BAT Kenya

"When the going gets tough…"

Recommendation: HOLD

We initiate coverage on BAT Kenya with a HOLD recommendation based on a fair value of KES 730.69. This represents a 13.4% downside from the current price of KES 844.00.

Our view is informed by the uncertainty looming on its business as sub-Saharan economies experience a slow-down in growth and unfavourable regulation is passed. We forecast a 3-year CAGR of 1.3% in net revenue to KES 20.6B in FY19F. The growth in net revenue is supported by a 3-year CAGR of 2.2% in local sales to KES 11.8B in FY19F and a 3-year CAGR of 0.2% in export sales to KES 8.9B in FY19F. We estimate the bottom line to grow at a 3-year CAGR of 4.8% to KES 4.9B in FY19F.

Continued uptake of BAT Kenya's products by the high end market, who are their main clientele, is expected to marginally drive revenues.

Positives

- BAT Kenya currently serves the high end cigarette market, therefore making demand for BAT Kenya's cigarette inelastic. This shields them from significant drop in sales when cigarette prices increase due to factors such as increase in excise duty.
- The company has a strong regional presence. It currently exports to 13 African countries.
- No major regulations to be passed going forward as all WHO member countries have implemented the FCTC. Therefore we expect the regulatory environment to remain predictable.

Challenges

- Tightening of regulation on tobacco. In the last two years, Tobacco Control Regulation, 2014 and excise duty 2015 have been passed and enforced. This has negatively impacted BAT's bottom line.
- The IMF projects a slow down in sub-Saharan Africa economic growth. This may translate into lower export sales for BAT Kenya.
- Turmoil in BAT Kenya's key export markets such as DRC Congo and Somalia, has lead to lower cigarette export sales.

Multiples Table	FY16A	FY17F	FY18F	FY19F
Revenue (KES M)	19,849	19,755	20,038	20,638
% y/y ch	(10.8)	(0.5)	1.4	3.0
Operating profit (KES M)	6,205	6,452	6,745	7,154
% y/y ch	(19.1)	4.0	4.5	6.1
EPS (KES)	42.3	43.3	45.5	48.7
% y/y ch	(14.9)	2.4	5.0	7.1
DPS (KES)	43.00	43.36	45.51	48.74
% y/y ch	(13.1)	0.8	5.0	7.1
P/E (x)	19.7	19.2	18.3	17.1
Div yield (%)	5.2	5.2	5.5	5.8
EV/EBITDA (x)	8.3	8.0	7.6	7.2

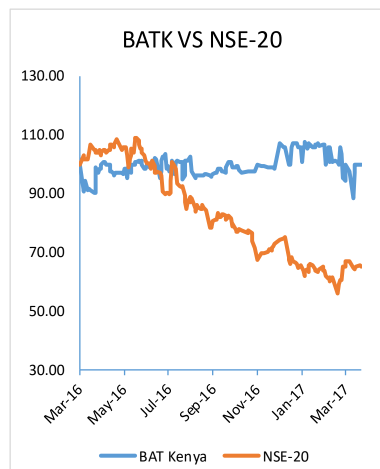
Source: Company fillings, ApexAfrica Research

Share Statistics

Bloomberg Ticker	BATK KN
Reuters Code	BAT.NR
Fair value	730.69
Current Price (KES)	844.00
Issued shares (M)	100
52 week low/high (KES)	750.00/920.00
Market cap (KES B)	85
Market cap (USD M)	825
Free float (%)	40.0
Foreign ownership (%)	80.2
Financial year end	Dec
3-month Av Traded Vol (USD)	235

