plantations, media and financial services (see Appendix 2 for more details).

Melstacorp to contribute modestly to revenue expansion, off a small base

While management has plans to make this a standalone conglomerate five years from now, at present, these operations account for only roughly 14% of group gross revenue, and we believe this will remain the case over our explicit forecast period.

We believe that, although small, these segments will generate revenue at a CAGR of 6.5% over FY14E-FY16E. Due to the lack of available information, it was challenging to forecast detailed revenues from each line of business. However, as this growth comes off a small base, we believe this should not have a material impact on our group-level estimates.

Net revenue to grow despite excise duty revisions

Since its inception, DIST has been a key contributor of tax revenue to the GoSL, paying approximately LKR37bn in excise duty during FY13, an 18.2% CAGR over FY10-FY13. We expect the excise duty paid to increase at a CAGR of 5.4% over FY14E-FY16E. Despite this, we believe DIST's net revenue will grow at a 5.8% CAGR over FY14E-FY16E, as over time, DIST should be able to gradually pass on the tax increases to its consumers by way of higher ASPs, as discussed earlier, while taking caution to ensure that this is not at the expense of a drastic volume decline.

Upside potential to top-line growth

- **Factory upgrade.** Management expects the on-going factory modernization program to enhance production capacity, improve quality and allow for DIST to cater to more diverse bottle shapes and sizes, which, in turn, should help improve revenue-generating capabilities.
- **Investments in the telecom sector.** DIST's presence in the telecom sector (6% of FY13 revenue) is through its investment in Lanka Bell (LB) Ltd. During FY13, this segment recorded 0.9% YoY growth. Although Sri Lanka's telecom industry is reaching its maturity and faces intense competition among key larger operators (such as Sri Lanka Telecom PLC [SLTL] and Dialog Axiata PLC [DIAL]), LB's technology upgrades to the government-stipulated Next Generation Network (NGN), together with the launch of its 4G connectivity around Colombo and its suburbs in February 2014, should see some positive effects on revenue in this segment (although off a smaller base).
- **New hotel opening in Negombo (north of Colombo).** DIST has invested in the construction of a new beach resort, Heritance Negombo (formerly known as Browns Beach Hotel). The revamped resort, scheduled to be opened in 2014, is set to include 143 rooms, banquet and spa facilities, along with restaurants and bars, with management targeting a 4-star plus rating. We expect Sri Lanka's budding tourism industry (as mentioned in Appendix 1) to contribute toward increasing occupancy at this property, which, in turn, could support overall top-line growth.
- **Improved weather conditions for plantations.** Volatility in weather conditions is a problem that constantly impacts the productivity of the plantations sector. Improved weather patterns should serve as a positive factor for DIST, enabling revenue to grow.
- **Other diversified segments.** DIST also has several opportunities stemming from the rest of its diversified portfolio – especially in finance and power. DIST's FY13 investment in Melsta Regal Finance Limited could allow the company to make some progress in the finance industry, while its Bogo Power (hydro-power generation) operation is also a positive growth area.

Capacity enhancements and improved performance across DIST's key diversified end-markets will provide some potential upside to revenue growth

Downside risks to revenue expectations

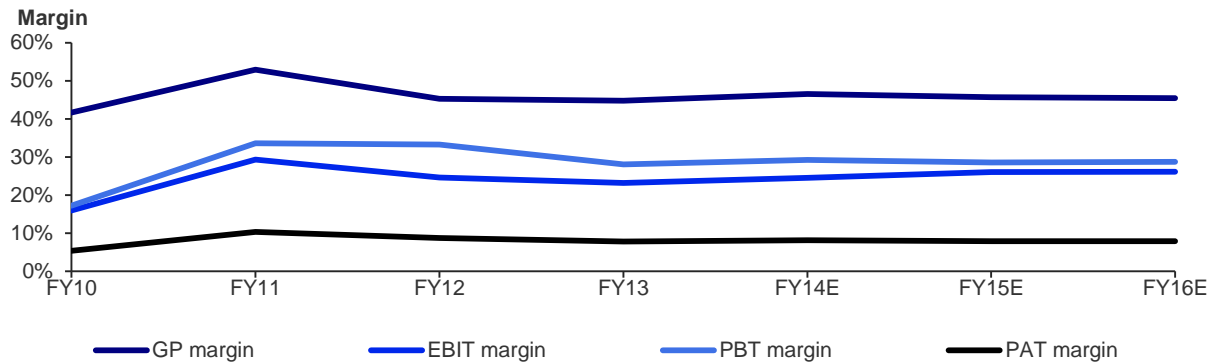
- **Tax hikes.** In an attempt to increase tax revenues to the GoSL, excise duty on alcohol consumption is regularly increased (often by way of an overnight gazette). In 2012/2013 alone, duties were revised as many as four times. As a result, firms in the industry are compelled to increase ASPs to cover these costs. While this remains sustainable to the legal producers for now, there is a risk of losing price-sensitive consumers if price increases are too high. For example, as a result of the price hikes witnessed in 2012, there was a volume shift to soft liquor products, with malt liquor accounting for over half of total alcohol consumption in Sri Lanka for the first time in the recent past. This would impact revenues of hard liquor manufacturers.
- **Greater competition.** Another knock-on effect of tax hikes is consumers switching over to the illicit market, where prices may be substantially lower, despite being inferior in regard to quality and hygiene. This shift could occur on the back of increasing ASPs.

Increases in excise duty and competition from the illegal and illicit markets are the biggest threats to DIST

PBT margin to improve 64bps through FY16E

We forecast DIST's PBT margin to improve to 28.7% in FY16E, a slight increase from FY13 levels, led by the beverage segment as well as associate income; however, we are less optimistic on the margin outlook for the company's diversified operations.

Figure 6: Profit margin analysis for DIST



Source: DIST, Copal Amba estimates
Note: Associate income is added to the EBIT

Beverage margin to expand modestly, increasing by 77bps to reach 33.4% in FY16E

We believe that stable volumes in the beverage segment, supported by top-line growth resulting from higher ASPs, will continue to drive growth in the PBT margin.

We noted an interesting shift away from arrack to DIST's subsidiary Periceyl's, locally made foreign liquors (LMFL) within DIST; based on our estimates arrack accounted for approximately 85-90% of total segment revenue in FY13, compared to around 95% a few years ago. We believe this shift should contribute to margin expansion, as LMFL's are the higher-margin products within the portfolio.

Being the market leader in the hard liquor industry will allow DIST to benefit from economies of scale through large-scale production and also serve as an entry barrier to new legal manufacturers, thus protecting its competitive advantage in the industry.

Furthermore, the on-going factory modernization program is set to lead to operational and cost efficiencies, which should contribute toward margin growth over our explicit forecast period.

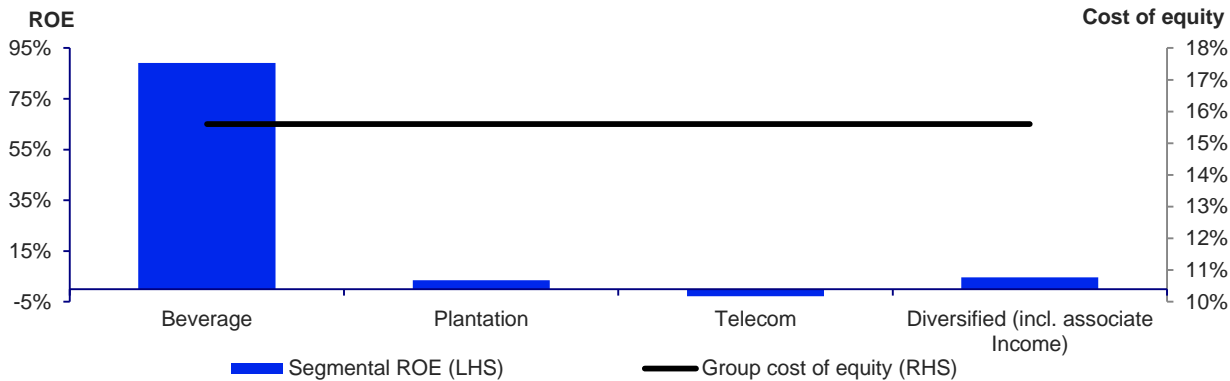
Beverage segment margin expansion to stem from economies of scale and cost efficiencies

Diversified operations remain a drag on profitability

DIST's investments over the years, while attempting to diversify its business operations and reduce dependency on a single business unit, have mostly resulted in the build-up of assets that, in our view, fail to generate viable returns (above the group's cost of equity) – thus eroding shareholder value.

Diversified segments continue to erode shareholder value

Figure 7: DIST's operations outside of beverages fail to generate returns above the group's cost of equity in FY13



Source: DIST, Copal Amba estimates

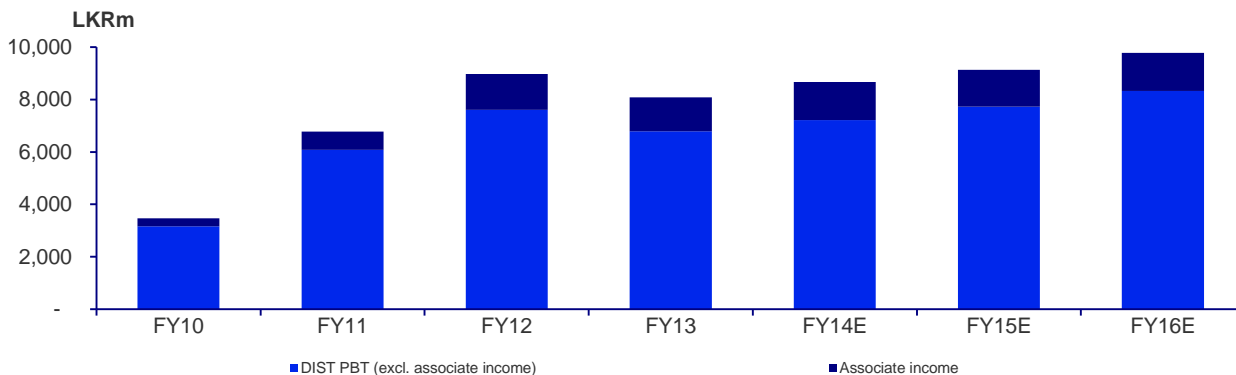
We expect the PBT margin from the non-beverage segments (excluding associate income) to expand by 157bps over FY14E-FY16E to reach 6.3% in FY16E, with this growth, however, coming off a small base (as non-beverage segments, excluding associate income, account for only 7% of DIST's PBT without associate income). While we remain positive on the steps taken by management to streamline the operations of the diversified segments, we believe that it will take more time for any restructuring benefit to come into effect, and we remain conservative on this outcome.

Associate income to continue with its key contribution to group PBT

DIST's associate investments have made sizeable contributions to the company's bottom line over the years, constituting approximately 16% of group PBT in FY13; we expect this figure to hold throughout our explicit forecast period. DIST's associates comprise Aitken Spence PLC [SPEN] (41.09%), Madulsima Plantations PLC (31.20%) and Pelwatte Dairy Industries Ltd (24.38%), with close to 100% of associate income coming from SPEN.

