

# Malaysia Company Guide

# British American Tobacco

Version 16 | Bloomberg: ROTH MK | Reuters: BATO.KL

Refer to important disclosures at the end of this report

DBS Group Research . Equity

21 Feb 2020

## BUY (Upgrade from FULLY VALUED)

Last Traded Price ( 20 Feb 2020): RM12.70 (KLCI : 1,534.98)

Price Target 12-mth: RM17.10 (35% upside) (Prev RM16.30)

### Analyst

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### What's New

- 4QFY19 earnings beat expectation driven by improved sales volume and lower operating costs
- Illegal cigarettes market share dropped from 72% to 68%
- Increase FY20-21F earnings forecast by 27-33% on better sales volume and cost control
- Negatives priced in; stock currently trading at -2 SD of 3-year mean; upgrade to BUY with TP of RM17.10 and dividend yield of 8%

### Price Relative



### Forecasts and Valuation

FY Dec (RMm)	2018A	2019A	2020F	2021F
Revenue	2,823	2,509	2,590	2,603
EBITDA	624	514	466	473
Pre-tax Profit	624	464	433	437
Net Profit	469	346	324	327
Net Pft (Pre Ex.)	449	367	324	327
Net Pft Gth (Pre-ex) (%)	(14.1)	(18.2)	(11.7)	0.8
EPS (sen)	164	121	114	114
EPS Pre Ex. (sen)	157	129	114	114
EPS Gth Pre Ex (%)	(14)	(18)	(12)	1
Diluted EPS (sen)	157	129	114	114
Net DPS (sen)	155	118	102	103
BV Per Share (sen)	148	136	140	152
PE (X)	7.7	10.5	11.2	11.1
PE Pre Ex. (X)	8.1	9.9	11.2	11.1
P/Cash Flow (X)	7.3	10.9	10.2	10.0
EV/EBITDA (X)	6.3	7.8	8.6	8.5
Net Div Yield (%)	12.2	9.3	8.0	8.1
P/Book Value (X)	8.6	9.3	9.1	8.4
Net Debt/Equity (X)	0.8	1.0	1.0	0.9
ROAE (%)	116.6	85.3	82.2	78.5
Earnings Rev (%):			27	33
Consensus EPS (sen):		117	116	118
Other Broker Recs:		B: 6	S: 5	H: 6

Source of all data on this page: Company, AllianceDBS, Bloomberg Finance L.P

## Attractive valuation

**Negatives priced in; upgrade to BUY.** British American Tobacco's (ROTH) share price plunged largely due to; 1) disappointing 3QFY19 results as illegal cigarettes and vapour products controlled 74% of total market share, 2) concerns on its ability to retain high dividend payout (>95%) due to weak earnings and, 3) removal from the MSCI Global Standard Index effective end of this month.

However, there were encouraging signs in its 4QFY19 results such as; 1) ROTH and industry's sales volume improved, 2) lower market share for illegal cigarettes (4QFY19: 68%) and lower operating expenses (4QFY19: -22% q-o-q). We think the 4QFY19 results signals an inflection for the stock. ROTH's valuation is attractive given that the stock is currently trading at 11x FY20 EPS (below -2 SD of 3-year mean of 14x). Furthermore, at current price the stock offers attractive dividend yield of 8% (assuming 90% payout). Upgrade to BUY.

**Where we differ: More conservative than consensus.** Due to a tough operating environment, we are relatively more conservative on sales volume assumptions.

**Potential catalysts: Lower illicit trade and better cost control.** Lower market share for illegal cigarettes boosting legal volume and better cost control mainly from operating expenses.

### Valuation:

Post-earnings revision, we increased DCF-based TP to RM17.10.

### Key Risks to Our View:

Lower market share for illicit cigarettes due to effective enforcement.

### At A Glance

Issued Capital (m shrs)	286
Mkt. Cap (RMm/US\$m)	3,626 / 867
Major Shareholders (%)	
British American Tobacco BV	50.0
Aberdeen Asset	5.0
Employees Provident Fund	3.8
Free Float (%)	50
3m Avg. Daily Val (US\$m)	3.5
<b>GIC Industry</b> : Consumer Staples / Food, Beverage & Tobacco	



Live more, Bank less

## WHAT'S NEW

## Encouraging signs

**4QFY19 beat expectations.** Stripping off various non-core adjustments including a restructuring exercise of RM15.4m and inventory write down of RM6.3m, the group's 4QFY19 core net profit came in at RM119m (+11% y-o-y, +44% q-o-q). This brings FY19 core profit to RM367m which beat our and consensus expectations.