Price Return	BAT	NSE-20
3m	-7.1%	12.5%
6m	-1.2%	-1.2%
12m	10.3%	-20.6%

Price Trend



Source: Bloomberg, ApexAfrica Estimates

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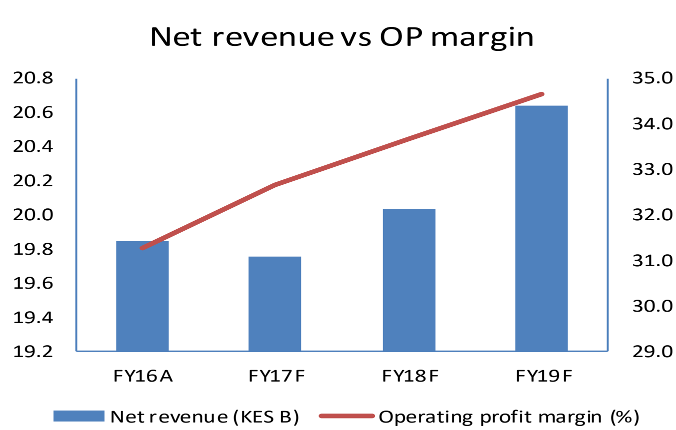
Financial Outlook

Net revenue to increase at a slow rate

We predict a 0.5% y/y drop in net revenues in FY17F to KES 19.8B. This is mainly because of a 2.3% y/y decline in export sales to KES 8.6B (FY17F) due to a slow (2.6%) Sub-Saharan Africa (SSA) GDP growth in 2017. However, we estimate a 3-year CAGR of 1.3% in net revenue to KES 20.6B in FY19F. This is informed by a 3-year CAGR of 2.2% to KES 11.8B in FY19F in local sales and a 3-year CAGR of 0.2% to KES 8.9B in FY19F for export sales. Growth in export sales will be boosted by a rebound in SSA economic activity in the medium term. In addition, we expect a more balanced and predictable regulatory environment going forward. The management looks to be more creative in its product portfolio and has continued focus on route to market.

Cost management to anchor the bottom line

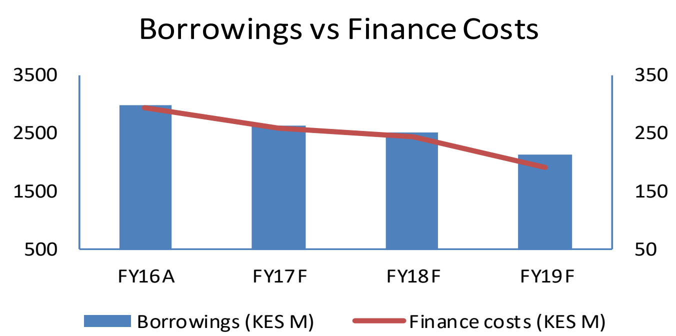
We estimate an impressive 3-year CAGR of –0.4% in cost of operations to KES 13.5B in FY19F with the operating profit margin at 34.7% in FY19F. The management is aiming to reduce costs on productivity, logistics and indirect costs. Productivity cost saving entails substituting the export leaf with local leaf for manufacturing. The company has also been negotiating for better prices on wrapping materials. Logistics costs savings will be achieved by increasing economies of scale of the warehouse and negotiating for fair freight rates adjustment. Through outsourcing IT support services and indirect procurement the company is able to reduce its indirect costs. We expect the costs to remain low as management works to maintain cost efficiency.



Source: Company fillings, ApexAfrica Research

Finance costs to remain on a downward trend

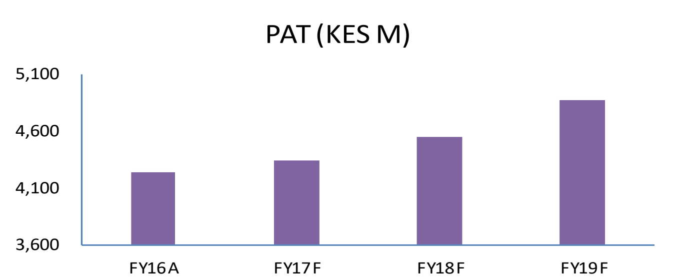
BAT Kenya gets its long-term funding from BATIF and funds its short-term expenses using overdraft from local banks. The loan from BATIF is an unsecured US Dollar denominated floating rate loan repayable by 31 July 2018 at an interest rate of USD LIBOR plus 4.675% up to 31 July 2018. We forecast a 3-year CAGR of –15.7% in the firm's finance costs to KES 194.3M in FY19F. This is mainly attributable a 3-year CAGR of –19.8% in overdraft facility to KES 900.2M in FY19F. The reduction in use of overdraft over the years will be as a result of enhanced working capital management. Overall, we forecast a 3-year CAGR of -13.3% in total finance costs to KES 191.8M in FY19F.