Associate income makes valuable contributions to the bottom line

Figure 8: Associate income to contribute approximately 16% to DIST's PBT over FY14E-FY16E



Source: DIST, Copal Amba estimates

We expect income from associates to increase to LKR1.5bn in FY16E (from LKR1.3bn in FY13), while maintaining an average ROI of 6.0% over FY14E-FY16E. We believe this growth would be generated solely from SPEN, driven by its exposure to Sri Lanka's growing tourism industry (38% of SPEN's FY13 revenue).

Downside risks to margin expansion

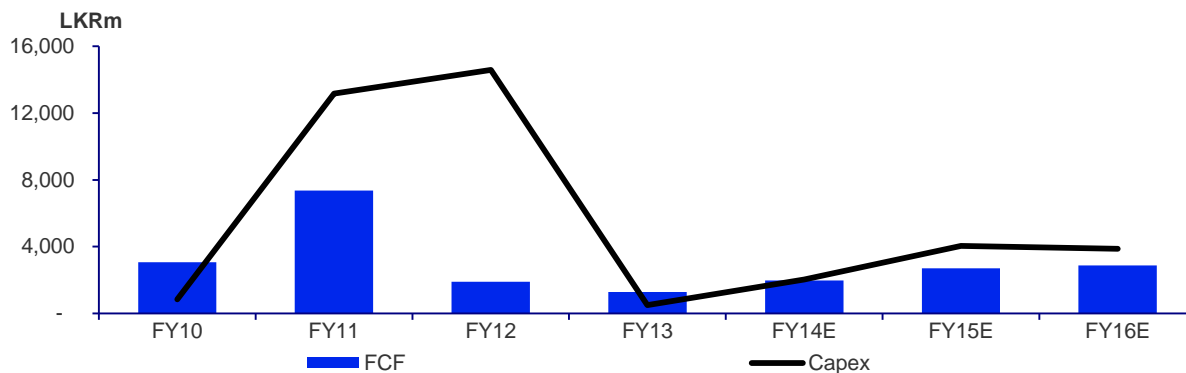
- **Drop in beverage volumes.** Demand for soft liquor and illicit hard liquor from the cost-conscious consumer is rising owing to increasing taxes and ASPs in the hard liquor industry. Consequently, DIST faces the risk of declining volumes in its core beverage segment as a result of declining volume market share.
- **Higher operational costs.** Higher raw material costs (e.g., toddy spirits) and other overheads (such as electricity and fuel) pose a potential downside risk to margin growth. Any significant increase in these expenses could squeeze margins.
- **Fall in associate income.** As associate income makes up a significant share of DIST's PBT, a fall in income earned, particularly from SPEN, could negatively impact margins.
- **Diversified operations performing worse than forecast.** A slowdown in the end markets of the company's key subsidiaries under the Melstacorp umbrella, along with associated cost increases in these subsidiaries, could result in margin pressure. For example, the plantations industry faces volatility owing to adverse weather conditions and is continuously plagued with increasing wage costs. Similarly, depreciation in technology, amortization, as well as writedowns are a regular feature within the telecommunications industry. This, in addition to the low-tariff rates in Sri Lanka (among the lowest in the world), should limit any meaningful margin improvements from these investments.

Fall in beverage volumes, increase in operational costs, lower associate income and adverse results from diversified operations could contract PBT margins further

DIST's FCF generation remains solid; dividend payout restricted owing to investment needs outside beverages

DIST has historically maintained a sound FCF position, averaging LKR3.4bn over FY10-FY13, driven by the beverage segment, which has remained the company's cash cow. FCF/net sales averaged 6% over the past seven years; however, in FY13, FCF came in at LKR1.3bn (lower than its historical average). We believe this was due to the company's capex requirements. We expect FCF to remain below LKR2.0bn levels in FY14E on account of the on-going factory modernization program, which we believe is primarily funded through internal sources. We forecast that FCF will rebound to above LKR2.5bn levels from FY15E onwards.

Figure 9: FCF generation to remain positive despite capex outflow



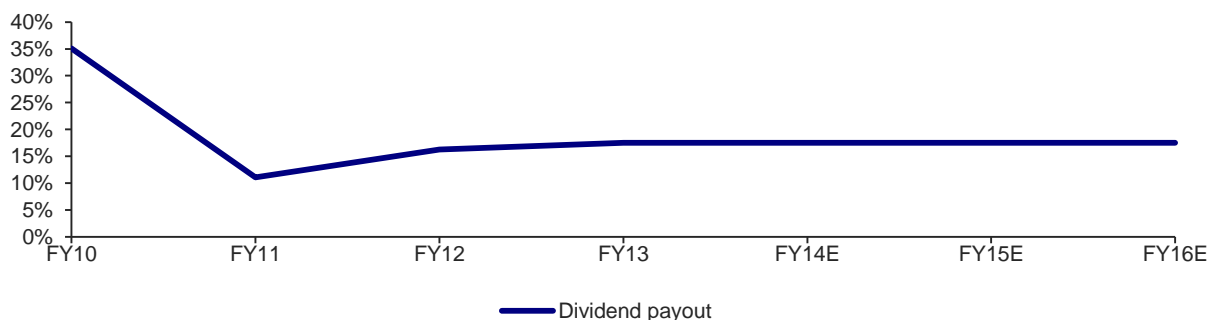
Source: DIST, Copal Amba estimates

Strong FCF generation usually means that equity holders are set to benefit through stable dividend payouts over the long term. However, DIST's payout ratio declined from its FY10 level of 35%, averaging only 15% during FY11-FY13. We believe this is owing to the company's investment in acquisitions and other capex requirements being funded largely through internal sources. Our view is further supported by DIST's stable and relatively low gearing levels (discussed later).

Dividend payout to remain at current levels on account of internally generated funds being used for capital investments

Therefore, despite generating stable margins on the back of its strong beverage business, we expect dividend payouts to remain at FY13 levels (17.5%) throughout our explicit forecast period, as we believe the company will continue to use internally generated funds for diversification opportunities.

Figure 10: Dividend payout to remain at 17.5% levels over FY14E-FY16E due to non-beverage investment requirements



Source: DIST, Copal Amba estimates

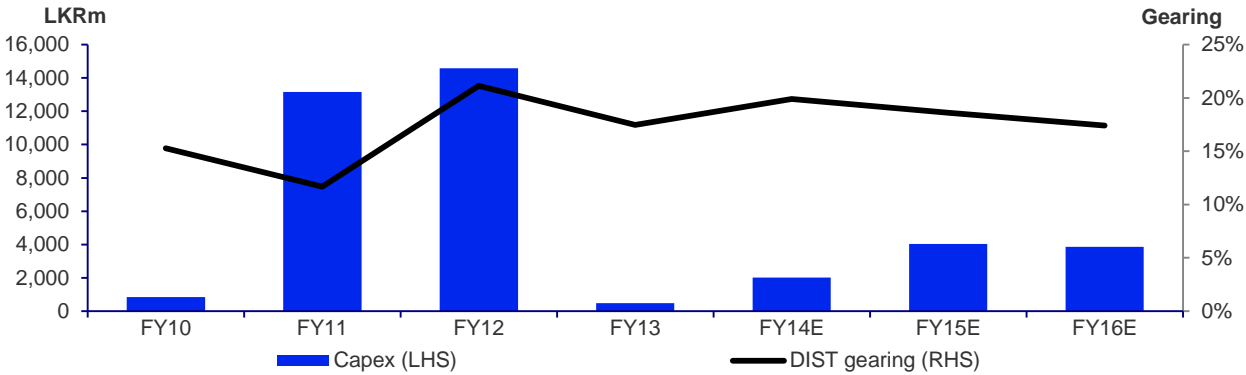
Low gearing levels to support further financing needs

DIST's gearing levels have averaged 16% since FY10, despite the company's capex requirements during these years (the capex/net sales ratio averaged 60% during FY11-FY12, compared with an average of 12% over FY07-FY10). We believe this is primarily owing to DIST largely funding its capital requirements through internal sources.

Low gearing will allow DIST to raise additional debt finance if required

Low gearing levels place DIST in a position to easily finance any further investments (including organic growth) should the company choose to do so. We believe that its low debt position will continue into the foreseeable future given the availability of sufficient FCF. This means that DIST could easily consider external debt funding (with debt easier to obtain at attractive rates) if required.

Figure 11: Gearing levels remain low despite capex spend

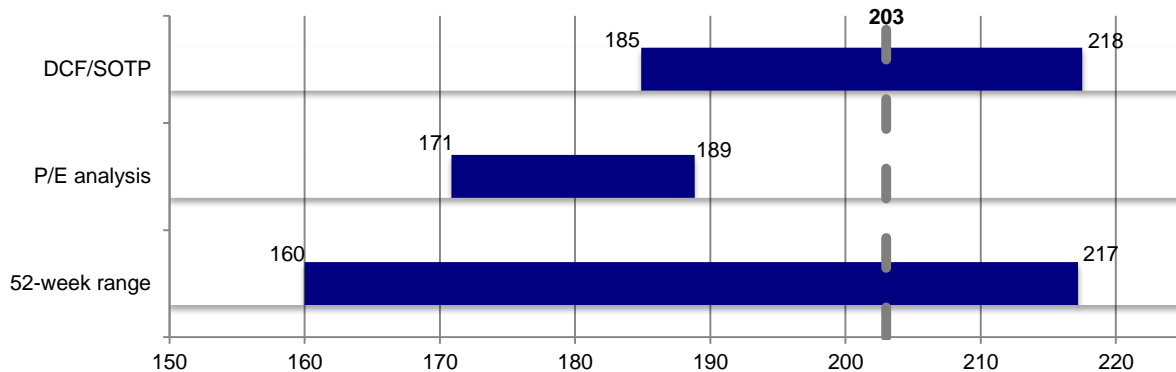


Source: DIST, Copal Amba estimates

We establish a valuation range of LKR171-218 for DIST's shares

We establish a 12-month valuation range of LKR171-218 per share, based on our current earnings outlook for DIST shares, compared with the current share price of LKR203 as of 28 March 2014. We arrive at our valuation range by applying scenario analysis to a DCF/SOTP valuation, and using a P/E-based relative valuation approach. For comparison, we also assess DIST's valuation levels relative to a group of peers.