The group also declared interim net dividends per share (DPS) of 33 sen. This brings its total dividend payout for FY19 to RM1.18, implying a payout ratio 98%.

**Both industry and ROTH'S sales volume improved.** On q-o-q basis, legal industry volume and ROTH's sales volume increased by 8% and 14% respectively which can be attributed to; 1) seasonality as 4Q has usually been stronger than 3Q, 2) Rothman gaining more market share (FY19: +5 ppt in the Value-For-Money (VFM) segment and lower market share for illegal cigarettes).

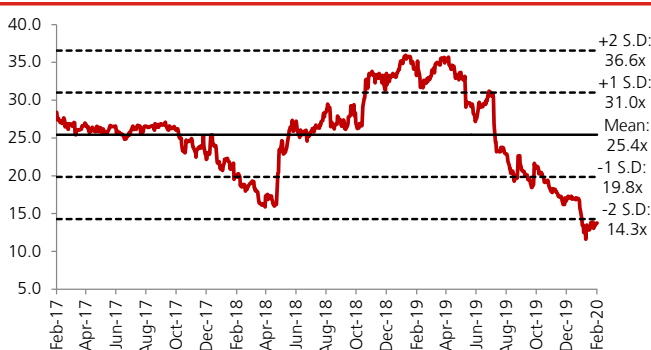
**Market share for illegal cigarettes down to 68%.** We are pleasantly surprised that market share for illegal cigarettes (including vapour products) fell to 68% from 74% in the previous quarter. While it is still considered very high, we view this as a positive sign for the industry.

**Better cost control going forward.** Excluding its restructuring exercise and inventory write down, its operating expenses in 4QFY19 improved (-59 y-o-y; -35% q-o-q) following some cost control by the management such as reprioritising marketing costs and postponing some planned expenditure.

**Increase FY20-21F earnings by 27-33%.** We increase our FY20 and 21 assumptions by 27% and 33% respectively mainly on; 1) better sales volume as we dial down our assumption for illegal cigarettes market share for FY20 and FY21 to 67% from 72% previously and, 2) cost savings from its restructuring exercise. ROTH's management has guided for potential cost savings from the restructuring exercise at RM35m/year (~15.6% of FY19 operating expenses).

**Upgrade to BUY with revised TP of RM17.10.** We think that negatives have largely been priced in and ROTH's valuation is attractive given that the stock is currently trading at -2 SD of 3-year mean of 14x FY20F. At current price, the stock offers attractive dividend yield of 8% (assuming 90% payout). As such, we upgrade our call to BUY with higher TP of RM17.10. Our TP implies 15x FY20F price-to-earnings (PE) which is still below -1 SD of 3-year mean of 20x.

## Trading at -2 SD of 3-year mean (PE)



Source: AllianceDBS, Bloomberg Finance L.P

**Quarterly Income Statement (RMm)**

FY Dec	4Q2018	3Q2019	4Q2019	% chg yoy	% chg qoq
Revenue	771	584	662	(14.0)	13.4
Cost of Goods Sold	(547)	(423)	(471)	(14.0)	11.3
<b>Gross Profit</b>	<b>223</b>	<b>162</b>	<b>192</b>	<b>(14.1)</b>	<b>18.8</b>
Other Oper. (Exp)/Inc	(70.1)	(49.1)	(31.9)	(54.5)	(35.0)
<b>Operating Profit</b>	<b>153</b>	<b>112</b>	<b>160</b>	<b>4.4</b>	<b>42.3</b>
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	nm	nm
Associates & JV Inc	0.0	0.0	0.0	nm	nm
Net Interest (Exp)/Inc	(3.1)	(3.6)	(4.0)	(29.3)	(12.4)
Exceptional Gain/(Loss)	8.94	0.0	(21.8)	nm	nm
<b>Pre-tax Profit</b>	<b>159</b>	<b>109</b>	<b>134</b>	<b>(15.6)</b>	<b>23.3</b>
Tax	(42.6)	(25.7)	(36.4)	(14.4)	41.8
Minority Interest	0.0	0.0	0.0	nm	nm
<b>Net Profit</b>	<b>116</b>	<b>83.1</b>	<b>97.7</b>	<b>(16.0)</b>	<b>17.5</b>
Net profit bef Except.	107	83.1	119	11.2	43.7
EBITDA	155	116	164	5.5	41.1
<b>Margins (%)</b>					
Gross Margins	29.0	27.6	29.0		
Opg Profit Margins	19.9	19.2	24.1		
Net Profit Margins	15.1	14.2	14.7		