Source: Company fillings, ApexAfrica Research

Bottom line to grow on the back of proper cost management

We forecast a 3-year CAGR of 4.8% on BAT's net earnings in the medium-term with the net profit margin at 23.6% in FY19F from 21.3% in FY16A. This is mainly attributable to the drop in costs (3-year CAGR of –0.4%) even as revenue increases (3-year CAGR of 1.3%). BAT Kenya has maintained c.100% dividend pay-out ratio. Therefore we project a continuation of the same.



Source: Company fillings, ApexAfrica Research

Tobacco Industry Analysis: Global

The tobacco industry is dominated by five major companies in the world;

1. China National Tobacco Corporation (CNTC)

This the world's single largest producer of cigarettes with 44.0% of the global market share. It is owned and run by the Chinese government and sells approximately 99.0% of its products in China

2. Philip Morris International (PMI)

PMI is a publicly traded American company. It has a global market share of 15.0%. PMI only sells its products outside of the United States. The company operates in more than 180 markets and sells 6 of the top 15 brands in the world.

3. British American Tobacco (BAT)

BAT is the world's 3rd largest producer in the global tobacco market and controls 11.0% of the international cigarette market. It operates in more than 200 markets. 71.0% of its sales are from the emerging markets. In Africa, BAT mainly carries out its operations in the continent from South Africa, Nigeria and Kenya.

4. Japan Tobacco, Inc. (JT)

JT operates in 120 countries and controls 9.0% of the world's cigarette market. International tobacco sales account for more than 65.0% of J T's profits.

5. Imperial Tobacco Group

This British company is the fifth largest company participator in the global tobacco market controlling 5.0% of the international cigarette market.

Tobacco Industry in Kenya

Kenya's tobacco industry is controlled by two main players; BAT Kenya and Mastermind Kenya. It is estimated that BAT Kenya controls approximately 77.0% of Kenya's cigarette market followed by Mastermind Kenya which controls 18.0% of the market.

Mastermind Tobacco Kenya (MTK) is a tobacco company based in Kenya, established in the late 1980s. It also has a Ugandan subsidiary, Continental Tobacco Uganda (CTU). The entry of Mastermind Kenya as a local company in the late 1980's broke BAT's monopoly.

BAT Kenya has a stronghold in high end market for expensive products brands such as Dunhill and embassy, while Mastermind mainly serves the lower end clientele where brands such as Supermatch and Rocket are common.

Tobacco Regulation in Kenya

The past two years has seen the government of Kenya enforce tobacco control regulations in line with compliance with the World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC). The FCTC is a supranational agreement that seeks to "protect present and future generations from the devastating and health, social, environmental and economic consequences of tobacco consumption and exposure to tobacco smoke". This is by enacting a set of universal standards stating the dangers of tobacco and limiting its use in all forms worldwide.

Significant Provisions of WHO FCTC Treaty

Topic	Measure
Lobbying	Call for a limitation in the interactions between lawmakers and the tobacco industry.
Demand reduction	Tax and other measures to reduce tobacco demand.
Passive smoking	Obligation to protect all people from exposure to tobacco smoke in indoor workplaces, public transport and indoor public
Regulation	The contents and emissions of tobacco products are to be regulated and ingredients are to be disclosed.
Packaging and labelling	Large health warning (at least 30% of the packet cover, 50% or more recommended); deceptive labels ("mild", "light", etc.) are prohibited.
Awareness	Public awareness for the consequences of smoking.
Tobacco advertising	Comprehensive ban, unless the national constitution forbids it.
Addiction	Addiction and cessation programs.
Smuggling	Action is required to eliminate illicit trade of tobacco product
Minors	Restricted sales to minors.
Research	Tobacco-related research and information sharing among the parties.