Figure 12: Valuation range analysis provides a range of LKR171-218 per share (current share price: LKR203)



Source: DIST, Bloomberg, Copal Amba estimates

DCF/SOTP analysis yields a valuation range of LKR185-218 per share

In valuing DIST shares, we applied a combined DCF/SOTP approach. Key elements of this approach include the following:

- We have valued the beverage segment using a standard DCF approach, applying a risk-free rate of 9.0% and a market risk premium of 6.0%. DIST's current capital structure is 19.5% debt and 80.5% equity. We have assumed a 20/80 target capital structure, along with a terminal growth rate of 1.0%, and a 40% corporate tax rate. We have estimated FCF figures throughout the explicit and fade periods. Our terminal value for FY23E is calculated by applying the terminal growth rate to unleveraged FCF as of FY23E. Finally, we arrived at our segment equity value by discounting the unleveraged FCF values over the explicit and fade periods at the segmental WACC.
- For the telecommunications segment (LB), we have applied an EV/EBITDA multiple of 3.0x (a discount to its domestically listed peers, SLTL and DIAL) to the segment's FY14E earnings.
- Balangoda Plantations PLC (plantations segment) has been taken at its current market value (number of shares held by Melstacorp [DIST's fully-owned investment holding subsidiary] multiplied by the share price as on 28 March 2014).
- DIST's investment in Heritance Negombo (part of the diversified segment) has been taken based on its revalued property value as on 31 December 2013.
- We have then adjusted the equity value of the above-mentioned subsidiaries to account for associate investments. The two listed associates, Madulsima Plantations PLC and Aitken Spence PLC, have been taken at their current market values, based on the investment holding by Melstacorp.
- Based on the above assumptions, our bull-case scenario considers DIST's intrinsic value without a holding company discount.

Our base-case assumptions for the beverage segment include a risk-free rate of 9.0% and a market risk premium of 6.0%

- Further, we arrive at our bear-case equity valuation after assigning a 15% holding company discount. We have assigned the holding company discount in order to account for DIST's investments in some of its unprofitable subsidiaries under its diversified business operations (Melstacorp). We believe losses arising from some of these subsidiaries could result in the Melstacorp restructuring program taking longer to contribute materially to the company's valuation. Further, as discussed before, the diversified businesses generate ROEs well below the group average.

Figure 13: Amba DCF/SOTP assumptions schedule

Segment	Equity value (LKRm)	LKR per share
Beverages	38,766	129.2
Telecommunications – Lanka Bell Pvt Ltd	3,478	11.6
Plantations – Balangoda Plantations PLC	316	1.1
Other diversified: Browns Beach Hotel PLC	860	2.9
Total enterprise value	43,419	144.7
<u>Less: Net debt of group</u>	10,431	34.8
Add: Net debt of Balangoda Plantations PLC	205	0.7
Add: Short-term investments	2,317	7.7
Add: Long-term investments (other than those valued on DDM)	8,760	29.2
Add: Long-term investments (DDM valuation)	4,524	15.1
Equity value of subsidiaries	48,794	162.6
<u>Associate companies</u>		
Madulsima Plantations PLC	93	0.3
Aitken Spence PLC	16,366	54.6
Equity value of DIST (bull case)	65,253	217.5
Equity value of DIST post 15% holding company discount (bear case)	55,465	184.9

Source: Copal Amba estimates

P/E analysis yields a valuation range of LKR171-189 per share

DIST's 12-month forward P/E has ranged from 6.6x to 11.2x since April 2010. The share's normalized two-year average historical forward P/E multiple stands at 9.5x. The stock currently trades at an FY14E multiple of 10.7x (based on our forecasts) – a 12.9% premium to its normalized two-year historical average.

Figure 14: DIST has traded at a P/E of between 6.6x and 11.2x over the past four years



Source: DIST, Bloomberg

In determining a P/E valuation range, we apply two scenarios:

- Optimistic scenario:** Under this scenario, in addition to the factors providing a potential upside (as discussed on page 6), we assume that DIST will be able to improve its diversified portfolio (Melstacorp), and also that the company's current legal uncertainties regarding its investment in Pelwatte Sugar Industries PLC and its former investment in Sri Lanka Insurance Corporation (SLIC) may possibly be successfully resolved. Accordingly, we have applied a 5% premium to the normalized two-year historical P/E average and arrived at a forward multiple of 10.0x. Applied to our FY14E EPS estimate of LKR18.9, this leads to a share price of LKR189 per share.
- Pessimistic scenario:** Here, we assume a 5% discount to the normalized two-year historical average, implying that DIST will trade at a forward multiple of 9.0x. This is driven mainly by lower-than-expected volume growth in beverages, stemming from higher ASPs and the consumer shift to the illegal/illicit market. Here, we also consider the above-mentioned legal issues taking longer to be settled. Applying this multiple to our FY14E EPS estimate, we arrive at a fair value of LKR171 per share.

Scenario analysis driven by the outcome of the diversified operations' restructuring program, legal uncertainties facing DIST, and changes in beverage volumes

Relative valuation data used as a measure of comparison

Selecting an adequate peer group for a conglomerate is challenging, as no potential peer has an identical slate of business segments. Since beverages account for over 85% of DIST's operations (based on gross revenue), we have selected other domestic and regional alcohol operators to provide some measure of comparison with other local and regional players.

Figure 15: DIST's P/E relative to regional peers

Company name	P/E				EPS CAGR	FCF yield	
	2012	2013	2014E	2015E	2014E-2015E	2012	2013
Distilleries Company of Sri Lanka PLC	8.8x	9.7x	10.7x	10.5x	6.5%	3.9%	2.6%
Lion Brewery Ceylon PLC	13.1x	25.5x	NA	NA	NM	0.5%	-18.3%
United Spirits Limited	23.1x	77.4x	88.2x	47.6x	50.0%	-8.5%	-0.5%
Hebei Hengshui Laobaigan Liquor Co Ltd	31.6x	46.2x	31.0x	26.7x	0.0%	1.4%	-3.1%
Sichuan Tuopai Shede Wine Co Ltd	26.3x	501.3x	69.6x	61.8x	112.1%	3.2%	NA
Shanghai Jinfeng Wine Co Ltd	29.3x	36.9x	31.9x	25.5x	20.8%	1.9%	1.3%
Dukang Distillers Holdings Ltd	4.4x	4.7x	NA	NA	NM	1.5%	11.5%
Mean	21.3x	28.3x	31.5x	40.4x	45.7%	-0.1%	2.3%
Median	24.7x	31.2x	31.5x	37.2x	35.4%	1.5%	0.4%
High	31.6x	46.2x	31.9x	61.8x	112.1%	3.2%	11.5%
Low	4.4x	4.7x	31.0x	25.5x	0.0%	-8.5%	-3.1%

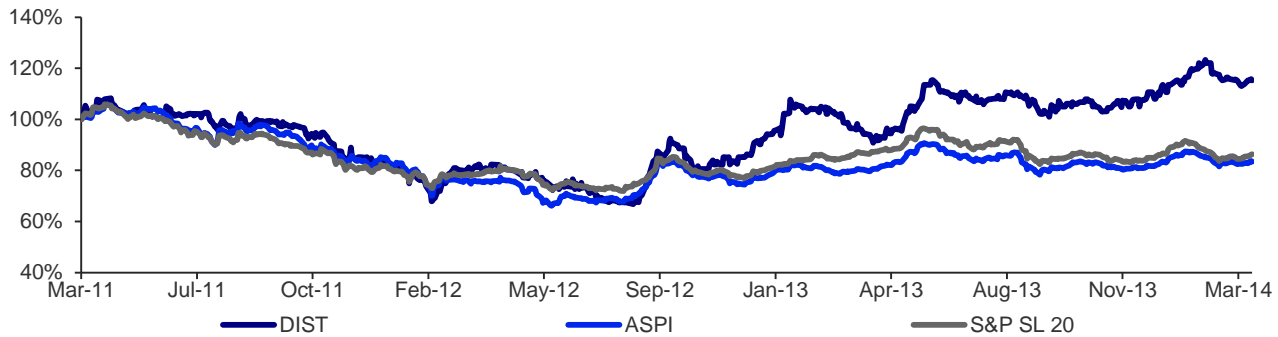
Source: DIST, Bloomberg, Copal Amba estimates

Note: Multiples above 50x have been considered as outliers

Share price performance

DIST shares closed at LKR203 on 28 March 2014, LKR38 higher than 12 months earlier, an increase of 21.9%, compared to a 0.6% decrease in the S&P SL 20 and a 4.5% increase in the All Share Price Index (ASPI).

Figure 16: DIST has outperformed the market over the past 12 months



Source: CSE, Bloomberg

As shown in Figure 17, DIST has outperformed the CSE's two main indices over the past three years.

Figure 17: DIST vs. key indices

	3m	6m	1 year	2 years	3 years
DIST	6.7%	7.4%	21.9%	40.0%	11.9%
S&P SL 20	1.0%	2.0%	-0.6%	9.8%	-15.3%
ASPI	2.0%	3.2%	4.5%	10.7%	-16.9%

Source: CSE, Bloomberg

Earnings release focus areas

Here is a checklist of items that investors should track in the next – and subsequent – quarterly earnings release. We will closely track DIST's performance across these key areas, and will revise our forecasts and update our valuation range in future earnings update notes.

1. Have there been any revisions to the excise duty? Has DIST been able to pass these onto consumers through higher ASPs?
2. Has the excise department published the latest volume data?
3. How has the industry consumption mix-shift changed towards soft liquor?
4. Have there been any new retail operators (distributors) that have entered the market?
5. Have GDP per capita income levels grown as per the Central Bank of Sri Lanka's expectations?
6. Is the factory modernization program on track?
7. What is the progress on the Melstacorp restructuring initiative? Have there been any new acquisitions or divestments of subsidiaries and/or associates?
8. Any updates on the current legal issues surrounding DIST's investment in Pelwatte Sugar Industries PLC and its former investment in Sri Lanka Insurance Corporation (SLIC)?
9. Has there been any change to the dividend payout policy?

Appendix 1: The Sri Lankan alcohol industry

Sri Lanka is the largest and oldest manufacturer of coconut arrack in the world. Coconut arrack is a distilled alcoholic drink produced from the fermented sap (nectar) of unopened coconut flowers. Sri Lankan coconut arrack is said to be among the purest, naturally-derived hard liquors in the world, and it is distilled through a natural fermentation process. Arrack may also be produced using sugarcane, red rice or fruit.