Source of all data: Company, AllianceDBS

## British American Tobacco

### CRITICAL DATA POINTS TO WATCH

**Pricing policy drives earnings.** Operating in an oligopoly with three leading players (ROTH, Japan Tobacco International and Philip Morris International) in the legal cigarette market, the ability of ROTH to raise prices to pass on increased costs (mainly arising from hikes in the country's sin taxes) without affecting its market share and profit remains its key earnings driver.

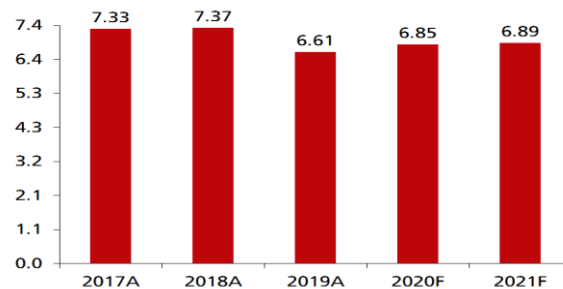
**Influence on market price.** ROTH has a commanding market share of c.54% in the legal cigarette market in Malaysia. Such a dominant position has, to some extent, allowed the group to be a price-leader.

**Optimising costs.** To mitigate the impact of illicit trade on its earnings, the group has undertaken cost cutting initiatives such as overhead savings, lower marketing investment and distribution cost. As a result, its operating expenses in FY19 fell by 18% compared to the same period the previous year (FY18: -4%).

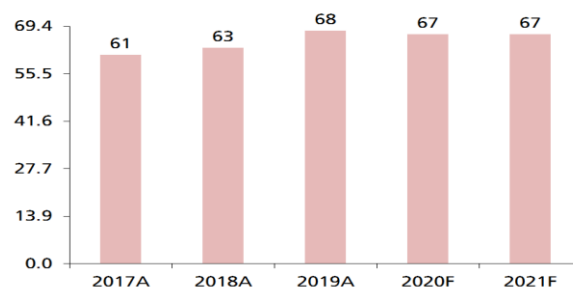
**High illicit trade and alternatives.** Given ROTH's dominant position in the legal cigarette market, high illicit trade continues to be a drag on its earnings growth. Despite strong enforcement recently by the authorities, illicit trade remains high at 64% of the estimated total market share. The increasing popularity of alternatives such as tobacco heating products (THP) could pose new challenges to the industry.

**New government measures.** The Malaysian tobacco industry's landscape remains challenging due to, (1) declining cigarette consumption per capita due to an increasingly health conscious population, (2) continuously high illicit trade, (3) regulatory risks and, (4) emergence of alternative offerings such as THP.

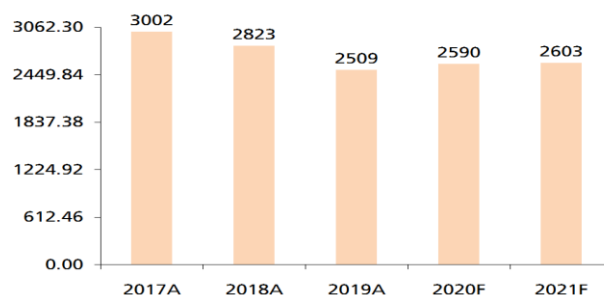
Domestic Legitimate trade volume (bn sticks)