Source: WHO

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Tobacco Control Regulation, 2014

The Tobacco Regulation, 2014 was passed in to law. The rules demand:

- cigarette makers to put graphic health warnings on packs,
- firms to disclose ingredients used in their manufacturing process,
- smoke-free environments in streets, walkways, verandas adjacent to public places,
- disclosure of annual tobacco sales and other industry disclosures,
- limited interaction between the tobacco industry and public health officials and other public officers,
- No sale of cigarettes as single sticks,
- Annual payment of 2.0% of the value of tobacco products manufactured or imported.

Excise Duty Act, 2015

The Excise Duty Bill 2015 came into effect on 1st December 2015. It introduced uniform specific excise for cigarettes at the rate of KES 2,500.00 per every 1,000 cigarettes (KES 50.00 per pack) with an annual adjustment for inflation. This represents a nominal tax increase of 2.0% for premium cigarettes, 43.0% - 50.0% on mid-priced cigarettes and 108.0% on low-priced or economy cigarettes.

This system departs from the Finance Act of 2012 which introduced a tobacco tax equal to KES 1,200.00 per every 1,000 cigarettes. Under this system tax on premium brands was increased by 35.0%.

In FY16, BAT Kenya's management increased cigarette prices by approximately 30.0% - 40.0% following the increase in excise tax rates in December 2015. Total excise duty paid increased 24.1% y/y in FY16. The increase in prices has had marginal effect on the demand for cigarettes. It has however, led to down-trading from some of the brands to the low-end brands.

Excise stamp increase in 2017/18 Budget

The Treasury doubled the excise stamp fees for cigarettes to KES 2.80 per sticker, setting the stage for an increase in retail prices by similar margins as manufacturers of the products pass on the costs to consumers.

Company Background

British American Tobacco Kenya (BAT Kenya) manufactures and markets tobacco and related products. BAT Kenya was founded in 1965 and its headquarters are in Nairobi, Kenya.

It manufactures cigarettes under contract and sells processed tobacco green leaf for its related companies. It sells its products both locally and internationally.

BAT has two manufacturing plants located in Nairobi and Thika and it primarily offers its own products under various brands such as Dunhill, Embassy and Sportsman.

The company has a majority foreign shareholding with British American Tobacco PLC owning 60% through Molensteegh Invest BV. The major shareholders of the company and their share distribution are shown in the table below.

BAT Kenya Top Ten Shareholders

Name	N.o. of Shares	Percentage
Molensteegh Invest	60,000,000	60.0
Wasatch Advisors	1,241,941	1.2
Kenya Reinsurance	500,000	0.5
Aberdeen Asset Managers	403,973	0.4
Boutique Collective INV RF PTY	360,525	0.4
JP Morgan Chase Co.	342,020	0.3
Danske Bank	262,100	0.3
Russell Investments Ireland	200,300	0.2
Coeli Asset Management	190,331	0.2
Bank of Montreal	189,793	0.2
Others	36,309,017	36.3
Total	100,000,000	100.0