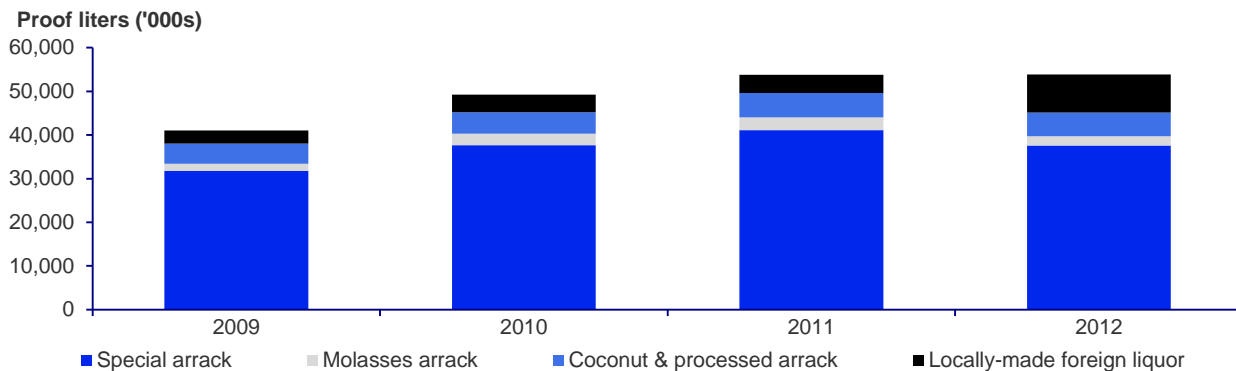
Figure 18: Snapshot of the domestic alcohol market

Hard liquor	Growth drivers	Key players (2012)
Special arrack	The low end of the market should likely witness moderate to low demand following price hikes as tax increases prompt consumers to switch. However, demand for high-end/specialty/ flavored arracks should likely increase due to higher earning power and increasing tourist arrivals	DIST, International Distilleries Limited (IDL), Acme Lanka
Coconut arrack	We expect demand for coconut arrack to be moderate going forward	DIST, Periceyl, Rockland, IDL
Locally made foreign liquor (LMFL)	High demand: Increasing demand for foreign liquor – such as whisky, gin and brandy – backed by improving income levels	IDL, Rockland, Periceyl
Soft liquor	Growth drivers	Key players
Malt liquor (beer) with alcohol % above 5%	High demand: Growth underpinned by shift to high-alcohol soft beer from hard liquor due to increasing tax hikes	Lion Brewery, Asia Pacific Brewery
Malt liquor (beer) with alcohol % below 5%	Moderate demand: We believe the spillover effect from the shift in volumes to soft liquor benefits this category of producers as well	Lion Brewery, Millers Brewery

Source: Copal Amba

The hard liquor market can be broken up based on its key product types (special arrack, coconut and processed arrack, molasses arrack, and locally made foreign liquor), as shown in Figure 19, with special arrack accounting for approximately 70% of the total hard liquor market in Sri Lanka. In 2012, the total volume of hard liquor produced amounted to approximately 54m proof liters. Proof liters measure the amount of alcohol content in a beverage. For example, one bulk liter with an alcohol content of 100% is equal to one proof liter.

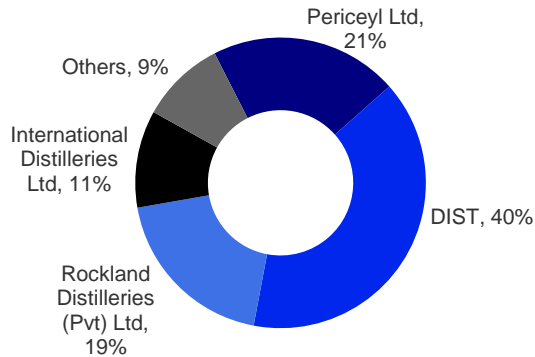
Figure 19: Special arrack continues to dominate the hard liquor industry



Source: Excise Department of Sri Lanka, Copal Amba estimates
 Note: Data as of 2012. Excise Department data is available on a calendar-year basis.

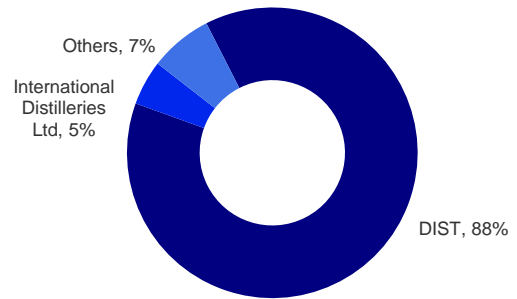
DIST is the market leader in the coconut and processed arrack (60% volume share in 2012) as well as the special arrack (88% volume share in 2012) segments. DIST also remains the overall market leader in the domestic hard liquor market, with a market share of approximately 71% in 2012.

Figure 20: Key players in the coconut and processed arrack segment



Source: Excise Department of Sri Lanka

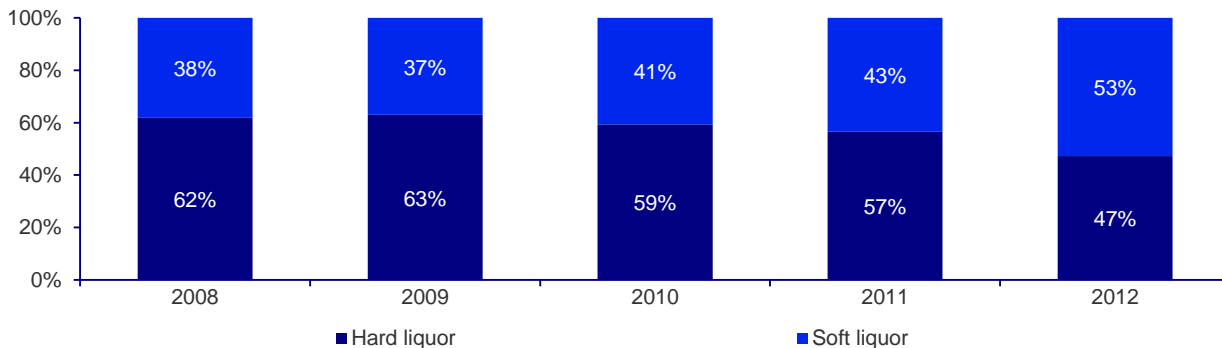
Figure 21: Key players in the special arrack segment



Source: Excise Department of Sri Lanka

By 2012, the domestic alcohol market was split roughly 45:55 between hard and soft liquor as shown in Figure 22; this ratio having been roughly 60:40 previously, more in favor of hard liquor. We believe the recent trend towards soft liquor (beer) is owing to its widespread distribution (through retail outlets and other consumer touch points) as well as higher prices of hard liquor, resulting from increased government taxes.

Figure 22: Split between hard and soft liquor consumption volumes (liters)



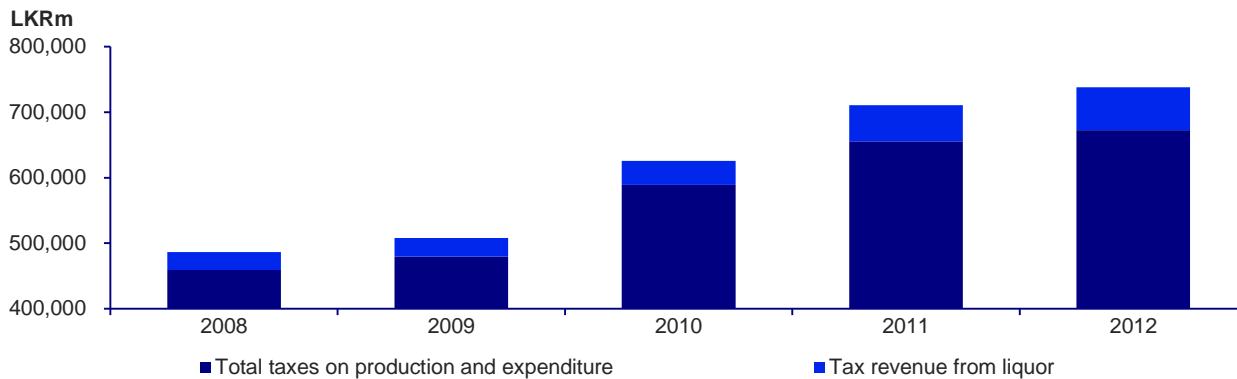
Source: Excise Department of Sri Lanka

Note: Data as of 2012. The Excise Department data is available on a calendar-year basis.

Government influence

The main impact that the government has on the industry is by way of excise duty policies, with taxes being payable every 15 days on production volumes. The domestic alcohol industry has always been a major tax revenue source for the GoSL, generating LKR65.2bn in revenue in 2012, through the excise revenue earned. Tax revenue from liquor accounted for roughly 10% of total tax revenue earned on production and expenditure in 2012, and contributed 2% of GDP in the same year.

Figure 23: Tax revenue from liquor accounted for 10% of taxes earned on production and expenditure in 2012



Source: Central Bank of Sri Lanka, Copal Amba estimates

Note: Data as of 2012. Central Bank data is available on a calendar-year basis.

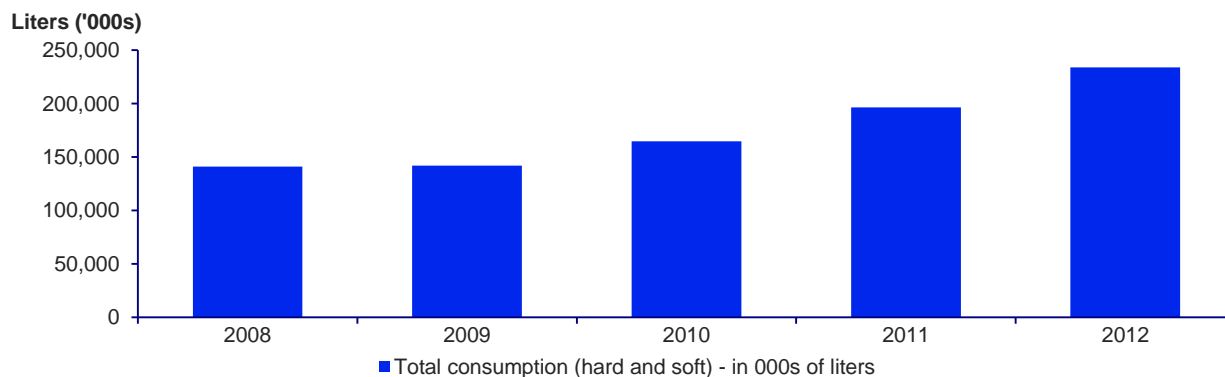
We note that one impact of the tax increases in recent times has been the gradual mix-shift to soft liquor (such as beer), with malt liquor making up 53% of total consumption in 2012 (surpassing the 50% mark after several years, when compared to the recent past) as reflected in Figure 22. Furthermore, according to management, these constant upward tax revisions have also led to increased consumption of illicit (moonshine) and illegal (imitations produced by licensed manufacturers or those liters produced not declared for tax purposes) hard liquor products among consumers, who are looking for greater value for money, measured by the 'kick-per-buck'. According to industry experts, illicit and illegal brewers make up approximately 50% of the domestic alcohol industry in Sri Lanka, with around 200,000 illicit brew retailers, compared to approximately 3,300 licensed wine shops, based on statistics from the Institute of Policy Studies.

Since these illicit players remain untaxed and unregulated, illicit alcoholic products are significantly less expensive (as much as 30-40%, as stated by DIST management), which makes them a suitable substitute to the price-sensitive consumer, despite the inferior quality and poor hygiene standards.

Industry demand drivers for legal alcohol

The fundamental growth drivers for the overall local legal alcohol market in Sri Lanka continue to remain healthy, in our view. As shown below, total liquor consumption trends in Sri Lanka have seen a steady increase since 2010, with a 10% CAGR over 2008-2012.