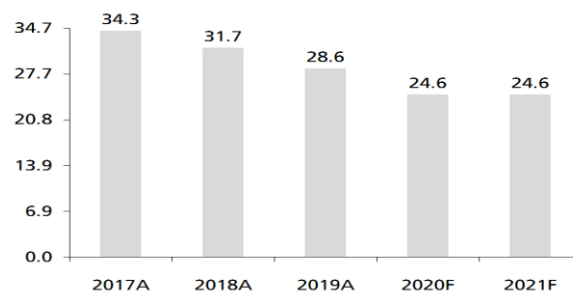
Illicit trade market share (%)



Total revenue (RM m)



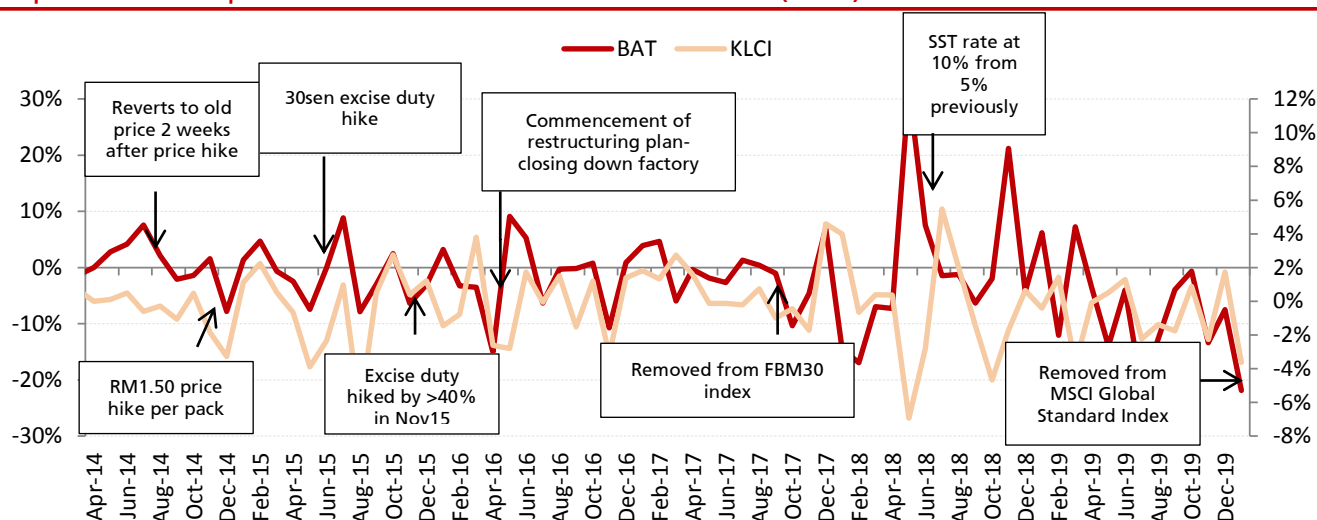
Gross margin (%)



Source: Company, AllianceDBS

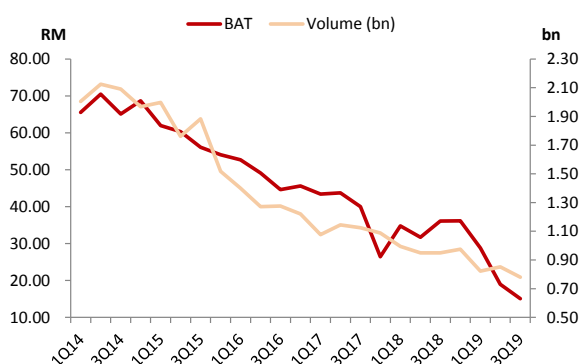
## British American Tobacco

Graph 1: ROTH's share price movement relative to FBM KLCI index movement (m-o-m)



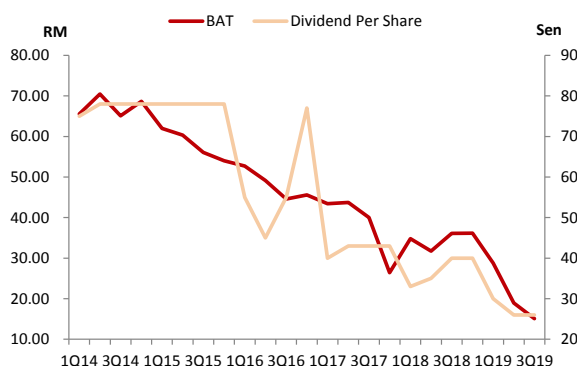
Source: Company, Bloomberg Finance L.P., AllianceDBS