BAT Kenya Board of Directors

Mr. George Maina - Chairman

Mrs. Beverly Spencer-Obatoyimbo - Managing Director

Mr. Sidney Wafula - Finance Director

Mr. Gayling May -

Ms. Carol Musyoka

Dr. J. Mohamed

Mr. Peter Mwangi

Mrs. Teddy Mapunda

Ms. Ruth Ngobi

Source: Company fillings

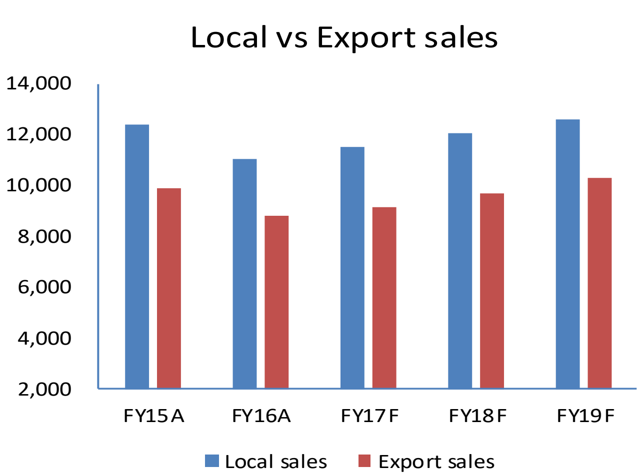
BAT Business Model

Sourcing– BAT sources tobacco from contracted farmers. In 2016 the company contracted a total of 5,100 growers. BAT purchased a total of 7.5M kgs of tobacco from the farmers. The farmers received KES 1.3B as payment in FY16. In Kenya, tobacco farming takes place in Western, Cental and Eastern regions.

Production– BAT Kenya has manufacturing facilities in Nairobi and Thika. The tobacco bought from the contracted farmers is taken through the primary processing plant (Green Leaf Threshing) facility in Thika, then to the cigarette making factory in Industrial Area, Nairobi. The brands produced by BAT Kenya include Rooster, Safari, Sportsman, Sweet Menthol, Embassy and Dunhill.

Distribution– Most of BAT's products are sold by retailers who are supplied by the company's distributors. The company's distribution channels involve wholesalers, distributors and logistics providers.

Consumption– BAT sells its products both locally and internationally. The company exports to 13 markets in Africa. In FY16 the company exported a total of 9.0B cigarette sticks valued at USD 8.8B. Additionally, the volume of leaf and cut rug tobacco exported totalled 1.1M kgs valued at USD 8.8M. Exports make 66.0% share of factory output.



Source: Company fillings, ApexAfrica Research

Growth Drivers

BAT Kenya's main advantage is that it serves the high end market. Therefore price increases on its products may not have a material effect on its revenues. However, the company has no significant growth drivers for its local market. The management may have to increase its efforts to gain market share in other African markets so as to boost their export sales.

The bottom line may be aided by the stringent cost cutting measures that the management has engaged in.

Challenges facing BAT Kenya

1. Legal challenges

The government of Kenya has been vigilant in passing laws that are aimed at protecting the public against negative effects of tobacco smoking. This has had a negative impact on BAT's top line. The Excise duty Act and the Tobacco Control Regulation have been passed in the last two years. However, all parties of WHO have already implemented the legal framework contained in the FCTC. Therefore the legal environment is likely to be predictable going forward.

2. Slow sub-Saharan economic growth

According to the IMF, Sub-Saharan Africa registered a growth of 1.9% in 2016. The IMF projects a 2.6% and 3.5% Sub-Saharan GDP growth in 2017 and 2018 respectively. In 2016, Sub-Saharan economic growth hit a 22-year low. This was attributed to deteriorating commodity prices and tighter financing conditions. Countries facing these challenges responded at a slow rate to these shocks deterring private investment, and stifling new sources of growth.

3. Turmoil in export markets

Turmoil in export markets disrupts cigarette sales as demonstrated in DRC Congo and South Sudan (FY16). We remain optimistic on the return to peace on these countries. However, this may take time further disrupting cigarette sales in these regions.

4. Tobacco Control Regulation, 2014

The Tobacco Control Regulation, 2014 requires cigarette makers to put graphic health warnings on packs, no sale of cigarettes as single sticks and smoking allowed only in public smoking zones. These conditions are meant to slow down growth of demand for tobacco and therefore will have a negative effect on BAT's top line.