Figure 24: Total consumption of liquor (including hard and soft) continues to grow with increasing income levels

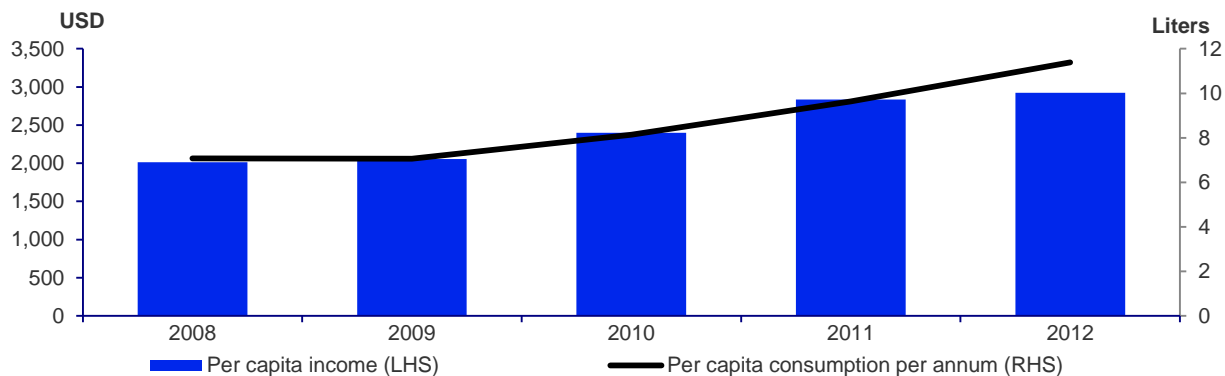


Source: Excise Department of Sri Lanka, Copal Amba estimates

The hard liquor market, however, appears to be reaching maturity, evident by a 3% consumption CAGR over 2008-2012. Therefore, we believe that the domestic hard liquor market (legal, illegal, and illicit) will experience flat volume growth in the future. However, any material volume increases in the legal segment of the hard liquor industry should come from the shift away from illicit and illegal products, as consumers are now increasingly aware of the health risks arising from the consumption of illicitly brewed alcohols, and would therefore turn to legal manufacturers and brands.

We believe this demand would be driven by rising per capita income levels, allowing for greater disposable income levels (the government of Sri Lanka [GoSL] expects per capita income to increase to USD4,000, an 8% CAGR from 2013 levels), which should contribute toward growth in demand for both hard and soft liquors. As shown in Figure 25, the 'dependence' on alcoholic beverages has made demand for liquor increase along with per capita growth.

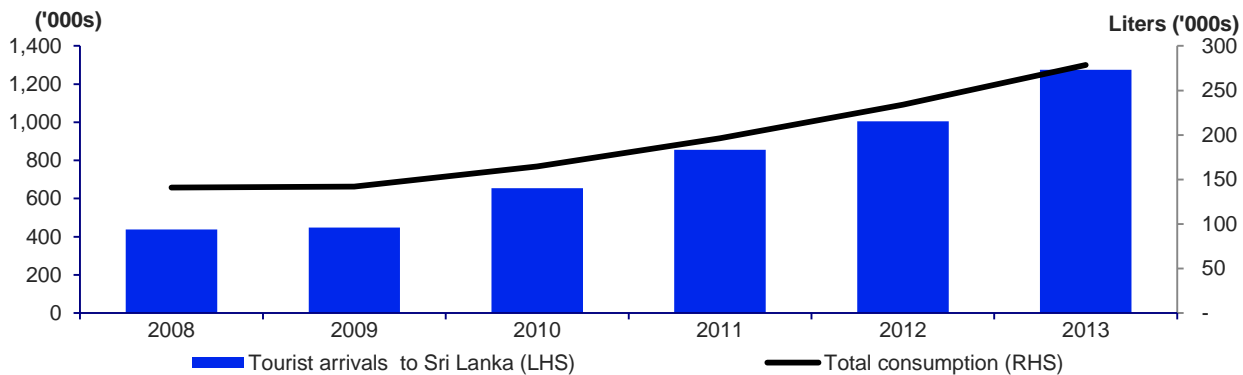
Figure 25: Per capita income in USD vs. per capita alcohol consumption



Source: Central Bank of Sri Lanka, Excise Department of Sri Lanka
 Note: Data as of 2012. Central Bank data is available on a calendar-year basis.

We expect increasing tourist arrivals into Sri Lanka to also drive demand growth. Tourism is a burgeoning industry in Sri Lanka, and it has taken off post war (since May 2009). Tourist arrivals grew 30% from 2009 to reach 1.27m in 2013. The GoSL expects tourist arrivals to increase to 2.5m by 2016, and we believe this would contribute to growth in liquor consumption (see Figure 26).

Figure 26: Increasing tourist arrivals will increase the demand potential for products such as alcohol



Source: Sri Lanka Tourism Development Authority (SLTDA), Excise Department of Sri Lanka, Copal Amba estimates
 Note: SLTDA and Excise Department data is available on a calendar-year basis. 2013 consumption levels are based on Copal Amba estimates.

In addition, the product's inelastic nature of demand means that volume should continue its upward trajectory, despite price increases (primarily due to higher excise duties) each year. For example, 2012/2013 saw excise duty revisions (upwards) on four occasions; this was in addition to the two increases during 2011/2012. However, based on data provided by the Excise Department of Sri Lanka (ED) and our calculations, we estimate 2012 per capita alcohol consumption to have grown to 11.4 liters (an 18.3% YoY increase), versus 7.1 liters in 2008, clearly indicating the price inelasticity of alcohol.

Competitive analysis of the Sri Lankan alcohol industry using Porter's framework

Porter's analysis – named after its creator, Harvard Business School professor, Michael Porter – is an analytical tool used for industry and competitive analysis. To assess overall industry attractiveness, the tool uses seven elements: barriers to entry, barriers to exit, rivalry among competitors, power of buyers, power of suppliers, availability of substitutes and government action. Based on a range of specific analytical points for each element, the industry and/or company subject to analysis are rated on a spectrum of highly unattractive to highly attractive. Each rating is then used to arrive at an overall industry rating.

Conclusion: Threat of new entrants and increasing rivalry among existing players remain high

We view the relative attractiveness of the market as moderate. In the legal segment of the market, DIST could face the increasing threat of new entrants, who could apply for approval from the ED and enter the hard liquor market. In addition, in the illicit market, which targets the low-income strata of the market, DIST faces increasing competition from players whose products are suddenly more attractive given the tax hikes, which have made prices of legally brewed liquor more costly.

Threat of new entrants – high

We view the threat of new entrants as high to moderate. The alcohol industry is regulated by the ED, which has to provide licenses for the manufacture or sale of liquor. While manufacturing licenses are difficult to obtain (as no new licenses are issued, and an existing license will have to be bought out by a new entrant), distribution licenses are not impossible to obtain. The threat of new entrants is more significant in the illegal segment of the industry, where illicit alcohol brewers enter and exit the market unregulated.

Barriers to exit – low

Barriers to exit are low. While setting up large-scale breweries requires significant capital investment, there are no significant legal ramifications if a firm wants to exit the business.

Rivalry among competitors - high

We rate rivalry among competitors as significantly high in the local alcohol industry, not excluding the illicit alcohol manufacturers, who operate outside the purview of the law and therefore can undercut legal brewers in terms of price. DIST mainly competes with privately held players – such as International Distilleries Ltd, Rockland Distilleries (Pvt) Ltd, Hingurana Distilleries Ltd and Sri Lanka Distilleries – in its major end market within the hard liquor space. Moreover, local manufacturers such as Lion Brewery and Asia Pacific Brewery compete for consumer wallet share in the soft liquor segment.

Bargaining power of buyers – low-moderate

We view the bargaining power of buyers as low to moderate as they have limited negotiating power in the industry. The prices of DIST's products are determined by the taxes imposed on the sector with a margin on top. Therefore, buyers in the legal segment of the industry are largely price takers. However, we believe price-sensitive consumers will easily switch over to the illicit market, once prices become too high for them to purchase legally brewed liquors.

Bargaining power of suppliers – moderate

We view the bargaining power of suppliers as moderate as firms operating in the legal alcohol market offer fair rates for suppliers of toddy, while the illegal sector tends to prefer artificial toddy in

times of scarce supply. In addition, suppliers have to ensure the required quality standards are met before they approach the larger distilleries.

Threat of substitutes – high

We rate the threat of substitutes as high as any alcoholic/non-alcoholic beverage can substitute DIST's core products, namely hard liquor. This could range from soft liquors such as beer, wine, cedar, and non-alcoholic beverages such as fizzy drinks, sparkling drinks and soft drinks.

Government action – high

The government plays a key role in DIST's final product prices through its excise taxation policy, which it carries out through the excise ordinance. DIST stated the ED had increased taxes on hard liquor manufacturers four times during 2012-2013.

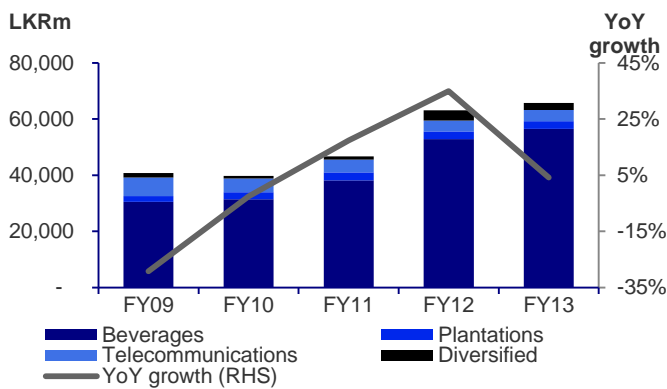
Appendix 2: Company overview

DCSL was established in 1913 when the Excise Department (ED) of Ceylon, as it was known at the time, expanded its operations to include the manufacturing of liquor. However, in 1974, the liquor manufacturing entity was incorporated into a state department while the ED returned to its primary role as monitor and excise law enforcer. In 1989, the Distilleries Corporation was privatized and turned into a limited liability company, and its shares were transferred on the Colombo Stock Exchange in 1992.

With a market capitalization of LKR60.9bn (USD466m) as on 28 March 2014 and a market share of 71% of the local hard liquor market in 2012 (based on data from the ED), DIST is the market leader in the domestic legalized alcohol industry.