## ROTH's share price vs domestic sales volume



Source: Company, Bloomberg Finance L.P., AllianceDBS

## ROTH's share price vs dividend per share (ex-special div)



Source: Company, Bloomberg Finance L.P., AllianceDBS

## Remarks

As the largest distributor of cigarettes in Malaysia with c.54% market share in the legal cigarette market in Malaysia, ROTH's share price performance correlates strongly with the expansion and contraction of the group's domestic sales volume (correlation coefficient of 0.9), given that the group mainly derives its earnings from domestic consumption.

## Remarks

With strong cash flow generating operations and consistently high dividend payout, ROTH is viewed as a dividend yield stock by the investment community. As such, the group's share price performance is closely correlated with its ability to pay out higher dividends (correlation coefficient of 0.8).

## British American Tobacco

### Balance Sheet:

**Healthy balance sheet.** The group's balance sheet remains healthy despite its net gearing position of about 0.8x (mainly used for working capital), given the strong cash generation of its business, which allows the group to comfortably meet its debt obligations and maintain a high dividend payout without overstretching its balance sheet.

### Share Price Drivers:

**Decline in illicit trade.** A consistent drop in market share of illegal cigarettes could be a major game changer as it is an early indicator of the industry's performance. In our estimation, a 1% drop in illicit cigarettes' market share could increase ROTH's earnings by c.3%.

### Key Risks:

**High illicit trade.** Counterfeit and smuggled cigarettes could continue to cap domestic sales volume in the legal cigarette market. Illicit trade rose from 47.1% in November 2015 to 58% of total market share in December 2016. Combined with vapour products, illegal cigarettes market share hit an all-time high of 74% in September 2019.

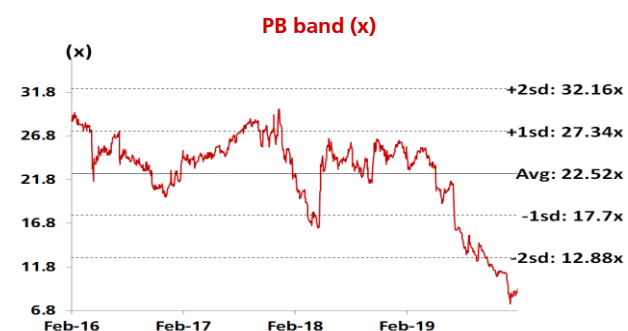
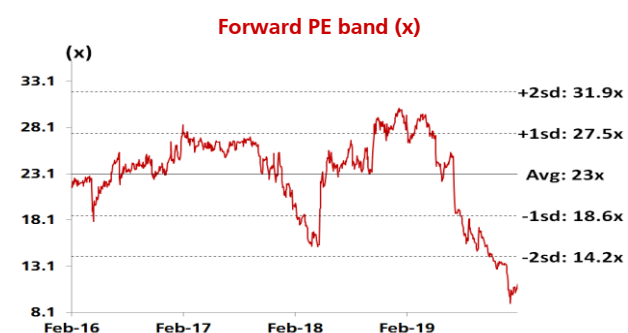
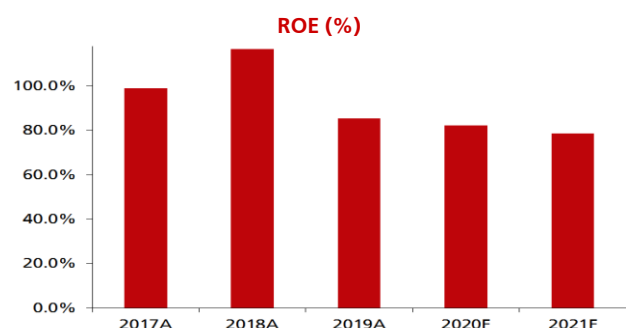
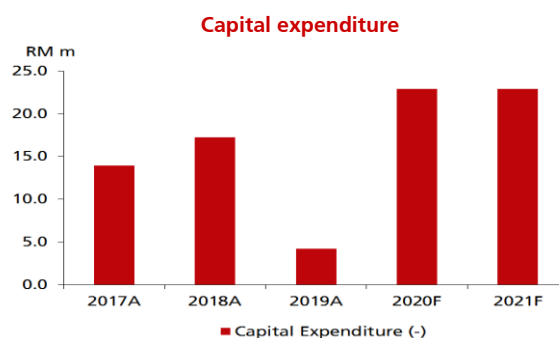
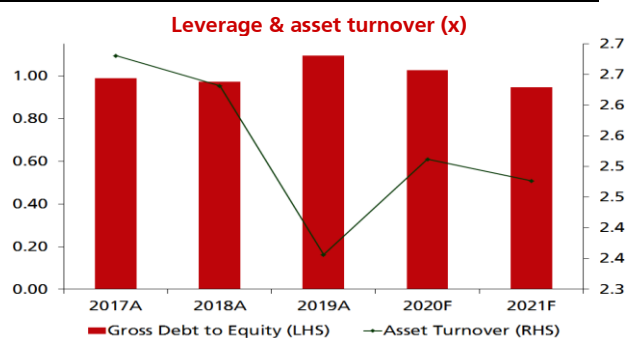
**High taxes.** In view of the persistently high illicit trade and low consumer affordability, we are doubtful of the ability of tobacco players to fully pass on any potential sales tax hike.