Peer Comparables

Name	Country	P/E	P/B	EV/EBITDA	Net Margin	Div Yield	ROE
		x	x	x	x	%	%
BAT Kenya	**KN**	**20.1**	**9.7**	**12.1**	**21.3**	**5.1**	**48.0**
Eastern Co.	EG	14.8	3.5	6.4	23.5	2.6	25.7
Tanzania Cigarette Co.	TZ	16.7	6.2	10.4	22.8	6.1	38.0
Al-Eqbal Investment Co.	JO	18.5	8.0	14.6	26.2	5.8	46.4
Average		17.5	6.8	10.9	23.5	4.9	39.5
Median		17.6	7.1	11.2	23.2	5.4	42.2

(Source: Bloomberg)

Valuation

Assumptions		
Risk free (%)	13.3	(5-year T-Bond yield)
Beta	0.63	(Bloomberg)
Risk premium (%)	5	
Cost of equity (%)	16.5	
cost of debt (%)	5.0	
Long-term growth rate (%)	7.0	

FCFE	FY17F	FY18F	FY19F	Terminal
FCFF (KES M)	5,533	6,230	6,222	82,586
Discounted FCFF (KES M)	5,026	4,919	4,269	56,665
FCFE (KES M)	73,795			
Number of shares (M)	100			
Fair value (KES)	**737.95**			

P/E Method	
Historical average (x)	16.89
Industry average (x)	17.5
Weighted average (x)	17.2
FY17 EPS (KES)	43.36
Fair value (KES M)	**748.57**

EV/EBITDA Method	
Historical average (x)	8.0
Industry average (x)	11.2
Weighted average (x)	9.6
FY17 EBITDA (KES B)	7.4
EV (KES B)	71.7
Market Cap (KES B)	85.0
Fair value (KES)	**703.30**

Blended fair value	KES
P/E	748.57
EV/EBITDA	705.54
FCFE	737.95
Blended fair value	**730.69**
Current price	844.00
Upside (%)	**-13.4**

(Source: ApexAfrica Estimates)

Up close- FY16 Earnings Analysis

BAT Kenya's FY16 PAT declined 15.0% y/y to KES 4.2B while net revenue reduced 10.8% y/y to 19.9B. This is mainly attributable to a 24.1% y/y increase in excise duty and VAT that brought down net revenues (-10.8% y/y).
The group announced a final dividend of KES 39.50 bringing the total dividend for FY16 to KES 43.00 (FY15 KES 49.50)

Top-line declines as higher excise duty pushes prices up: BAT Kenya posted a 10.8% y/y decline in net revenue to KES 19.9B. This is despite an increase of 2.0% y/y in gross revenue. The decline in top-line was attributed to a 24.1% y/y increase in excise duty and VAT to KES 16.8B following the implementation of a single tier Excise Regime on 1 December 2015. Domestic revenues increased following excise led price increases which were offset by lower contract manufacturing sales.

Cost of operations decline on tight cost management: Cost of operations posted a 9.0% y/y decline to KES 13.3B on the back of stringent cost management, productivity and overheads savings. The company introduced new ways of working primarily in the factory in order to manage the cost base and deliver savings into the future. This caused company to incur a reorganization cost of KES 338M in 2H16.

Finance costs fall on lower foreign exchange losses: Finance costs declined by 45.0% y/y to KES 295M. The decline was mainly due to lower foreign exchange related losses and interest expense due to a stable exchange rate.

Operating cash flow increases significantly: BAT Kenya posted a 31.3% y/y increase in net cash generated from operations to KES 5.2B. The cash generated from operations was boosted by enhanced working capital management during the year. The current ratio increased to 2.0x from 2.2x FY15.