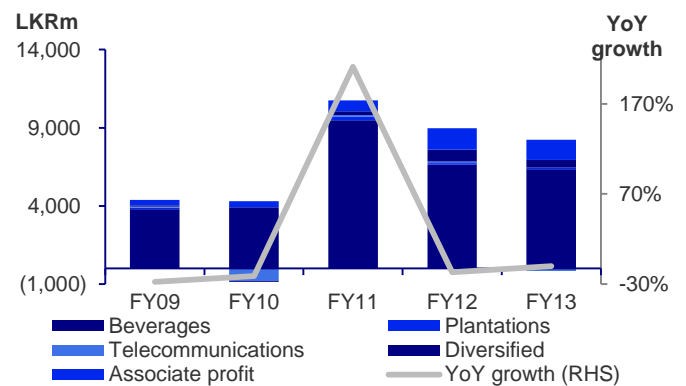
DIST recorded LKR65.8bn in gross revenue for FY13, and paid approximately LKR37bn as excise duty to the government out of this. We believe DIST manufactured roughly 115m liters of alcohol in FY13E, generating a gross revenue CAGR of 12.7% over FY10-FY13. The beverage segment remained the largest contributor to the top and bottom lines, accounting for roughly 86% of FY13 revenue and 94% of FY13 group PBT (excluding associate income). The group generated PBT of LKR8.1bn (including associate income) in FY13, representing a 16.5% CAGR over FY10-FY13.

Figure 27: DIST's gross revenue grew at a 12.7% CAGR over FY10-FY13



Source: DIST

Figure 28: DIST's PBT grew at a 16.5% CAGR over FY10-FY13



Source: DIST

DIST's business segments

DIST's core beverages business supplies several varieties of coconut-based arrack, locally manufactured foreign liquor and imported foreign liquor varieties. Over the past few decades, the company has also diversified into other business streams with operations in the plantation sector, telecommunications sector and other diversified businesses, including financial services, textiles, IT and leisure.

Beverages segment

This segment (86% of FY13 revenue) operates under three broad sub-segments:

- Coconut and processed arrack.** DCSL manufactures several coconut arrack brands (distilled through a natural fermentation process) – such as Special Arrack, Old Arrack, White Label Arrack, Blue Label Arrack and Double Distilled Arrack – at its fully automated bottling plants located in four regions across Sri Lanka (Seeduwa, Kandy, Kalutara and Badulla). These products are made available to consumers at licensed restaurants, premium supermarket chains, clubs and through the hospitality industry.

- **Locally manufactured foreign liquor.** Incorporated as a joint venture between DIST and France-based Pernod Ricard in 1996, this sub-segment operates under DIST's subsidiary, Periceyl (Pvt) Limited, and includes flagship brands such as Franklin Brandy, Black Opal Premium Arrack, Tillsider whisky, Balmora white rum and Petroff vodka, among others.
- **Imported foreign brands.** Through Periceyl, DIST is the exclusive distribution agent for foreign liquor brands by Pernod Ricard, including Royal Salute, Chivas Regal, Absolut Vodka, Havana Club Rum, Jacob's Creek and Long Mountain.

Diversified segment

Most of DIST's diversified segment operations (18 subsidiaries, both direct and indirect, and 3 associates) come under the Melstacorp Limited umbrella and include the following:

- **Telecommunications.** This segment (6% of FY13 revenue) comprises Lanka Bell (LB), which joined the DIST group in 2005. LB is the second-largest fixed telephone operator in Sri Lanka, being the market leader in the CDMA industry, with over 1.2m subscribers. LB also provides broadband services, call center facilities and hardware and software networking solutions to its corporate and residential customer base. Its services are offered through several distribution networks (which include 62 of its own branches) across Sri Lanka.
- **Plantations.** This operation consists of Balangoda Plantations PLC, which came under the DIST group in 1997. The 23 estates span over 13,000 hectares, comprising tea and rubber plantations. In FY13, plantations contributed about 4% to group revenue.
- **Others (excluding associate companies).** DIST's other diversified operations include financial services operations (Continental Insurance and Melsta Regal), automobile servicing and logistics (Melsta Logistics), textile dyeing and fabric printing (Texpro), BPO and KPO services (BellVantage), power generation (Bogo Power), leisure (Browns Beach Hotel), sugar and molasses manufacturing and trading (Pelwatte Sugar), as well as Splendor Media (Pvt) Ltd (media buying and creative services).
- **Associate companies.** The group's three associate investments (16% of group PBT in FY13) comprise Aitken Spence PLC (a leading diversified blue-chip conglomerate in Sri Lanka), Madulsima Plantations PLC (tea cultivation and processing), and Pelwatte Dairy Industries Ltd (produces and sells milk and milk-based products).

Management strategy, transparency and governance

The main strategy change taking place at DIST is the separation of the beverage and non-beverage businesses. In the recent past, DIST has aligned most of its non-beverage operations under the Melstacorp umbrella, with the aim of allowing the group to focus more on its non-beverage revenue streams. Melstacorp acts as a diversified holding company and DIST expects it to emerge as a standalone diversified conglomerate over the next five years.

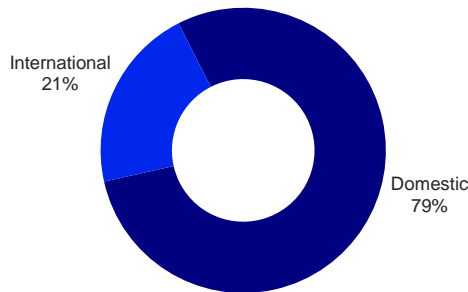
DIST's disclosure levels pose a number of challenges to the analytical process. The company's disclosure at a segment level is insufficient to arrive at accurate calculations and forecasts. Key items such as breakdown of revenue and volumes of the main beverage segment are unavailable. Therefore, we sourced this data in particular from publications by the ED.

The management discussion and analysis section of the annual report does not list DIST's specific targets (ROE, margins expected, market share, etc.), and investors and analysts have to make assumptions regarding the company's future direction. In addition, quarterly operational disclosure levels are also minimal at best. We believe providing these additional details on a quarterly and annual basis would be of greater value to current and potential investors.

Shareholding structure

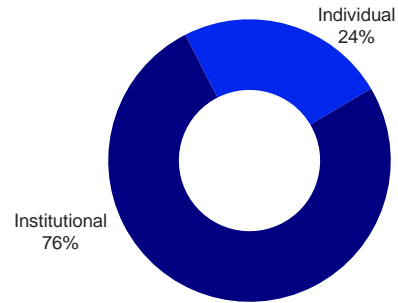
Domestic investors hold 79%, and institutional investors (both domestic and international) hold 76% of DIST's shares. Milford Exports (Ceylon) Limited is the largest shareholder, with a 41.49% stake.

Figure 29: DIST is 79% domestic owned; Milford Exports (Ceylon) Limited is the largest shareholder with 41.49%



Source: DIST (as of March 2013)

Figure 30: Institutional investors hold around 76% in DIST



Source: DIST (as of March 2013)

The top five shareholders as of 31 December 2013 are listed below.

Name of shareholder	Description	Stake
Milford Exports (Ceylon) Limited	Manufactures and exports tea. A subsidiary of Stassen Exports Ltd of Sri Lanka.	41.49%
Lanka Milk Foods (C.W.E.) PLC	Imports, manufactures and distributes domestic-branded dairy and beverage products.	12.65%
Mr. Muzaffar Ali Yaseen	A Sri Lankan high net worth individual and domestic businessman.	11.08%
Mrs. Lorraine Estelle Marlene Yaseen	Mr. Muzaffar Ali Yaseen's spouse.	4.78%
Melstacorp Limited	A diversified holding company under DIST's purview.	2.88%

Source: DIST

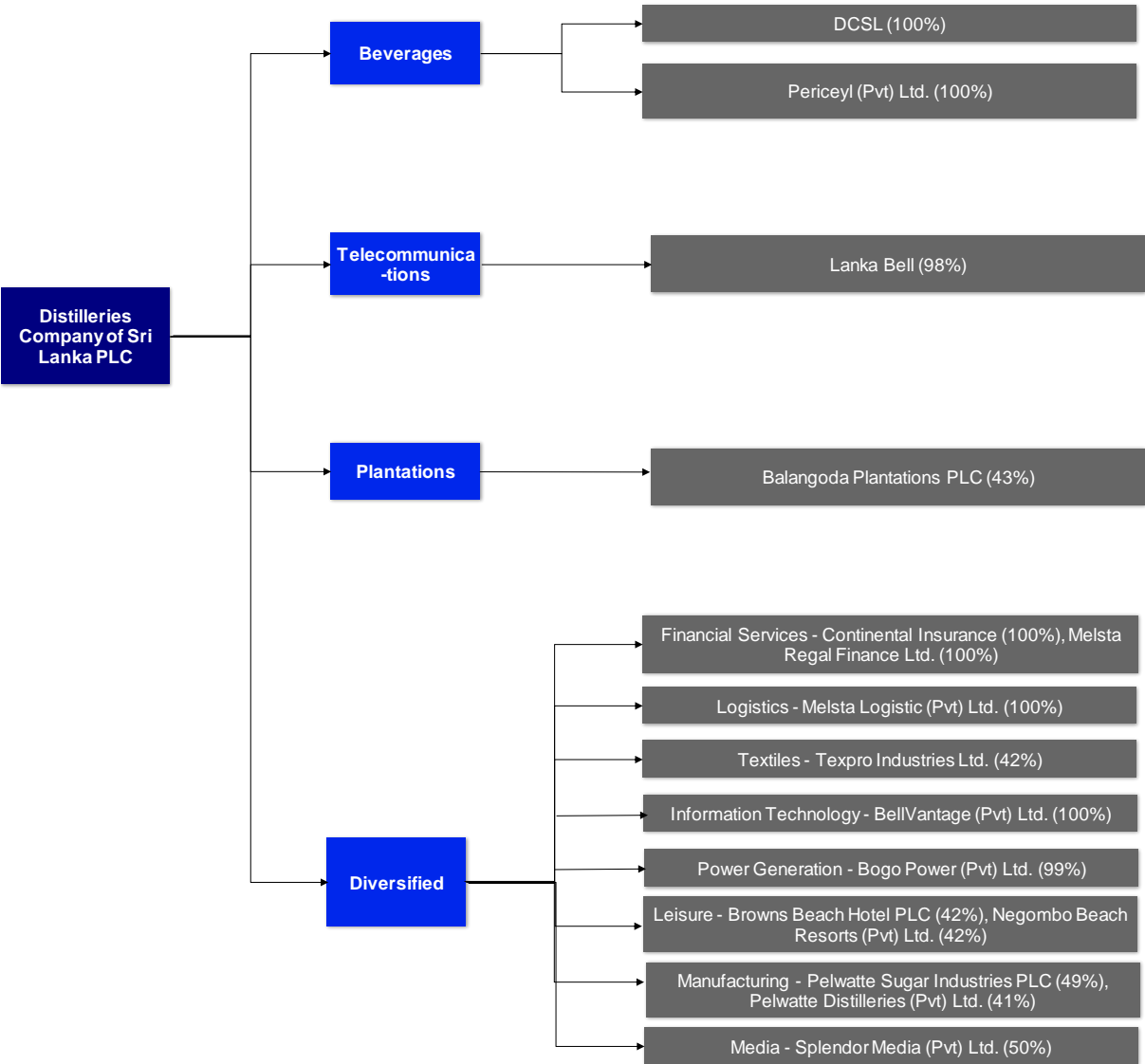
Board of directors

As of March 2013, DIST's board comprised nine directors. Their details are provided below.