### Environmental, Social, Governance (ESG):

As a result of the acquisition of Reynolds American Incorporated (RAI), British American Tobacco plc. is now subject to US securities law, including the Sarbanes-Oxley Act of 2002 (the Act). British American Tobacco plc. had assigned the eleven sections of the Act to respective functional owners such as its Public Company Accounting Oversight Board (PCAOB), White-Collar Crime Penalty Enhancements and Enhanced Financial Disclosure

### Company Background

ROTH is a major distributor of cigarettes in Malaysia. Its portfolio includes the Dunhill, Pall Mall and Kent brands. The group has a c.54% market share of legal cigarettes in Malaysia.



## British American Tobacco

## Key Assumptions

FY Dec	2017A	2018A	2019A	2020F	2021F
Domestic Legitimate trade volume (bn sticks)	7.33	7.37	6.61	6.85	6.89
Illicit trade market share (%)	61.0	63.0	68.0	67.0	67.0
Gross margin (%)	34.3	31.7	28.6	24.6	24.6

## Income Statement (RMm)

FY Dec	2017A	2018A	2019A	2020F	2021F
Revenue	3,002	2,823	2,509	2,590	2,603
Cost of Goods Sold	(1,972)	(1,928)	(1,791)	(1,954)	(1,963)
<b>Gross Profit</b>	<b>1,031</b>	<b>895</b>	<b>718</b>	<b>636</b>	<b>639</b>
Other Opng (Exp)/Inc	(350)	(279)	(218)	(187)	(187)
<b>Operating Profit</b>	<b>680</b>	<b>617</b>	<b>500</b>	<b>449</b>	<b>452</b>
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Associates & JV Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(9.9)	(12.2)	(14.7)	(15.2)	(14.6)
Exceptional Gain/(Loss)	(29.8)	20.0	(21.3)	0.0	0.0
<b>Pre-tax Profit</b>	<b>641</b>	<b>624</b>	<b>464</b>	<b>433</b>	<b>437</b>
Tax	(147)	(154)	(117)	(109)	(110)
Minority Interest	0.0	0.0	0.0	0.0	0.0
Preference Dividend	0.0	0.0	0.0	0.0	0.0
<b>Net Profit</b>	<b>493</b>	<b>469</b>	<b>346</b>	<b>324</b>	<b>327</b>
Net Profit before Except.	522	449	367	324	327
EBITDA	693	624	514	466	473
<b>Growth</b>					
Revenue Gth (%)	(20.1)	(6.0)	(11.1)	3.2	0.5
EBITDA Gth (%)	(29.0)	(10.0)	(17.6)	(9.2)	1.4
Opg Profit Gth (%)	(29.3)	(9.4)	(19.0)	(10.2)	0.7
Net Profit Gth (Pre-ex) (%)	(31.9)	(14.1)	(18.2)	(11.7)	0.8
<b>Margins &amp; Ratio</b>					
Gross Margins (%)	34.3	31.7	28.6	24.6	24.6
Opg Profit Margin (%)	22.7	21.8	19.9	17.3	17.4
Net Profit Margin (%)	16.4	16.6	13.8	12.5	12.6
ROAE (%)	99.0	116.6	85.3	82.2	78.5
ROA (%)	44.0	43.7	32.5	31.4	31.1
ROCE (%)	69.7	58.3	44.9	40.2	39.8
Div Payout Ratio (%)	98.0	94.5	97.5	90.0	90.0
Net Interest Cover (x)	68.8	50.4	34.0	29.6	30.9

