

DYER & BLAIR INVESTMENT BANK

EARNINGS UPDATE

Founder Member of the Nairobi Securities Exchange

17TH JULY 2020



DYER & BLAIR
INVESTMENT BANK

WE KNOW. YOU KNOW.

BAT KENYA LIMITED

1H20 EARNINGS UPDATE

Dear All,

BAT Kenya (BATK) released its 1H20 results reporting a 6.0% y-o-y increase in PAT to KES 2.7 BN despite lower revenue, primarily on account of reduced costs, higher export sales and favorable domestic tax policies i.e. the reduction in VAT from 16.0% to 14.0% and downward revision of corporate tax rate from 30.0% to 25.0%.

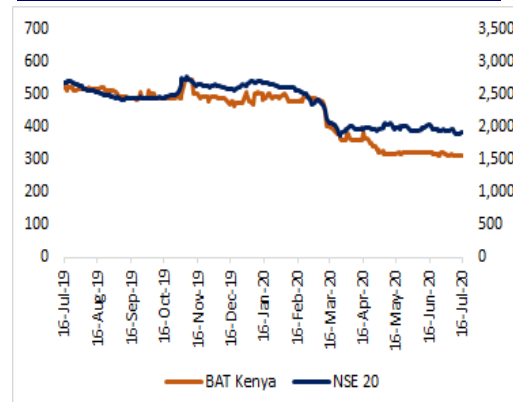
Below please find key highlights:

Net revenue dropped 6.7% y-o-y to KES 10.5 BN. Gross revenue edged down 13.6% y-o-y to KES 16.6 BN owing to a 16.0% y-o-y decline in cigarette volumes sold as a result of the impact of the COVID-19 crisis on distribution and consumer affordability. The domestic to export revenue mix stood at 40:60 in contrast to a 48:52 mix reported in 1H19.

Net domestic revenue edged down 22.2% y-o-y to KES 4.2 BN on the back of affordability challenges occasioned by excise led price increases from the 20.0% upward revision in excise duty implemented from November 2019; and subdued disposable income given a weak economic environment.

Net export revenue edged up 7.7% y-o-y to KES 6.3 BN. The drop in sales occasioned by affordability challenges in the wake of the COVID-19 crisis was shored up by increased orders from Egypt. Owing to COVID-19 related complications, the dominant player, Eastern Company S.A.E (circa 70.0% market share) was unable to sufficiently service the market leaving a vacuum, which BAT stepped in to fill. In the short term, management expects to continue reaping these benefits. Export revenue growth was also bolstered by the approximately 80.0% increase in cut rag sales given increased demand from Nigeria and South Sudan.

BAT KENYA: 52 WEEK PRICE PERFORMANCE



(Source: NSE, DBIB Research)

PRICE RETURN	ABSOLUTE RETURN	EXCESS RETURN
3 months (%)	(19.3)	(16.2)
6 months (%)	(36.1)	(7.5)
12 months (%)	(38.5)	(9.5)

KEY METRICS

Current Price (KES)	310.00
52 week Range (KES)	309.50-545.00
YTD Return (%)	(38.0)
Issued Shares (MN)	100.0
Market Cap KES BN)	31.0

Recommendation	BUY
Target Price	Under Review
EPS (KES)*	37.34
NAV (KES)*	93.23
P/E (x)*	8.3
P/B (x)*	3.3
Div Yld (%)*	11.0

*Trailing ratios

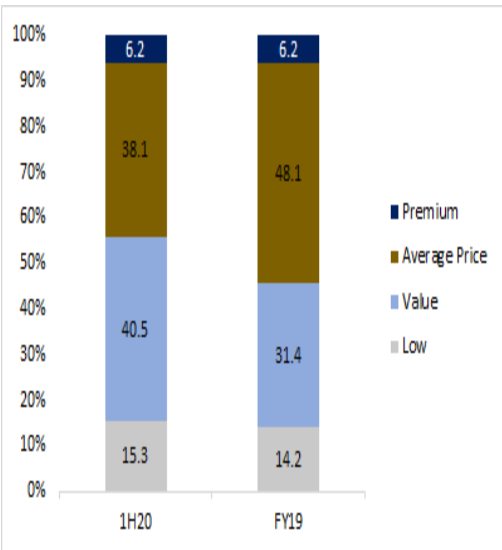
Research Analyst

Cynthia Wangari

cwangari@dyerandblair.com

+254 709 930 130

Revenue contribution by product category



(Source: NSE, DBIB Research)

Consumption dynamics: Cigarette consumption edged down 49.0% y-o-y as a result of a 19.0% y-o-y decline in Average Daily Consumption (ADC) per consumer to around 7 cigarettes. This is testament to the severity of the impact of the COVID-19 crisis and the 20.0% excise duty increase on consumer affordability. Down trading was also a prominent theme over the period with the contribution of Value For Money (VFM) and Low category cigarettes sales rising 910 bps and 110 bps h-o-h to 40.5% and 15.3% respectively and the contribution of averagely priced (AP) cigarettes dropping 1,000 bps h-o-h to 38.1%. The contribution of premium product sales remained constant at 6.2%.