Income Statement	FY15 KES M	FY16 KES M	chg y/y %
Gross revenue	35,817	36,676	
Excise duty and value added tax	(13,560)	(16,826)	
Net revenue	22,257	19,850	-10.8
Total operating costs	(14,585)	(13,306)	-8.8
Operating profit	7,672	6,544	-14.7
Reorganisation costs	0	(338)	
Finance cost	(533)	(295)	-44.7
Profit before tax	7,139	5,911	-17.2
Income tax expense	(2,163)	(1,677)	-22.5
Profit after tax	4,976	4,234	-14.9
EPS (KES)	49.76	42.34	-14.9
DPS	49.50	43.00	-13.1
Statement of Financial Position			
Total equity	8,853	8,797	-0.6
Non-current liabilities	3,227	3,357	4.0
Non-current assets	9,102	9,532	4.7
Current assets	9,579	8,968	-6.4
Current liabilities	6,601	6,346	-3.9
Cash flow			
Cash generated from operations	5,660	7,987	41.1
Net interest paid	(338)	(315)	-6.8
Tax paid	(1,391)	(2,510)	80.4
Statement of Cash Flow			
Net cash generated from operations	3,931	5,162	31.3
Net cash (generated from investing activities	(559)	(287)	-48.7
Net cash used in financing activities	(4,250)	(4,950)	16.5
Net increase in cash & cash equivalents	(878)	(75)	-91.5
Cash & cash equivalents at end of year	1,612	(1,687)	-204.7
Ratios			
Operating profit Margin (%)	34.5	33.0	
Net Margin (%)	22.4	21.3	
Payout Ratio (%)	99.5	101.6	
Effective Tax Rate (%)	30.3	28.4	
Current Ratio (%)	1.45	1.41	
Return on Assets (%)	26.6	22.9	
Return on Equity (%)	56.2	48.1	
P/E (x)	17.2		
P/B (x)	16.0		
Dividend Yield (%)	5.8		

Financials forecasts

Income Statement	FY16A	FY17F	FY18F	FY19F	1-yr % ch	3-yr % CAGR
Revenue	19,850	19,755	20,039	20,639	-0.5	1.3
Operating profit	6,206	6,453	6,746	7,154	4.0	4.9
Finance costs	(295)	(259)	(244)	(192)	-12.2	-13.3
Profit before tax	5,911	6,194	6,502	6,962	4.8	5.6
Income tax expense	(1,677)	(1,858)	(1,951)	(2,089)	10.8	7.6
Profit after tax	4,234	4,336	4,551	4,874	2.4	4.8
EPS (KES)	42.34	43.36	45.51	48.74	2.4	4.8
DPS (KES)	43.00	43.36	45.51	48.74	0.8	4.3

Statement of Financial Position	FY16A	FY17F	FY18F	FY19F	1-yr % ch	3-yr % CAGR
Shareholders' Funds	8,797	8,833	9,048	9,370	0.4	2.1
Non-current Liabilities	3,357	3,357	3,357	3,357	-	-
Net Assets	12,154	12,190	12,405	13,074	0.3	2.5
Non current Assets	9,531	9,586	9,648	9,730	0.6	0.7
Net Working Capital	2,622	2,604	2,757	3,344	-	-
Current Assets	8,968	8,544	8,598	8,839	-4.7	-0.5
Current Liabilities	6,346	5,941	5,841	5,496	-6.4	-4.7
Net Assets	12,154	12,190	12,405	13,074	0.3	2.5

Statement of Cash Flow (KES M)	FY16A	FY17F	FY18F	FY19F
Cash generated from operations	7,987	7,633	7,436	8,092
Net cash from operating activities	5,161	5,516	5,241	5,812
Net cash from investing activities	(286)	(832)	(844)	(869)
Net cash from financing activities	(4,950)	(4,300)	(4,336)	(4,551)
Change in cash	(75)	384	61	391
At the start of the period	(1,612)	(1,687)	(1,303)	(1,242)
At the end of the period	(1,687)	(1,303)	(1,242)	(850)

Ratios and margins	FY16A	FY17F	FY18F	FY19F
Gross profit margin (%)	81.1	53.1	53.1	53.1
EBITDA margin (%)	35.1	36.6	37.6	38.5
Operating profit margin (%)	31.3	32.7	33.7	34.7
Pretax margin (%)	29.8	31.0	32.2	33.9
Net profit margin (%)	21.3	21.7	22.6	23.8
ROaA (%)	33.4	37.6	41.7	44.7
ROaE (%)	48.0	50.8	53.8	56.7
Net debt to equity (x)	33.2	25.2	25.4	18.5
Financial leverage (x)	2.1	2.0	1.9	1.9
Current Ratio (x)	1.4	1.4	1.4	1.5
Cash conversion cycle (x)	154.3	154.3	154.3	154.3
Cash conversion cycle (x)	154.3	154.3	154.3	154.3

Source: Company Filings, ApexAfrica Research