Lower operating expenses post

Conservatively assuming lower payout

Source: Company, AllianceDBS

## British American Tobacco

## Quarterly / Interim Income Statement (RMm)

FY Dec	4Q2018	1Q2019	2Q2019	3Q2019	4Q2019
Revenue	771	621	641	584	662
Cost of Goods Sold	(547)	(440)	(457)	(423)	(471)
<b>Gross Profit</b>	<b>223</b>	<b>181</b>	<b>184</b>	<b>162</b>	<b>192</b>
Other Oper. (Exp)/Inc	(70.1)	(60.3)	(77.0)	(49.1)	(31.9)
<b>Operating Profit</b>	<b>153</b>	<b>120</b>	<b>107</b>	<b>112</b>	<b>160</b>
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Associates & JV Inc	0.0	0.0	0.0	0.0	0.0
Net Interest (Exp)/Inc	(3.1)	(3.1)	(4.1)	(3.6)	(4.0)
Exceptional Gain/(Loss)	8.94	(0.8)	0.26	0.0	(21.8)
<b>Pre-tax Profit</b>	<b>159</b>	<b>117</b>	<b>103</b>	<b>109</b>	<b>134</b>
Tax	(42.6)	(28.0)	(26.4)	(25.7)	(36.4)
Minority Interest	0.0	0.0	0.0	0.0	0.0
<b>Net Profit</b>	<b>116</b>	<b>88.6</b>	<b>76.3</b>	<b>83.1</b>	<b>97.7</b>
Net profit bef Except.	107	89.4	76.0	83.1	119
EBITDA	155	124	110	116	164

Better cost control

## Growth

Revenue Gth (%)	4.8	(19.4)	3.2	(8.8)	13.4
EBITDA Gth (%)	(15.3)	(20.0)	(11.2)	5.2	41.1
Opg Profit Gth (%)	(15.5)	(21.4)	(11.5)	5.5	42.3
Net Profit Gth (Pre-ex) (%)	(20.6)	(16.8)	(15.0)	9.4	43.7

## Margins

Gross Margins (%)	29.0	29.1	28.6	27.6	29.0
Opg Profit Margins (%)	19.9	19.4	16.6	19.2	24.1
Net Profit Margins (%)	15.1	14.3	11.9	14.2	14.7