Excise duty and VAT declined 23.4% y-o-y to KES 6.1 BN on account of lower domestic sales volumes and the downward revision of VAT rates in Kenya from 16.0% to 14.0%. The proportion of excise duty and VAT to gross revenue declined 471 bps y-o-y to 36.6%.

Operating expenses edged down 10.1% y-o-y to KES 6.8 BN. Of the KES 761.0 MN decrease, around KES 200.0 MN (26.3%) was attributable to the decline in the volumes of production, KES 210.0 MN (27.7%) was ascribable to productivity savings, KES 100.0 MN (13.1%) was the result of reduced marketing and distribution costs and KES 250.0 MN (32.8%) was the product of lower overheads given the government's COVID-19 containment measures. Management is yet to reach an agreement with the Government of Kenya on the basis of computation of the 2.0% solatium levy. They therefore remained consistent in their approach applying it to gross revenue in 1H20.

Income tax expense dropped 8.9% y-o-y to KES 987.0 MN despite a 1.5% y-o-y increase in profits before tax to KES 3.7 BN on account of the reduction in corporate tax rate from 30.0% to 25.0% in Kenya.

New category products: BATK recorded KES 100.0 MN in net revenue from the sale of its nicotine pouches dubbed 'Lyft'. This was despite the downward revision in the price per packet of 20 from circa KES 450.00 to KES 250.00 in order to benchmark them against the premium cigarette brands; and the adverse impact of the COVID-19 crisis on both consumer affordability and the effectiveness of the nationwide launch that had been expected this year. We remain cautious on the extent to which government overreach could impact growth of the nascent reduced harm category products.

Illicit trade: The incidence of illicit cigarettes remained constant h-o-h at 11.3% on account of the sustained price differential between illicit and legitimate products which continues to be widened by excise based price increments. Management noted that more than 90.0% of illicit cigarettes came from Uganda and were becoming more prevalent in retail markets.

Going forward: Domestic sales are likely to pick up in the second half of the year as retail outlets gradually reopen and COVID-19 related restrictions are relaxed. Going by management guidance, increased demand from Egypt on account of COVID-19 related shortfalls by the monopoly player are likely to continue to buffer export revenue performance in the short-term. We see consumer affordability remaining a key challenge owing to the increased levels of unemployment and depressed economic performance in the region as a result of the COVID-19 crisis. Down trading is therefore likely to remain a concern. Of comfort however is that BATK has a well balanced portfolio of cigarettes that allows it to cover the major price points, allowing its consumers to down trade within the same brand therefore mitigating the risk of market share erosion.

On a trailing basis, BATK is trading at a P/E multiple of 8.3x against a sector median of 7.5x and a P/B multiple of 3.3x against a sector median of 0.7x. Its ROE stands at 40.1%, against a sector median of 25.1% whereas ROA stands at 17.6%, against a sector median of 7.7%. We maintain our **BUY** recommendation.

PROFIT AND LOSS SUMMARY (KES MN)

KES MN	1H20	1H19	y-y % ch	2H19	h-h % ch	FY19
Gross Revenue	16,615	19,228	(13.6)	20,599	(19.3)	39,827
Excise duty and VAT	(6,078)	(7,939)	(23.4)	(7,849)	(22.6)	(15,788)
Net revenue	10,537	11,289	(6.7)	12,750	(17.4)	24,039
Cost of operations	(6,790)	(7,551)	(10.1)	(10,762)	(36.9)	(18,313)
Operating profit	3,747	3,738	0.2	1,988	88.5	5,726
Finance costs	(81)	(126)	(35.7)	(67)	20.9	(193)
Profit before tax	3,666	3,612	1.5	1,921	90.8	5,533
Income tax expense	(987)	(1,084)	(8.9)	(564)	75.0	(1,648)
Profit after tax	2,679	2,528	6.0	1,357	97.4	3,885
Fair value and revaluation gains	(71)	6	-	14	(607.1)	20
Comprehensive income	2,608	2,534	2.9	1,371	90.2	3,905
EPS	26.79	25.28	6.0	13.57	97.4	38.85
DPS	3.50	3.50	-	30.00	(88.3)	33.50

(Source: Company, DBIB Research)

BALANCE SHEET SUMMARY (KES MN)

KES MN	1H20	FY19	1H19	y-y % ch	h-h % ch
Share capital	1,000	1,000	1,000	-	-
Revaluation & Hedging Reserve	1,756	1,756	1,833	(4.2)	-
Retained Earnings	6,567	6,959	5,860	12.1	(5.6)
Shareholders' Funds	9,323	9,715	8,693	7.2	(4.0)
Non Current Liabilities	1,861	1,871	3,481	(46.5)	(0.5)
	11,184	11,586	12,174	(8.1)	(3.5)
Non-current assets	10,867	10,685	9,830	10.5	1.7
Current Assets	10,353	11,251	8,258	25.4	(8.0)
Current Liabilities	(10,036)	(10,350)	(5,914)	69.7	(3.0)
Working Capital	317	901	2,344	(86.5)	(64.8)
	11,184	11,586	12,174	(8.1)	(3.5)