Name of Director	Description
Mr. D.H.S Jayawardena	Mr. Jayawardena was appointed as DIST's chairman in 2006 after almost two decades of service as the company's managing director (MD). He is the founder and current chairman/MD of the Stassen Group of Companies.
Mr. R.K. Obeyesekere	Non-independent, non-executive director. He has been a director of the group since 1992, with over 30 years of experience in Sri Lanka's export sector. He also holds directorships in some of the group's subsidiaries.
Mr. C.R. Jansz	A director with many years of experience in logistics, documentation, banking, finance and insurance in relation to international trade. He also holds directorships in many of DIST's subsidiary companies.
Mr. N.de S. Deva Aditiya	Independent non-executive director. He was appointed to the board in September 2006 and is a member of the Conservative Party of the European Parliament elected from South East England.
Capt. K.J. Kahanda	Executive director since 2006. He has been with DIST from 1993. A former officer of the Sri Lanka Army, he is also a director of Pelwatte Distilleries (Pvt) Ltd, a group subsidiary.
Mr. C.F. Fernando	Independent, non-executive director and former MD and CEO of DIST. Mr. Fernando serves as the chairman of the audit committee and also serves on the remuneration committee. He counts over 18 years of financial and general management experience in plantation companies.
Dr. Naomal Balasuriya	Independent, non-executive director. He is also a director at Melstacorp Ltd, a DIST subsidiary.
Ms. V.J. Senaratne	A lawyer by profession, Ms. Senaratne was appointed as company secretary in 1993. She also serves as company secretary of Periceyl (Pvt) Ltd, a DIST subsidiary.
Mr. Amitha Gooneratne	A veteran in the banking industry, Mr. Gooneratne served as the MD of Commercial Bank of Ceylon PLC from 1996-2012. Currently the MD of Melstacorp Ltd, he also holds directorships in several DIST subsidiaries.

Source: DIST

Figure 31: Corporate holding structure



Source: DIST

Appendix 3: SWOT analysis

Strengths

- Market leader in the hard liquor industry in Sri Lanka
- Well positioned with strong distribution network and well-established brand name
- Diversified business model offers additional avenues of growth – such as financing, power, insurance, leisure and telecommunication
- Strong cash position, which could allow the company to expand its operations to new business streams or vertically integrate its existing businesses

Weaknesses

- Telecom and plantation businesses continue to be a drag on profitability
- Despite attempts to diversify, the company still has a sizable exposure to the beverage business and is vulnerable to the government's excise duty hikes
- DIST still awaits compensation from the government takeover of its Sri Lanka Insurance stake along with the Pelwatte Sugar Industries stake
- Inability to enhance dividend payout despite beverages generating strong cash flow due to loss-making investments outside beverages

Opportunities

- Increasing demand for alcohol in Sri Lanka as per capita income improves and tourism arrivals increase
- Opportunity to capture growth drivers in the leisure sector, with a possible increase in the Aitken Spence stake

Threats

- Competition from both illegal and illicit hard liquor brewers
- The plantation sector is impacted by changing weather patterns, which could impact revenue and profitability during the year, along with global demand for tea and rubber, which determines the price offered
- Increasing competition in segments such as beverages and telecommunications

Appendix 4: Key financial data

Summary group financials (LKRm)

INCOME STATEMENT	2011	2012	2013	2014E	2015E	2016E
<i>(For the year ended 31 March)</i>						
Gross revenue	49,789	63,125	65,790	69,712	73,418	77,350
Net revenue	20,173	26,975	28,766	29,709	31,965	34,051
Associate income	702	1,365	1,292	1,454	1,408	1,457
EBIT	5,908	6,633	6,679	7,302	8,329	8,909
EBT	6,782	8,977	8,084	8,678	9,143	9,786
Net profit	5,139	5,536	5,140	5,679	5,827	6,138

BALANCE SHEET	2011	2012	2013	2014E	2015E	2016E
<i>(As at 31 March)</i>						
Current assets						
Cash and cash equivalents	8,634	4,955	4,843	5,033	5,124	5,637
Short term investments	2,453	1,316	1,768	2,317	2,317	2,317
Accounts receivable	5,940	8,210	8,190	9,067	9,655	10,172
Inventories	4,666	5,785	6,140	6,221	6,657	7,891
Total current assets	21,813	20,744	21,691	23,406	24,520	26,785
Non-current assets						
Property, plant and equipment	14,494	14,462	15,438	17,659	19,860	21,915
Goodwill	1,032	1,378	601	601	601	601
Intangible assets	2,385	4,812	5,024	5,265	5,265	5,265
Investments in JV/associates	12,197	19,656	20,915	22,368	24,275	26,232
Total non-current assets	30,307	52,612	56,554	62,716	67,324	71,536
Total assets	52,120	73,355	78,245	86,121	91,844	98,321
Current liabilities						
Short term debt	3,894	11,048	10,553	13,296	13,296	13,296
Accounts payable	9,524	11,414	11,467	12,275	13,075	14,364
Income tax payable	1,262	1,288	727	1,219	1,219	1,219
Total current liabilities	14,844	23,977	22,989	27,402	28,202	29,490
Non-current liabilities						
Long term debt	705	1,320	602	691	691	691
Postretirement benefit obligation	1,039	1,103	1,148	1,129	1,129	1,129
Total non-current liabilities	2,480	3,232	2,543	2,458	2,458	2,458
Equity						
Common share capital	300	300	300	300	300	300
Retained profit	25,301	23,024	27,234	31,019	35,826	40,889
Total equity	34,796	46,146	52,713	56,261	61,184	66,372
Total liabilities and equity	52,120	73,355	78,245	86,121	91,844	98,321

CASH FLOW STATEMENT	2011	2012	2013	2014E	2015E	2016E
<i>(For the year ended 31 March)</i>						
Operating activities						
Net cash flow from operating activities	13,482	4,153	4,120	5,951	6,742	6,736
Investing activities						
Purchase of PPE and intangible assets	(6,114)	(2,253)	(2,837)	(3,977)	(4,038)	(3,868)
Net cash flow from investing activities	(6,755)	(15,633)	(2,128)	(6,333)	(5,038)	(4,568)
Financing activities						
Debt issuance/(repayment)	(1,077)	1,496	(686)	(617)	-	-
Dividends paid to common shareholders	(900)	(750)	(891)	(1,891)	(1,020)	(1,075)
Net cash flow from financing activities	(1,993)	541	(1,578)	(2,637)	(1,614)	(1,655)
Net increase/(decrease) in cash and cash equivalents	4,734	(10,940)	414	(3,019)	91	513

Key ratios

KEY RATIOS	2011	2012	2013	2014E	2015E	2016E
Growth						
Gross revenue growth (%)	25.1	26.8	4.2	6.0	5.3	5.4
Net revenue growth (%)	0.6	33.7	6.6	3.3	7.6	6.5
EBIT growth (%)	84.5	12.3	0.7	9.3	14.1	7.0
EBT growth (%)	95.9	32.4	(9.9)	7.3	5.4	7.0
Net profit growth (%)	140.6	7.7	(7.1)	10.5	2.6	5.3
Recurrent diluted EPS growth (%)	140.6	7.7	(7.1)	10.5	2.6	5.3
Margins						
EBIT margin (%)	29.3	24.6	23.2	24.6	26.1	26.2
EBT margin (%)	33.6	33.3	28.1	29.2	28.6	28.7
Net profit margin (%)	25.5	20.5	17.9	19.1	18.2	18.0
ROCE (%)	13.7	8.8	6.9	7.1	7.3	7.3
ROE (%)	19.6	15.1	11.5	11.4	10.8	10.8
Liquidity and Efficiency						
Current ratio (x)	1.5	0.9	0.9	0.9	0.9	0.9
Total asset turnover (x)	1.0	0.9	0.8	0.8	0.8	0.8
Gearing and Cash Flow						
Debt/capital (%)	11.7	21.1	17.5	19.9	18.6	17.4
Interest cover (x)	15.0	9.8	4.1	5.7	6.0	6.4
Free cash flow (FCF) yield (%)	13.6	3.9	2.6	3.2	4.4	4.7
Net debt/FCF (x)	0.9	(3.2)	(3.5)	(3.4)	(2.4)	(2.1)
Valuation						
P/E (x)	10.5	8.8	9.7	10.7	10.5	9.9
P/BV (x)	1.7	1.2	1.0	1.2	1.1	1.0
EV/EBITDA (x)	5.4	6.6	6.5	7.6	6.6	6.3
EV/sales (x)	1.0	0.9	0.8	1.0	0.9	0.9
EV/FCF (x)	6.4	28.9	42.5	34.2	25.0	23.5

PER SHARE DATA	2011	2012	2013	2014E	2015E	2016E
Recurrent diluted EPS	27.08	18.45	17.13	18.92	19.42	20.37
Common dividend per share (LKR)	3.00	3.00	3.00	3.31	3.40	3.57
Book value per share (BVPS)	105.45	138.59	159.93	171.50	187.52	204.32
Net operating cash flow per share	44.94	13.84	13.73	19.83	22.48	22.36
Net cash flow per share	15.78	(36.47)	1.38	(10.07)	0.30	1.63

Source: DIST, Copal Amba estimates

FX rates (LKR/USD): Y/E 31 March 2013 = 129.59

Y/E 31 March 2012 = 112.64

Y/E 31 March 2011 = 112.12

Segmental summary

Beverage segment	2011	2012	2013	2014E	2015E	2016E
Gross revenue	38,163	52,908	56,479	59,932	62,999	66,105
Net revenue	11,584	16,757	19,455	19,929	21,546	22,806
PBT	9,489	6,636	6,349	6,932	7,182	7,617
<u>YoY growth</u>						
Gross revenue	21.6%	38.6%	6.8%	6.1%	5.1%	4.9%
Net revenue	-0.4%	44.7%	16.1%	2.4%	8.1%	5.9%
PBT	142.7%	-30.1%	-4.3%	9.2%	3.6%	6.1%
<u>Margin</u>						
PBT	81.9%	39.6%	32.6%	34.8%	33.3%	33.4%

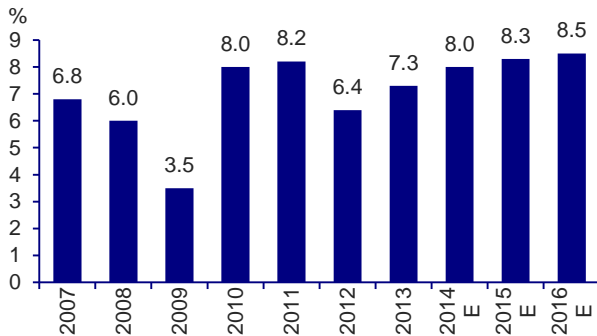
Non-beverage segments	2011	2012	2013	2014E	2015E	2016E
Revenue	8,589	10,217	9,312	9,780	10,419	11,245
PBT (excluding associate income)	570	975	444	291	553	712
<u>YoY growth</u>						
Revenue	2.0%	19.0%	-8.9%	5.0%	6.5%	7.9%
PBT (excluding associate income)	NM	71.0%	-54.5%	-34.4%	89.9%	28.7%
<u>Margin</u>						
PBT (excluding associate income)	6.6%	9.5%	4.8%	3.0%	5.3%	6.3%

Fact sheet

Sri Lanka investment environment overview

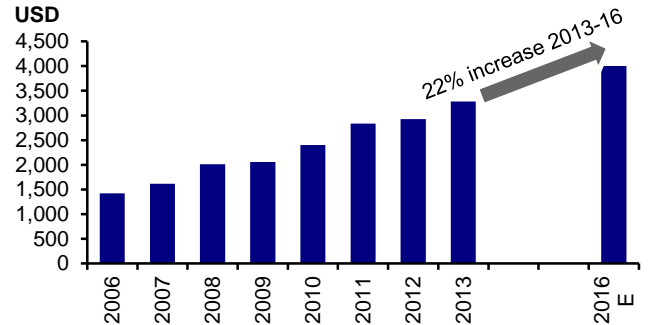
Sri Lanka's economy has been on an upward trajectory since the end of the three-decade civil war in May 2009. Sri Lanka currently boasts South Asia's highest GDP growth, conducive fiscal and monetary policy, and favorable socio-economic conditions, which together create an attractive investment destination.