## Balance Sheet (RMm)

FY Dec	2017A	2018A	2019A	2020F	2021F
Net Fixed Assets	34.8	44.0	65.5	69.3	69.6
Invt in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other LT Assets	451	444	432	434	435
Cash & ST Invt	12.0	79.5	20.8	10.6	41.0
Inventory	237	162	98.3	101	102
Debtors	304	361	403	410	412
Other Current Assets	6.60	9.42	8.22	8.22	8.22
<b>Total Assets</b>	<b>1,045</b>	<b>1,101</b>	<b>1,028</b>	<b>1,034</b>	<b>1,068</b>
ST Debt	378	410	425	410	410
Creditor	277	236	171	181	181
Other Current Liab	7.68	33.6	21.7	21.7	21.7
LT Debt	0.0	0.0	0.0	0.0	0.0
Other LT Liabilities	0.0	0.0	21.8	21.8	21.8
Shareholder's Equity	382	422	389	400	433
Minority Interests	0.0	0.0	0.0	0.0	0.0
<b>Total Cap. &amp; Liab.</b>	<b>1,045</b>	<b>1,101</b>	<b>1,028</b>	<b>1,034</b>	<b>1,068</b>
Non-Cash Wkg. Capital	263	264	317	318	319
Net Cash/(Debt)	(366)	(330)	(405)	(399)	(369)
Debtors Turn (avg days)	39.3	43.0	55.6	57.3	57.7
Creditors Turn (avg days)	63.5	48.7	41.8	33.1	34.0
Inventory Turn (avg days)	42.1	37.9	26.8	18.8	19.1
Asset Turnover (x)	2.7	2.6	2.4	2.5	2.5
Current Ratio (x)	0.8	0.9	0.9	0.9	0.9
Quick Ratio (x)	0.5	0.6	0.7	0.7	0.7
Net Debt/Equity (X)	1.0	0.8	1.0	1.0	0.9
Net Debt/Equity ex MI (X)	1.0	0.8	1.0	1.0	0.9
Capex to Debt (%)	3.7	4.2	1.0	5.6	5.6
Z-Score (X)	7.3	8.5	7.7	7.3	7.2

Source: Company, AllianceDBS



## British American Tobacco

## Cash Flow Statement (RMm)

FY Dec	2017A	2018A	2019A	2020F	2021F
Pre-Tax Profit	639	623	462	433	437
Dep. & Amort.	12.9	7.05	14.2	17.7	21.1
Tax Paid	(129)	(124)	(117)	(109)	(110)
Assoc. & JV Inc/(loss)	0.0	0.0	0.0	0.0	0.0
Chg in Wkg.Cap.	(111)	(24.3)	(42.6)	(0.7)	(1.1)
Other Operating CF	(39.7)	11.5	14.0	15.2	14.6
<b>Net Operating CF</b>	<b>372</b>	<b>494</b>	<b>331</b>	<b>356</b>	<b>361</b>
Capital Exp.(net)	(14.0)	(17.2)	(4.2)	(22.9)	(22.9)
Other Invt.(net)	0.0	0.0	0.0	0.0	0.0
Invt in Assoc. & JV	0.0	0.0	0.0	0.0	0.0
Div from Assoc & JV	0.0	0.0	0.0	0.0	0.0
Other Investing CF	94.7	3.29	2.45	0.79	1.04
<b>Net Investing CF</b>	<b>80.7</b>	<b>(14.0)</b>	<b>(1.7)</b>	<b>(22.1)</b>	<b>(21.9)</b>
Div Paid	(711)	(431)	(377)	(313)	(294)
Chg in Gross Debt	248	32.0	11.0	(15.4)	0.0
Capital Issues	0.0	0.0	0.0	0.0	0.0
Other Financing CF	(11.4)	(13.5)	(21.8)	(16.0)	(15.7)
<b>Net Financing CF</b>	<b>(474)</b>	<b>(413)</b>	<b>(388)</b>	<b>(344)</b>	<b>(309)</b>
Currency Adjustments	0.0	0.0	0.0	0.0	0.0
Chg in Cash	(21.3)	67.1	(58.2)	(10.2)	30.4
Opg CFPS (sen)	169	181	131	125	127
Free CFPS (sen)	126	167	115	117	119

Source: Company, AllianceDBS

## Target Price &amp; Ratings History



Note: Share price and Target price are adjusted for corporate actions.

S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	22 Feb 19	36.30	30.00	FULLY VALUED
2:	29 May 19	31.00	30.00	HOLD
3:	26 Jul 19	26.20	25.00	FULLY VALUED
4:	01 Nov 19	18.50	16.30	FULLY VALUED

Source: AllianceDBS

Analyst: Abdul Azim Muhthar

AllianceDBS recommendations are based on an Absolute Total Return\* Rating system, defined as follows:

**STRONG BUY** (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

**FULLY VALUED** (negative total return, i.e., > -10% over the next 12 months)

**SELL** (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

*\*Share price appreciation + dividends*

Completed Date: 21 Feb 2020 09:18:01 (MYT)

Dissemination Date: 21 Feb 2020 09:44:26 (MYT)

Sources for all charts and tables are AllianceDBS unless otherwise specified.

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