(Source: Company, DBIB Research)

CASHFLOW SUMMARY (KES MN)

KES MN	1H20	FY19	1H19	y-y % ch	h-h % ch
Cash generated from operations	465	10,384	3,397	(86.3)	(95.5)
Net interest paid	(94)	(207)	(116)	(19.0)	(54.6)
Tax paid	(1,867)	(2,493)	(1,356)	37.7	(25.1)
Net cash from/(used in) operating activities	(1,496)	7,684	1,925	(177.7)	(119.5)
Net cash from/(used in) investment activities	(449)	(1,564)	(360)	24.7	(71.3)
Net cash from/(used in) financing activities	(2)	(4,499)	(2,169)	(99.9)	(100.0)
Change in cash & equivalents	(1,947)	1,621	(604)	222.4	-
Cash at the start	1,811	190	190	853.2	853.2
Cash at the end	(136)	1,811	(414)	(67.1)	(107.5)

(Source: Company, DBIB Research)

OPERATING PERFORMANCE

	1H20	FY19	1H19	y-y bps ch	h-h bps ch
Gross Profit margin (%)	22.6	14.4	19.4	311	817
Excise duty & VAT (%)	36.6	39.6	41.3	(471)	(306)
Operating margin	35.6	23.8	33.1	245	1,174
Pretax margin (%)	22.1	13.9	18.8	328	817
PAT margin (%)	16.1	9.8	13.1	298	637
Fixed Assets Turnover (x)*	3.1	3.7	3.9	(85)	(67)
Current Assets Turnover (x)*	3.2	3.5	4.7	(145)	(33)
Current Liabilities Turnover (x)*	3.3	3.8	6.5	(319)	(54)
Working capital turnover (x)*	104.8	44.2	16.4	8,842	6,062
Current ratio (x)	(1.0)	1.1	(1.4)	36	(212)

*Annualized ratios

(Source: DBIB Research)

FINANCIAL STABILITY & LIQUIDITY

	1H20	FY19	1H19	y-y % ch	h-h % ch
Net debt (KES MN)	1,997.0	60.0	3,895.0	51	3,328
Enterprise value/share (KES)	329.97	480.60	558.95	59	69
EV/EBIT (x)	8.8	8.4	15.0	59	105
Current ratio (x)	1.0	1.1	1.4	74	95
Interest cover (x)	46.3	29.7	29.7	156	156
CFO/share (KES)	4.65	103.84	33.97	14	4
NTA/share (KES)	93.23	97.15	86.93	107	96
Book value/share (KES)	93.23	97.15	86.93	107	96
	1H20	FY19	1H19	y-y bps ch	h-h bps ch
Net debt/equity (%)	21.4	19.3	44.8	(2,339)	216
Net debt/EV (%)	6.1	0.1	7.0	(92)	593
Payout ratio (%)	13.06	86.2	13.8	(78)	N/A

(Source: DBIB Research)

INVESTMENT RETURN

	1H20	FY19	1H19	y-y bps ch	h-h bps ch
RoA*	24.3	17.7	23.0	132	659
RoE*	57.5	40.0	58.2	(69)	1,748
RoIC*	47.9	33.5	38.3	958	1,438

*Annualized ratio

(Source: DBIB Research)

APPENDIX

COMPANY INVESTMENT RATINGS

Buy: Share price may generate more than 15.0% upside over the next 12 months

Overweight: Share price may generate between 5.0% and 15.0% upside over the next 12 months

Hold: Share price may fall within the range of <+5.0/ -10.0% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels. Company fundamentals however remain strong

Underweight: Share price may generate between 10.0% and 15.0% downside over the next 12 months

Sell: Share price may generate more than 15.0% downside over the next 12 months, significant business and/or financial risks present, industry concerns

Not Rated: Counter is not within regular research coverage

SECTOR INVESTMENT RATINGS

Overweight: Industry performance better than that of the whole market

Equal weight: Industry performance about the same as that of the whole market

Underweight: Industry performance worse than that of the whole market

DISCLAIMER

While every care has been taken in preparing this report and it has been prepared from sources believed to be reliable, no representation, warranty, or undertaking (express or implied) is given and no responsibility is accepted by Dyer and Blair Investment Bank Limited, its related companies, subsidiaries, affiliates, its employees and agents, as to the accuracy and completeness of the information contained herein or in respect of any reliance on or use thereof. This report is solely intended for distribution to clients of Dyer and Blair Investment Bank Limited. Any information may be changed after distribution at any time without any notice.