Figure 32: Sri Lanka's GDP projected to increase at a 5% CAGR 2014E-2016E



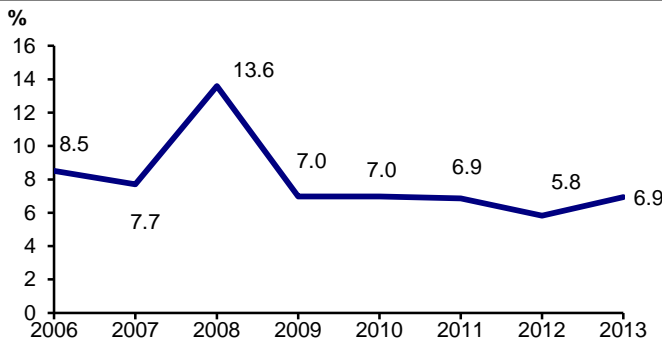
Source: Central Bank of Sri Lanka, Department of Census and Statistics

Figure 33: GDP per capita to increase 22% by 2016E



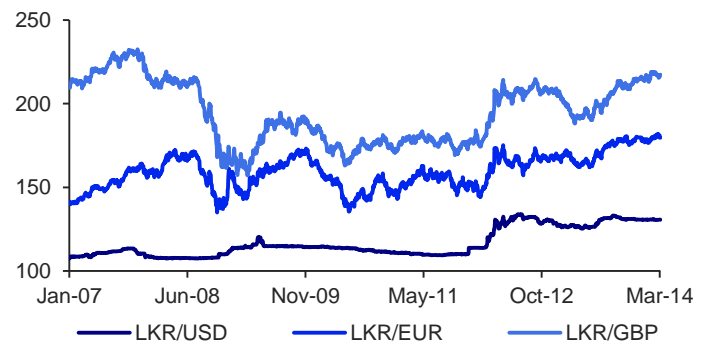
Source: Central Bank of Economic and Social Statistics of Sri Lanka 2012, Road Map 2013 - Central Bank of Sri Lanka

Figure 34: Annual core inflation post-war has averaged 6.7%, government targeting mid-single digit levels in the medium term



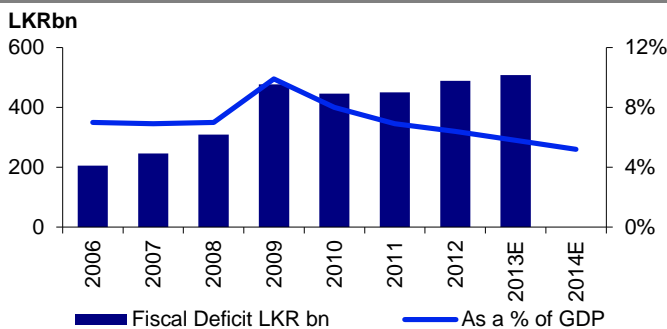
Source: Department of Census and Statistics, Central Bank of Sri Lanka

Figure 35: CBSL expects the rupee to stabilize in the medium term despite recent volatility



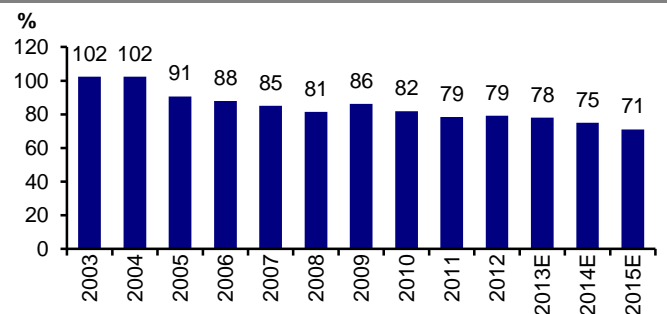
Source: Bloomberg

Figure 36: Fiscal deficit target of 5.2% of GDP for 2014E



Source: Central Bank of Sri Lanka

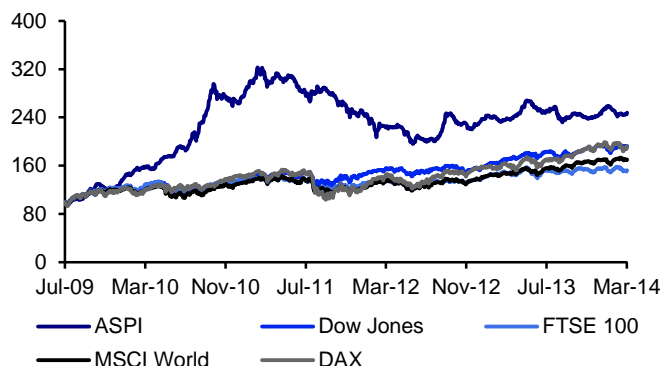
Figure 37: Debt-to-GDP to fall to 71% by 2015E



Source: Central Bank of Sri Lanka

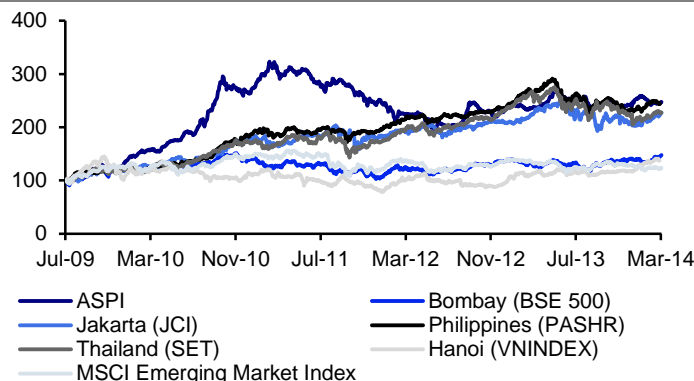
The Sri Lankan equity market offers a rare and attractive alternative to investors in an investment era impacted by economic growth worries. Backed by the country's robust economic growth, the Sri Lankan capital market is well set to offer attractive returns to investors who are keen to be a part of this emerging market success story. There are several strong incentives for entering the Sri Lankan capital market.

Figure 38: Post war, the ASPI has significantly outperformed global and developed market indices



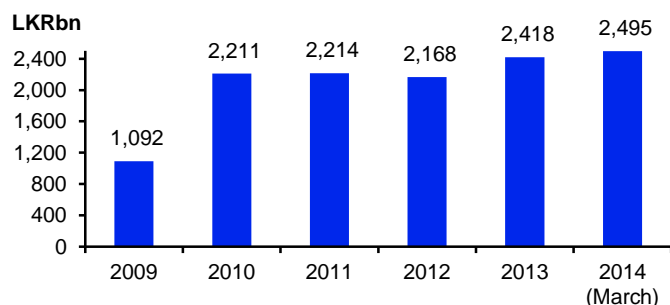
Source: Bloomberg
*Note: All figures re-based to 1 July 2009

Figure 39: Post war, the ASPI has also outperformed some of the best-performing regional indices



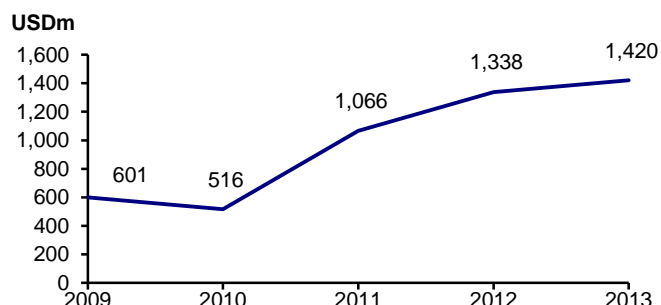
Source: Bloomberg
*Note: All figures re-based to 1 July 2009

Figure 40: The CSE's market capitalization has doubled since 2009



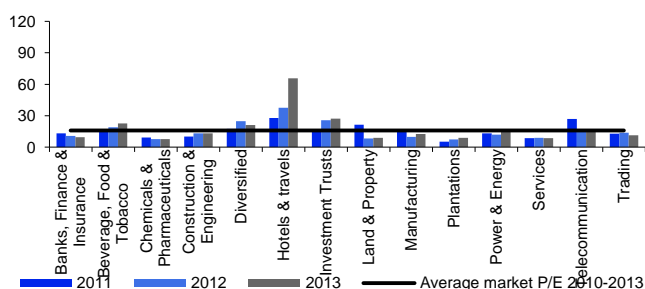
Source: Bloomberg, Central Bank of Sri Lanka

Figure 41: FDI inflows reached USD1.4bn in 2013, an 11% CAGR 2009-2013



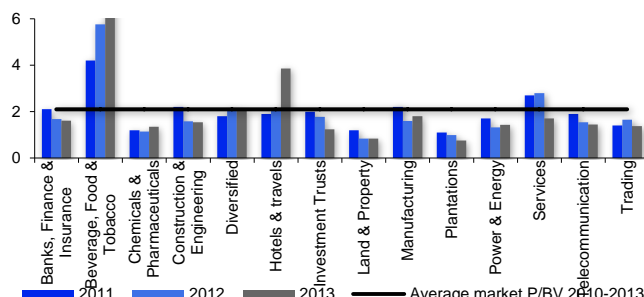
Source: Ministry of Finance and Planning, Board of Investment of Sri Lanka

Figure 42: Most sector P/E's are below market average and historical valuations



Source: Colombo Stock Exchange

Figure 43: Trend is similar on a P/BV value



Source: Colombo Stock Exchange

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